CHAPTER VII

ROLE OF ISLAMIC BANKING AND FINANCIAL INSTITUTIONS IN THE ECONOMIC DEVELOPMENT OF MALAYSIA

INTRODUCTION

Economic growth and development has been the most ambitious goal of policy-maker in every countries especially that of developing nations in their development and planning programme. In pursuing economic development of any economy, capital formation through various formal and informal financial institutions plays the key factor. The important is not only enough resource available that can bring about growth but rather how such resources are managed to realize such goal.

Conventional as well as Islamic financial institutions both can play developmental role with respect to capital mobilization. The difference between them lies in the fact that in the conventional system, interest rate represents the crucial actor whereas under Islamic system, profit and loss sharing or rate of return represents the key mechanism. For Muslim countries like Malaysia, the main focus of capital formation as the mechanism of development has been diversified to include the role of Islamic banking and financial institutions. For the country in question has paid prime attention to draw up the son of the soil or Bumiputera towards participating in the process of economic development of the country as a whole. Before we conclude our research, it seems appropriate to examine the developmental role of Islamic banking and financial institutions in general and their role in the economic development of Malaysia in particular. This will show the vitality and viability of this industry.
ISLAMIC CONCEPT OF DEVELOPMENT

It is worthwhile here first to go briefly into a definition of development and its various connotations and concepts which vary according to a number of economic schools of thought and which differ according to economic ideologies. Generally, development means 'growth' plus 'change'. It was often assumed that once economic growth was accomplished, other objectives such as elimination of unemployment, income inequalities and poverty would be realized automatically. Whereas ‘change’ implies structural change in the production and employment that the share of agriculture declines in both and that those of manufacturing and tertiary sectors increase. But economic development in this sense may not bring forth social, cultural, spiritual and moral uplift of the people.

The subject matter of all economics, irrespective of whether it is mainstream or Islamic, is the allocation and distribution of scarce resources which have unlimited uses. However, precisely because of the scarcity of resources and their alternative uses, it is not every allocation and distribution that is acceptable to society. Hence, economics has also been directly or indirectly involved in a discussion of human well-being to be realized through an improvement in the allocation and distribution of resources in conformity with the social vision.

Unlike the secularist market paradigm, in Islam human well-being is not considered to be dependent primarily on maximizing wealth and consumption; it requires a balanced satisfaction of both the material and the spiritual needs of the human personality. The spiritual need is not satisfied merely by offering prayers, it also requires the moulding of individual and social behaviour in accordance with Shari’ah which is designed to ensure the realization of the maqasid al-Shari’ah, two of the most important of which are socio-economic justice and the well-being of all God's creatures.
In spite of its emphasis on morals, Islam does not recognize any watertight distinction between the material and the spiritual. All human effort, irrespective of whether it is for 'material', 'social', 'educational', or 'scientific' goals, is spiritual in character as long as it conforms to the value system of Islam. Working hard for the material well-being of one's own self, family, and society is as spiritual as the offering of prayers, provided that the material effort is guided by moral values and does not take the individual away from the fulfillment of his social and spiritual obligations. Ideal behaviour within the framework of this paradigm does not thus mean self-denial, it only means pursuing one's self-interest within the constraint of social interest by passing all claims on scarce resources through the filter of moral values.

Islam is, thus, deeply concerned with the problem of economic development, but treats this as an important part of a wider problem, that of human development. According to Khurshid Ahmad, “the primary function of Islam is to guide human development on correct lines and in the right direction. It deals with all aspects of economic development but always in the framework of total human development and never in a form divorced from this perspective. This is why the focus, even in the economic sector, is on human development with the result that economic development remained an integrated and indivisible element of the moral and socio-economic development of human society....We would submit that the Islamic concept of development is to be derived from its concept of tazkiyah (purification plus growth), as it addresses itself to the problem of human development in all its dimensions and is concerned with growth and expansion towards perfection through purification of attitudes and relationships [with God, with man, with the natural environment, and with society and the state]. The result of tazkiyah is falah – prosperity in this world and the hereafter”.

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ROLE OF FINANCIAL SYSTEM IN ECONOMIC DEVELOPMENT

It is not exaggeration to place considerable importance to the financial system in economic development and maintain that the lack of a developed financial system restricts economic growth, and, therefore, government policy should be directed towards encouraging the growth of such a system. Financial system is viewed as a means to an end, the ‘end’ being economic development, and as a necessary input into the development process. However, it should be stressed that the availability and efficient use of finance can never be a sufficient condition for economic growth. Rather, it should be seen as only one of a number of necessary inputs, alongside natural resources, labour, markets, management, technology and entrepreneurial ability.

At the heart of most of the argument over the role of the financial system is the relationship between savers and investors. In a completely financially underdeveloped economy, there is no transfer of savings from one individual to another and the only investment possible will be out of personal savings. Thus investible resources are not efficiently utilized and those who do not wish to invest have no incentive to save. Financial intermediaries bridge this gap by providing such incentives and by helping to increase the volume and efficiency of the investment. Savers will now find that they have the possibility of a financial investment which offers them a return that may be preferable to continued high consumption or direct investment. Entrepreneurs will have access to savings other than their own, which increases the funds available to them for investment. Moreover, the development of financial instruments in the market will tend to channel funds towards the more productive investments. The argument relating to intermediation depends on a number of specialized financial institutions that will recognize the best investment opportunities and allocate funds to the perceived best investments and investors. This allocation function should then lead to an overall improvement in the efficiency as well as the volume of investment, thereby leading to faster economic growth.
Savers often prefer short-term to long-term savings as they represent less risk and loss of liquidity. In contrast, investors in physical assets require long-term finance, as the returns are generally long-term and these returns are needed before the debt can be serviced. By performing the important function of maturity transformation, institutions such as banks can meet the requirements of savers and investors simultaneously.

Risk transfer is an equally important function. Many savers are reluctant to accept the risks of lending directly to (or taking equity in) those investors who are prepared to take such risks. Apart from the loss of liquidity involved in such direct financings, the savers may not have the requisite technical know-how or the financial and legal strength to protect their loans or investments. Such savers prefer to use financial intermediaries in which they have confidence and which are perceived to be sound. Because of their financial weight, these institutions are in a better position to invest in an information base and to diversify risk.

THE CONCEPT OF DEVELOPMENT BANKING

According to Rodney Wilson, the term 'development banking' has been increasingly used by economists and specialists in finance from or with an interest in developing countries. Yet there does not appear to be any clear definition about how it differs from other forms of finance. Does it merely refer to all types of finance, which are or could be available to developing countries, including external funding as well as finance generated from domestic savings? Should the definition be restricted to grant aid from rich to poorer nations, both bilaterally and through multinational donor agencies? A wider definition might include concessional loans at below market interest rates such as the World Bank's IDA (International Development Assistance) lending or finance from the United States Agency for International Development (USAID). Such assistance to the poorest developing countries is usually socially rather than economically motivated in any case.
Such a definition presumably excludes middle-income countries such as Malaysia which no longer receive aid of this type. For the richer developing countries like Malaysia, the term ‘development banking’ implies an activity, which is commercial in nature rather than being charitable.

With respect to Islamic development banking particularly or precisely the function of Islamic Development Bank (IDB), its activities, as described by its name, are oriented more towards development rather than commercial in nature, aiming to foster the economic development and social progress of member countries and Muslim communities individually as well as jointly in accordance with the principle of Shari'ah. The functions of the Bank are to participate in equity capital and grant loans for productive projects and enterprises besides providing financial assistance to member countries in other forms of economic and social development. For the Islamic commercial banks, their activities are commercial in nature, whereas development function is said to be a built-in consequences and spirit representing through various principles of function employed by the banks.

**ISLAMIC BANKING AND ITS ROLE IN ECONOMIC DEVELOPMENT.**

An Islamic bank is not just a bank that does not operate under the interest mechanism. It is a bank based on certain economic and philosophical principles. It is an institution dedicated to serve the community and to foster economic welfare for the people and is given to development of human resources based on Islamic values. The prohibition of interest from Islamic banking makes direct investment and equity participation or venture capital and profit-sharing a must. Profit-sharing through *mudarabah* and *musharakah* not only bring about greater efficiency in the allocation of resources but also reduce poverty, inequality distribution of income and concentration of wealth, and ensure better human resource mobilization and employment generation. The philosophical principle of Islamic banking institutions based, of course, on the injunction of Qur’an and Sunnah. The key belief of Islamic banking is that God
is the Creator and Ultimate Owner of the Universe and man, on earth, is His vicegerent. Thus, individual property is recognized but it is restrained by the teachings of God. Therefore, Islamic banks are not free to do as they please, but they have to integrate moral values with economic action. Money and property are social tools to achieve the social good.\textsuperscript{10} The objective of an Islamic bank should be profit-maximization, as being a common objective of any (value-based) business entity, and a strike of balance between maximization of profit and social welfare should also be honoured.

Roles of Islamic banking and financial system towards economic development or industrialization process are discussed in the following heads.

**Islamic Banking and Capital Formation.**

Islamic bank is naturally a development institution involved in the mobilization of savings and investment. The struggle against hoarding, the system of \textit{zakat} imposition on idle assets and the channeling of savings towards investment (on profit-sharing basis) to serve society in a way compatible with the principles of Shari'ah support such assumption. It is an economic, social, financial, and banking institution that strives to make capital plays its basic role in society.

It is a basic assumption that rural people have a will as well as capacity to save. Potential new deposits can be mobilized more from the rural areas where a sizable portion of savings is being hoarded because of the absence of \textit{halal} (permissible) outlets. The findings of Professor Ungku Abdul Aziz in the late 1950s\textsuperscript{11} in Malaysia had shown that Muslims in rural areas are highly pious and had preferred to keep their savings hoarded and idle rather than deposit them in the interest-based banks.

For the people in rural areas, predominantly Muslim, a large portion of savings is done by purchasing real assets (such as gold, jewellery, durable consumer goods, real estate, animal), which shall be liquidated in the future
when the saved parts of today’s income are needed. For the economy as a whole, according to Volker Nienhaus, “this ‘real asset saving’ locks resources in the production of savings assets. These resources could be utilized for investments with a developmental impact only if people save not by buying real assets but by acquiring financial assets, i.e., depositing their money in (Islamic) bank accounts. In contrast to the real savings assets, ‘financial assets’ can be produced with only a negligible input of resources. A shift from savings in real assets to savings in financial assets would statistically increase the macroeconomic savings ratio without any retrenchment in the level of ‘effective’ private consumption, and additional productive factors would be set free for investment purposes”.  

It is crucial for achieving such a behavioral change that the rural populations find access to and confidence in banks. Local set-up Islamic banks are more suitable type of financial institutions than branches of nation-wide commercial banks active in the urban center. As in the urban center where interest-based commercial banks are well established, the concentration of newly established Islamic banking institutions in urban center would only find themselves in hard competition. They better be more alternatively active in rural area, which represents a relatively large market and form a network among themselves in commercial centers to utilize surplus funds from the rural areas in the urban commercial center. It will help to build up confidence if visible parts of the mobilized deposits are invested locally (and not in a distant commercial center). This will demonstrate the bank’s commitment to local economy, which is important for its acceptance by the population.

In the contemporary corporate world, the stock exchange plays an important role as financial intermediary between those who have surplus funds and those who need external and additional finance. In Malaysia, the Islamic capital market, through Kuala Lumpur Stock Exchange (KLSE), is an essential platform for the efficient mobilization of Islamic funds in various projects/enterprises’ investment. There is a need to develop capital market
instrument to attract funds from such institutions as Tabung Haji, Islamic banks and Islamic unit trusts as well as the increasing number of individuals looking for Shari'ah-compliant investment.  

**Equitable Distribution of Income & Wealth**

The object of the Islamic economic system is to secure the widest and most beneficent distribution of wealth through institutional set up and through moral exhortation. Wealth must remain in constant circulation among all sections of the community and should not become the monopoly of the rich. This very Qur'anic inspiration implies obligation on the rich who should, at their individual as well as collective level, try to develop the income earning capacity of the poor.

Islamic banking is equity-oriented and the Islamic instrument of financing based on profit-sharing would ideally convert the role of Islamic banks or capital owners or depositors from creditors to partners. It allows the capital owners to share the profits and losses of the capital users. It, thus, provides equal opportunities to all entrepreneurs to apply for financial accommodation from Islamic financial institutions. The entrepreneur's lack of capital does not stand in the way of his securing finances (as it would be in the interest-based economy which requires creditworthiness and collateral from the borrower) if the project is, otherwise, profitable and promises good returns on the capital. The technique of profit-sharing can help circulate wealth in the economy and can also provide better opportunities for that class of society without capital (but possess entrepreneurial skills). Also, since the capital owner and the human resources joining the profit sharing contract share the profit, there are more chances of better distribution of the benefits of growth between the capital owner and labour than there would be in a situation where entrepreneur is solely responsible for the capital borrowed under interest-based system. This is proved to be more just and equitable manner of distribution of income and wealth in the society. Through Islamic banking concept, wealth is no more
concentrated in few hands among the capitalists. It would not be possible for anyone to earn an income on savings without being willing to share risks of business. Thus, ownership, fruits and risks of business will be more widely distributed in an Islamic system than is possible under capitalism.

According to M. Fahim Khan, the Islamic system works against the concentration of wealth in two ways. On the one hand, prohibition of collateral to guarantee the repayment of principal with a fixed return on capital irrespective of the productivity of capital means the wealthy class loses the advantage of its wealth and all entrepreneurs stand on an equal footing with respect to their claims for the use of capital only on the basis of the profitability and feasibility of their projects. Small and medium-scale entrepreneurs thus have much better chances of attracting the capital than they would have done in an interest-based system.

On the other hand, since banks no longer have a guaranteed, pre-determined rate of return on capital, they now look for not only more profitable projects (irrespective of the wealth status of the entrepreneurs), but also to diversify their investments so as to minimize risk. Such diversification, of course, gives small and medium entrepreneurs more chance to acquire the bank’s capital. The built-in motivation in the Islamic system for the banks to look for the more profitable projects and diversify their investments achieves greater efficiency and equity simultaneously. Conversely, interest-based banking, according to him, has a built-in mechanism to work against equity consideration without gaining much on the efficiency grounds.14

**Better Utilization of Human Resources, Generation of Employment, and Poverty Elimination.**

In most of the developing countries, human as a factor of production exists in abundance. Human resource is an essential active engine of the growth process. A good organized structural plan, high quality resources, and high technology will still fail to help the country to achieve its aim of
development if it does not have efficient and competent or proper utilization of human resource available. A lot of effort must be put to utilize the available human capital. As an active engine of growth, they are the one who will exploit natural resources; accumulate capital; built up social, economic and political institutions; and be the catalyst for the growth process. They also provide important factors of production in the growth process, which is labour and entrepreneurship.

Entrepreneurs are men and women with knowledge and innovative concepts, with ideas how to do things better and use resources more efficiently – but without sufficient own financial means for the realization of these ideas. The realization of their ideas will not only enhance the income of the entrepreneurs, the more effective utilization of resources shall crate more jobs, additional income, and economic growth. These are benefits for the society.

There is no reason to assume that entrepreneurial talents and innovative ideas could be found only within the (usually small) group of today's capital owners, i.e., within the established capitalist elites. But potential entrepreneurs outside capitalist elites face serious problems to get finance for their ideas. The reasons are manifold, e.g., lack of collateral, high transaction costs, more profitable alternatives for commercial banks (e.g., financing budget deficits and trade), consideration of banks for the interest of present customers (whose market position may be challenged by new entrepreneurs), etc. Following or parallel to the creation of self-employment for poor people, financing should be made available for potential or actual entrepreneurs in the growing informal sector.

Islamic financial system has more relevant role to play in mobilizing capital and human in order to reduce unemployment and improve standard of living and welfare of the people. It is assumed that the Islamic financial system has a more powerful built-in model of human resource mobilization than the existing models developed under conventional economics. But the scope of this
paper will be confined to the discussion of various feature of Islamic financial system with specific reference to the mobilization of human resources, which according to M. Fahim Khan, are as follows.

1. The system has a provision for qard hasan for needy people. The institution of qard hasan will provide capital to people with little means, which, by definition, means the promotion of labour-intensive activities.

2. The system entitles the capital to earn a return only by bearing some of the risk associated with the activity. There are various Islamic modes of financing. Some modes may not mean risk bearing to the full extent or for the entire period of financing (as in leasing-based or trading-based modes of financing). Some modes of financing, however, imply risk bearing for the entire period of financing. Participatory forms of financing, which include mudarabah and musharakah, participate in the risk bearing to the full extent of the invested capital and for the entire period of financing.

Introduction of the participatory modes of financing as a core of the Islamic financial system allows the following features to emerge and prevail in the economy, promoting high level of employment, standard of living, and human resource mobilization.

2.1. Profitability of the project becomes the primary consideration for financial accommodation. Credit-worthiness becomes the secondary consideration, because the return on the project is not fixed but depends on the profitability of the project. In contrast, in the interest-based system, which guarantees principal with interest, credit-worthiness is the primary consideration and the profitability of the project becomes secondary importance. Although credit-worthiness may still exist in some form in the Islamic system, its magnitude is not likely to be as great as in the interest-based system where guarantees
and a fixed return are required for the capital borrowed as well as ensuring credit-worthiness in the form of collateral.

2.2. Financial institution may not be as inclined to finance large enterprises as they are in the interest-based system. Neutrality to the size of the enterprise is more likely to prevail. Profitability has generally been founded, empirically to be independent of the size of the enterprise. (The interest-based system has a clear bias towards financing large enterprises as the credit-worthiness of large enterprise is generally more easily established than that of small enterprises).

2.3. Finance has a chance to be more widely spread and distributed in the economy. Since the return on financial capital is associated with risk bearing, the diversity of the portfolio is a key to minimizing risk. The interest-based system has no compulsion to diversify because with the credit-worthiness feature, diversity will not help reduce risk and be more likely to increase it.

2.4. As a logical conclusion, when profitability and diversity are the primary considerations and there is nothing to suggest that these two elements are positively related with the size of an enterprise, small enterprises will get more encouragement and support from Islamic financial institutions. Smaller enterprises require smaller financial accommodation and, hence, diversity and the spread of risk become less by dealing with smaller enterprises.

It can be boldly concluded here that the small and medium enterprises are emphasized and given more significance under Islamic financial system. This will, no doubt, create more employment generation from the real sector and better standard living of the poor people and entrepreneur as well as foster new class of entrepreneur.
2.5 There is more likelihood of the efficient utilization of capital under the Islamic financial system, which forces financial institutions to look for the most profitable and feasible projects. Under the interest-based system, there is no such compulsion as the return on capital is fixed and guaranteed by collateral.

Thus, the Islamic financing on participatory basis has no built-in incentive towards capital intensity. Also under the system, there is no built-in mechanism to allow the concentration of capital in a few hands. Credit-worthiness and collateral need, though they may exist, will be of secondary significance. Furthermore, participatory finance yields a risk-bearing return and risk can be minimized by distributing capital on several projects. The concentration of capital and, hence, capital intensity is likely to decline with the introduction of participatory finance.

Although the leasing-based and trading-based modes of Islamic financing may have a tendency towards concentration of capital intensity (as compared to participatory finance). This tendency is likely to be lower than that in the interest-based system. This is due to the fact that large entrepreneurs do not have as much advantage as they have in the interest-based system, since goods or assets involved in trading or leasing-based financing can themselves serve the purpose of collateral.

Moreover, the Islamic financial system helps to correct factor price in several ways. Firstly, a fixed rate of interest in periods of inflation moves the relative factor prices against labour, making labour relatively increasingly more expensive. The Islamic financial system does not create this distortion in participatory finance where inflation will inflate the share in profit and, hence, the relative price of capital will not be reduced because of inflation alone.

Secondly, it corrects the price of entrepreneurship vis-à-vis capital. In the interest-based system, all productive risks go to the entrepreneur and entrepreneurship, therefore, becomes a too costly factor compared to capital,
which remains cheap irrespective of how risky it may be to initiate productive activities. Thus, there is no demand or very little demand in the society for entrepreneurship, although there is a lot of demand for capital. Hence, there is no (price) incentive for capital to take up the role of the entrepreneur. The relative prices have all the incentive for the capital to be only a fixed income earner.

Thirdly, it also corrects the price of entrepreneurship vis-a-vis the price of labour. Employees on a fixed wage basis and self-employed entrepreneurs who have their own business both provide human efforts. The latter, however, face the risk of losing the capital invested in their business while the former face no risk. In the interest-based system where capital is guaranteed with a certain fixed return, the risk is too much for the human resources to take up an entrepreneurial activity. This is particularly true for the human resources with little means. The interest-based financial system, thus, distorts the choice of human resources between taking up an entrepreneurial activity or a fixed wage-paid job. There is more demand for labour activity than for entrepreneurial activity. The Islamic financial system, particularly under participatory financing, corrects the choice, as the cost of taking up an entrepreneurial activity is reduced by forcing capital to share the risk.

3. There is a system of social insurance (in the from of zakat and charity) that is meant to meet the subsistence needs of those whose subsistence is threatened for any reason. Although it is not directly a part of the financial system, it has significant implications for supplementing the role of the Islamic financial system in mobilizing human resources. The institution of zakat and charities can be organized (through state body or private voluntary sector including Islamic banks which have a zakat division) to motivate and mobilize human resources involvement in an enterprise. By guaranteeing subsistence of new entrepreneurs (in case they fail) and/or in guaranteeing the principal amount of loans that the new entrepreneurs have borrowed. These institutional provisions can
further supplement the Islamic financial system's potential for mobilizing human resources.

**Islamic Banking and Growth with Stability.**

According to Tan Sri Dato' Dr. Lin See Yan, a former Deputy Governor of Bank Negara Malaysia, the allocation of resources in an Islamic financial system is growth-oriented because:

(a) it encourages efficiency in the mobilization, utilization, and allocation of all resources;

(b) it promotes profit maximization so long as this approach also promotes social welfare;

(c) under the Shari'ah, inflation is repugnant to the just society, i.e. monetary expansion as a source of financing development is only acceptable so long as it is not inflationary; and,

(d) it offers an arrangement (as opposed to the interest-based financial system) that is equitable and stable, i.e., promote distributive justice.

When it comes to the question of stability, all things considered, there appears to be room for offering some remarks on the stability of an equity-based Islamic financial system. The profit in the equity-based system will be dependent on the profit-sharing ratio (PLS ratio) and the ultimate outcome of the business. The share of the entrepreneur or financier cannot fluctuate violently from month to month. Moreover, the distribution of the total return on capital between the entrepreneur and financier would be determined more equitably by economic considerations and not by speculative financial market force. This factor should tend to have the effect of substantially reducing business failures, and in turn dampening, rather than accentuating, economic instability. Minsky argues that when each firm finances its own cash flow and plans to invest its own retained profits, there is no problem of effective demand,
the financial system is robust and investment has great inertia. When firms can raise outside finance direct from renters or through the banks, they are liable to instability. Schemes of investment are planned that are viable only if the overall rate of investment continues to rise. A fragile debt structure is built up. When the acceleration in the rate of investment tapers off, some business find current receipts less than current obligations, and a financial collapse occurs. During a boom, equity holders experience capital gains and increase the ratio of expenditure to income; when the boom breaks, thriftiness increases. Thus, long-run average growth may occur in cycles.

Interest rate volatility has defeated all efforts to restore stability in exchange rate. In a fixed parity system, it is impossible to keep the exchange rates pegged because of the movement of ‘hot’ money to take advantage of interest rate differentials. The effort to keep the exchange rate pegged leads to a significant loss of central bank reserves and impairs confidence in the strength of the currency. In a floating exchange rate system, where the rate tries to find its own equilibrium level and fluctuate excessively from day to day in response to international interest rate movements bearing no relationship to underlying economic condition, it become difficult to predict exchange rates. This renders long-term planning almost impossible. A country facing a recession is unable to keep its interest rate low because such a policy leads to an outflow of funds, depreciates the exchange rate of its currency and raises the cost of living. To prevent an even deeper plunge in the value of its currency, the recession-ridden country is forced to maintain interest rate at a higher level than dictated by the need for recovery. This in turn slows down the recovery and undermines confidence in the government.

The elimination of interest and its replacement by profit-sharing would not only change the level of uncertainty but also redistribute the consequences of uncertainty over all parties to a business. It would moreover, by removing the daily destabilizing influence of fluctuating interest rates, bring about a commitment of funds for a longer period [such as foreign direct investment
and also introduce a discipline in investment decisions. In such an environment the strength or weakness of a currency would tend to depend on the underlying strength of the economy, particularly the rate of inflation and exchange rates. Accompanied by the Islamic emphasis on internal stability in the value of money, exchange rates should prove to be more stable because all other factors influencing exchange rate, such as cyclical developments, structural imbalances, and differences in growth rates are of a long-run nature and influence expectations about long-term trends in exchange rates.\textsuperscript{21}

Moreover, in the Islamic system, there will also be a greater interdependence and a closer relationship between investment and deposit yields because banks can primarily accept investment deposits on the basis of profit-sharing and can provide funds to the enterprises on the same basis. Due to the fact that the return to liabilities will be a direct function of the return to asset portfolios and also because assets are created in response to investment opportunities in the real sector, the return to financing is removed from the cost side and relegated to the profits side, thereby allowing the rate of return to financing to be determined by the productivity in the real sector. Mohsin khan pointed out “the application of the mudarabah/musharakah-based system to the liability of banks makes the banking system more stable than in the interest-based system. This is because the liabilities of banks move in line with their assets and any shock to assets does not create an immediate crisis for the equilibrium of banks. Furthermore, the flexibility of prices in adjusting to change in supply and demand is the crucial for ensuring stability. Capital pricing based on sharing profits and losses is helpful in maintaining the equilibrium of the supply and demand for capital as well as for entrepreneurs.”\textsuperscript{22} It will thus, be the real sector that determines the rate of return to the financial sector in Islamic financial system rather than the other way around. For these reasons, Islamic banking tends to reduce the vulnerability of the capital importing country to fluctuations in the level of capital inflows and to a sharp slowdown of new investment due to uncertainty among investors.\textsuperscript{23}
Thus there is a great potentiality of Islamic banking system towards economic development. However, Islamic banking would be judged and assessed not by its name, but by the service and operation whether it is consistent with the teachings of Islam, i.e. for general welfare of the people.

There are some indicators, which lead to inference that most of the Islamic banks have not been able to give sufficient attention to financing activities of a developmental nature. From the data given in the IRTI study (Islamic Research and Training Institute, IDB), it appears that most of the finance being provided by Islamic banks went to trade sector. Data relating to the term structure of finance in the same study showed that most Islamic banks concentrated on providing short-term finance of six month or less or medium-term finance of one year or less. These data corroborate that development bias is not prominent in their financing operations. However, time series data which are available for some Islamic bank shows that as a bank grows in age and experience, it tends to bring about a shift in the pattern of its financing operation in favour of both longer duration financing and greater attention to the developmental requirements of agriculture and industry, and that it expands its client base and pays greater attention to its social responsibilities by extending larger assistance to small scale industries and new employment generating activities.

THE STATE OF MALAYSIAN ECONOMY

Malaysia is one of the South-East Asian countries which has enjoyed a very high economic growth rate. It has succeeded in utilizing natural and financial resources and manpower to eliminate backwardness, which is the heritage of the Muslim countries. The economy has made quantum leaps in just over three decades. It is noteworthy that rapid economic growth has been accompanied by a more equitable income distribution without significant inflationary overtones. Trade represents the life-blood of the Malaysian economy with foreign direct investments playing a pivotal role in the
industrialization process. Economic openness has brought prosperity as well as vulnerability. To be specific, the economy has been fairly resilient until it was caught in a major currency turmoil that began in mid-1997. However, the economy rests on solid foundations built since independence in 1957. The current problems are viewed as no more than a passing phase. There is basis to expect that Malaysia's strong economic fundamentals will reassert themselves, in no uncertain terms, once the dust has settled.

**Development Strategies and Macroeconomic Performance.**

Malaysia's track record in terms of economic development is very impressive. During 1985-95, the per capita GDP growth rate averaged 5.7\% in real term and investment accounting for 41\% of GDP in 1995. By the same year per capita GDP figure had reached US$ 3,890 and if an allowance is made for differences in international purchasing power reflecting relative prices, the real GDP per capita figure was US$ 9,020 according to United Nations estimates. Malaysia is therefore securely in the middle-income economy category, indeed it is near the upper end, as US$ 10,000 is the dividing line into the upper-income economies.\(^{27}\)

The overall incidence of poverty (percentage of poor households) in the country declined from 49.3\% in 1970 to 8.9\% in 1995. The ratio of *Bumiputera* (indigenous) household mean income to that of others has improved. In terms of rural-urban disparity, the ratio of rural mean income has increased from 47.0\% in 1970 to 54.5\% in 1995. The quality of life has improved enormously in terms of amenities in relation to population size.\(^{28}\) Unemployment rate has declined significantly from the highest point 8.8\% in 1986 to about 3.0\% in 1999. This posed the average unemployment rate during 1988-99 at 3.9\%.\(^{29}\) It is also remarkable that Malaysia has been able to register high GDP growth without inflationary pressure, except during the mid-1970s when double-digit inflation was experienced in the midst of the 'oil shock'. During high growth rate
of 1987-96, inflation was kept at 3.4%. In 1996, inflation stood at below 3.0% and the rate decelerated further below 2.0%.

The only sign of overheating for the Malaysian economy has been the growing deficit in the current account of the country's Balance of Payments (BOP). Traditionally, Malaysia has enjoyed trade surpluses with sporadic current account deficit due to huge shortfall in the services account. In 1995, current account BOP deficit amounted to 10.5% of GNP, declining to 5% of GNP in 1997. Until lately, these deficits have not posed a serious threat to the Malaysian economy, as these were more than offset by substantial foreign investment inflows.

Economic crisis is not new to Malaysia. It experienced a severe recession in the mid-1980s with a negative gross domestic product (GDP) growth in 1985 (i.e., -1.1), but it pulled itself out of the doldrums with remarkable speed. Since 1987, the Malaysian economy was growing at an average rate of over 8.5% per annum till 1996 in which the rate was 10.0%. In the first half of 1997, the GDP growth averaged 8.3% on an annualized basis before the currency crisis hit the country in July 1997. Despite the currency crisis, the Malaysian economy posted 7.5% growth in 1997, indicating that the real sector of the economy was yet to feel the pinch. Nonetheless, if the experience of the mid-1980s is at guide, one should be quite confident of Malaysia's capacity to overcome the present difficulties, In 1998 the country experienced a negative growth rate at -7.5% of GDP before recording a strong positive growth of 5.4%, higher than the earlier forecast of 4.3% in 1999, showing a great sign of recovery.

The government of Malaysia has adopted policies leading to high economic growth and coordinate socio-economic development avoiding ethnical conflict between the Bumiputera and the immigrants predominantly Chinese. In order to achieve this aim, the Malaysian government in the past 30 years implemented two major programmes, namely the New Economic Policy
(NEP), 1971-90, and the National Development Policy, 1991-2000. The first programme of prospective economic movement had led to rapid economic growth, reduction in poverty and unemployment, and created a relative economic balance among the various ethnic group of this multi-ethnical country.

The Second Outline Perspective Plan (SOPP), of the second programme (National Development Policy) covering the period 1991-2000, attempted to formulate policies and strategies to meet the challenge of achieving the status of an industrialized and fully developed nation by the year 2020. The thrust of the vision 2020 is the creation of a united Malaysian nation, which is fully developed in all respects, viz. economic, social, political, psychological and cultural. The major thrust of the Plan is the role of the private sector, (including FDI), as the engine of growth. As such, human resource development becomes the primary concern. The improvement of entrepreneurship, skills and management capacity to undertake investment activities to generate rapid economic growth is a necessary precondition. Malaysia is aiming for a balanced development-economic growth with a concern for equity, social justice and improved ethics, social welfare and standard of living.

Structural Development

The ambition of the government of Malaysia to turn the country into a major manufacturing economy has made manufacturing a leading sector. With the implementation of Malaysia's industrialization drive and export promotion strategy during the last decade (1988-97), the industry base was strengthened and growth of value-added in the manufacturing sector increased strongly by 13.9 % per year during the period 1988-97. The manufacturing sector was the leading growth sector increasing its contribution to GDP to 29.9 % in 1997 from 19.8 % in 1987. The policy framework laid by the First Industrial Master Plan (1986-1995) and the subsequent liberalization and deregulation of the economy
after the recession years of the mid-1980s provided the foundation for rapid growth of this sector. During 1989-99, production of resource-based industries was higher at 16.9 % led, mainly by the electronics and electrical products, transport equipment, metal products and paper and paper product industries. In particular, Malaysia had become one of the world largest exporters of semiconductors, a major producer of colour television sets and room air-conditioners by early 1990s. With the establishment of the national car manufacturer (representing a national heritage of Malaysia) namely, Proton in 1983 and Perodua in 1993 (having proven successful in the United Kingdom and other export markets), the transport equipment industry posted the strongest growth of 21.6% in 1988-97.38

Significant development occurred in the service sector, reflecting the changing role of the sector and the effect of the policy measures undertaken by the government to develop the service sector as a new growth sector so as to accelerate the transformation of Malaysian economy into a high technology-driven and high value-added economy. Valued-added in the services sector has increased at a stronger pace than the overall expansion of the economy. As the pace of industrialization became more rapid, capital investment in the services sector was promoted intensively during the 1990s. Rapid technological progress, the globalization of the world economy and the deregulation and deepening of financial markets have increased the inter-linkages between the services sector and the other sectors of the economy, in particular the manufacturing sector. During the period 1988-97, value-added of the services sector recorded a strong growth of 10.8 %. In 1998, it declined marginally by 0.8 % as the economy contracted, before recovering to record a growth of 0.6% in the first half of 1999. More recently, the government expedited reform on the financial sector. All these measures are aimed at improving the competitiveness of the services industries to prepare for an increasingly liberalized environment. The share of the services sector as a percentage of GDP increased from 45.3% in 1987 to 51.8% in 1997.39
As regards to other sectors contributing to the GDP, the construction sector expanded by an average rate of 12.9% during the period 1988-97. Nevertheless, its relative share of GDP remained relatively small at 4.8% in 1997 (1987:3.5%). Whereas the agriculture, forestry and fishing sector declined in relative importance during the decade (1988-97). The contribution of this sector to GDP declined to 9.1% in 1997 from 20% in 1987. Within this sector, the contribution of crude palm oil, fisheries and non-traditional agriculture (e.g. fruits, vegetables and floriculture) increased over the decade while that of rubber and saw logs declined. Within the sub-sector of non-traditional agriculture, the fruits, vegetable and floriculture industry group, comprising mainly small and medium-scale units, has shown signs of consolidation to larger-scale operation and has become increasingly commercialized. The production as well as exports of this sub-sector has increased over the years and in 1997 its share in agriculture rose to 29% from 23% in decade earlier. During 1998, this sector recorded a decline of 4.5% before turning around to record a positive growth of 2.8% in the first half of 1999.40

In the mining and quarrying sector, value-added rose moderately at an average annual rate of 3.5% during 1988-97, resulting a lower share to GDP of 7.3% in 1997 (1987:12.6%). Output was contributed primarily by production of crude oil and natural gas reflecting the Nation Depletion Policy aiming to ensure sustainable exploitation of natural resources. In 1998, value-added in this sector recorded a positive growth of 1.8% before declining by 4.1% in the first half of 1999.41

The Malaysian economy has always been very trade-dependent. Indeed, trade represents the life-blood of the economy. The ratio of exports to gross national product (GNP) has risen from 48.2% in 1965 to 100.3% in 1996. the total value of exports and imports is twice as large as the country's national income. The composition of exports has changed dramatically, reflecting the changing profile of the economy. The share of primary export in total exports has declined from 79.6% to 17.5% between 1970 and 1996. By contrast, the
share of manufactures in total exports has risen sharply from 11.1% to 80.6% during the same period.\textsuperscript{42}

The structure of Malaysia's imports has also undergone major changes. The ratio of consumption goods to total imports has fallen from 28.5% to 14.6% between 1970 and 1996, while that of investment foods and intermediate goods have increased conversely.\textsuperscript{43} The changing structure of imports reflects the industrialization process, which in itself is highly import-dependent with increased demand for machinery and intermediate inputs.

Foreign direct investment (FDI) has played a crucial role in the development of the Malaysian economy. As a matter of fact, trade and investment are interrelated. Much of the manufactured exports are associated with FDI activities in the country. Malaysia's main trading partners, namely Japan, Singapore, the US and Western Europe have also been the major sources of FDI for Malaysia. It was only recently that Taiwan and Korea have emerged as important investors in Malaysia. FDI has gone into a wide spectrum of manufacturing activities, ranging from food processing to the production of scientific and precision instruments. Nonetheless, electronics, chemicals, textiles and wood products account for the bulk of FDI stakes in the country.\textsuperscript{44}

Another salient feature of Malaysian economy is the booming of corporate sector because of various factors especially sound economic and financial policies and political stability in the country. Malaysia has learnt some lessons from the Japanese experience in the development of small and medium-sized industries (SMLs). It is argued that for the country to be fully industrialized, SMLs have to be well managed and they have to be efficient and competitive in the world market. It is not the abundance of money that makes SMLs successful and competitive in the world market, but rather it is the management of money and that is indeed a real challenge that faces the entrepreneur in the new world economic order. The government has paid
attention to developing the entrepreneur culture showing a gradual change of Malaysian government policy in recent years, from one of neglect to one of promoting SMIs in recognition of their vital role in the overall economic development.  

In this connection, the role of Islamic banking and finance is significant. As pointed out earlier, there is a great scope of Islamic banking and financial system towards the promotion of small and medium-sized venture capital in the corporate sector.

**Financing the Economy: Reliance on the Banking System**

The Malaysia's economic development has been helped by the high level of domestic resources, in relation to GDP, through banking institutions and corporate securities via issuing of bonds and equity as well as long-term loans from the provident and pension funds. Overall, much of the financing was intermediated through the banking system. As the ratio of (banking) deposits to GDP was very high at 154% of GDP in 1997. This ratio was 23.9% in 1971, 32.9% in 1980 and 30.4% in 1991. There is of course, a high correlation between domestic savings ratios and investment. For Malaysia, the ratio of investment to GDP rose from 22.4% in 1971 to 30.4% in 1980, 35.9% in 1991 and further to 149% in 1997. In these circumstances, it would be easily argued that there is no financing gap in Malaysia and therefore development finance is not really an issue. This may be the case at macroeconomic level, but at the microeconomic level there are gaps. The development of the country has been uneven, with much of investment concentrated in the region of national capital. Furthermore, despite three decades having passed since the New Economic Policy (NEP) and National Development Policy were introduced, many of the Bumiputeras have not participated actively in the development process. Bumiputera individuals still own less than 10 percent of the corporate sector, and over one quarter of the rural population is classified
as needy. As a majority of the Bumiputeras are Muslims, it is with respect to this group that there is potentially a clear role for an Islamic banking system.49

ROLE OF ISLAMIC BANKING IN ECONOMIC DEVELOPMENT OF MALAYSIA

The role of Islamic financial system, like conventional system in the economic development of Malaysia is significant from the very aspects of its potential development function outlined earlier. However, to what extent and how much the system has contributed to such development is difficult to measure in arithmetic term as is for some aspect of development that can never be precisely measured in mathematical term. Nevertheless, some aspects of contribution of Islamic financial system to the development of Malaysia’s economy can be categorized as under.

Islamic Banking as a Source of Drawing Non-Banked Savings

The chain of Islamic banking strengthens and broadens the capital formation of the country with respect to drawing non-banked savings, on religious ground, into the financial system for the purpose of investment. This aspect has been already discussed earlier, based on the finding of Professor Ungku Abdul Aziz in the late 1950s in Malaysia (see chapter 6)

Overall Islamic Banking Performance In Malaysia

Total Resources

Total resources of Islamic banking over the period 1988-1992 expanded at an average annual rate of 4.1% from RM 1.4 billion as at December 1988 to RM 1.7 billion as at December 1992. Deposits remained the primary source of funds, accounting for 93.6% of total resources. For the period 1993 to June 1999, Islamic banking resources increased rapidly at an average annual rate of 56.8%. Total resources increased form RM 2.4 billion in 1993 to RM 34.1 billion in June 1999, largely attributed to the increase in total deposits, shareholders’
funds of the Islamic bank and Islamic banking funds (IBF) of the SPI (interest-free banking scheme) banking operations. The Islamic bank increased its paid-up capital from RM 133 million to RM 500 million, while the SPI banking institutions increase their IBF from the minimum threshold of RM1 million to RM 5 million (for commercial banks and finance companies) and to RM 3 million (for merchant banks) beginning 2nd January 1999.50

Total Deposits

Total Islamic banking deposits registered marginal growth during 1988 to 1992 with an average annual growth of 1.3%, attributed to the deposits of the single Islamic bank. At the end-1992, the total deposits of the Islamic bank amounted to RM 1.3 billion. The Islamic banking deposits mobilized by the SPI banking institutions and the Islamic bank recorded strong growth during the period 1993-1999. Total deposits recorded an average annual growth of 65.7% from RM 2.2 billion in 1993 to RM 26.1 billion as at end-June 1999. The high growth rates were mainly due to the intensive publicity campaign to promote Islamic banking, the increased awareness among the public on the availability of Islamic banking products in most banking institutions, the increase in number of branches available in providing Islamic banking services throughout the country, and the relatively competitive returns of Islamic banking deposits as compared to the returns on conventional deposits.51

During the period 1993 to end-June 1999, the private sector remained as the major depositor in the Islamic banking system. As at end-June 1999, deposits from business enterprises accounted for 26.2% of total deposits, followed by the individuals (21.6%) and financial institutions (11.8%). Nonetheless, deposits from government agencies had improved significantly, with most of the deposits coming from statutory authorities (12.4%) and the Federal government (8.5%). Despite from government bodies were mainly in the form of current deposits. The continued strong domination of the private sector deposits reflected the general expansion of business activities in the
economy and the growing acceptance of Islamic banking concepts by individuals.\textsuperscript{52}

In terms of deposits by type, nearly three-quarters of the total deposits were in the form of investment deposits during the period 1993 to end-June 1999. As at end-June 1999, investment deposits constituted 71.3\% of Islamic banking deposits. Savings and demand deposits represented 9.0\% and 16.7\% respectively. Investment deposits continued to register a higher growth rate vis-à-vis savings and current deposits, recording more than 90\% annual growth in 1998 (108.9\%) and in the first half of 1999 (87.1\%). This obviously implies greater confidence in the Islamic banking system than in the conventional banking during and aftermath the crisis. The introduction of the Islamic Negotiable Instruments (INI) in December 1998 provided an additional funding avenue for the Islamic banking institutions. As at end-June 1999, the outstanding balance of INI in the market was RM 399 million.\textsuperscript{53}

In terms of maturity structure of the investment deposits, there was a marginal change in the maturity profile for the period 1993 to June 1999, with bulk of investment deposits placed in short-term maturities. As at end-June 1999, investment deposits of 6-month maturity and less accounted for 85.6\% of total investment deposits compared to 78.8\% in 1993.\textsuperscript{54} It is appropriate to conclude here that most depositors prefer short-term deposit to long one representing less risk and faster liquidity as well as return from the investment account. This aspect may not altogether be hindrance to the development process but rather supportive. As most of deposits with Islamic banking institutions are in investment accounts for the purpose of investment, the Islamic banks by performing the important function of maturity transformation can meet the requirement of savers, (i.e., liquidation of deposits on maturity) and investors (i.e., continuation of project) simultaneously. This process is conducive to growth.
Total Financing

During 1988 to 1992, total financing recorded an annual average growth of 12.9% from RM 646 million in 1988 to RM 1,046 million in 1992. As at end-December 1993, the extension of credit following the inception of SPI remained insignificant as, reflected by a growth of only 5.0% in 1993 (RM1.1 billion). Although the number of banks participating in the SPI increased, they preferred to focus their pilot operations in deposit-taking products, which were much more easier to manage as compared to financing. From 1994 to 1997, the situation began to improve when Islamic financing recorded an average annual growth of 77.8%. The period 1994-1997 also coincided with the emergence of a number of unit trusts managed under Islamic principles, which increased the appetite for Islamic financing for the purchase of unit trust funds. From mid-1997 onwards, total financing recorded a relatively small growth following the financial crisis. The tight liquidity and risk aversion of banking institutions had adversely affected the momentum of credit extension. The increase in the level of prepayments and small drawdowns also contributed to the slow growth of 1.8% during 1997-1998. The rebound of the Malaysian economy since the second quarter of 1999 saw the growth rate in financing improving to 6.8% for the first six months of 1999.55

In terms of direction of financing, the bulk of financing extended by the Islamic bank during 1988-1992 concentrated on three main sectors, namely the manufacturing sector (24.8%) real estate and construction sector (23.1%) and residential houses (20.4%). As at end-December 1993, the sectoral profile charged slightly whereby financing to the manufacturing (29.6%) residential properties (19.2%), purchase of shares (8.3%) and construction (7.9%) sectors accounted for the bulk of the financing portfolio. As at end-June 1999, 22.4% of the total financing was extended to the residential property sector, 19.8% to the real estate and construction, 12.2% to manufacturing, 11% to transport and storage sector and 8.6% was credit for consumption purposes. It is noteworthy that, while financing of others sectors remained more or less unchanged, the
financing for the manufacturing sector contracted more than 50% and that of services sectors increased. This reflects the government policy to place significance on the service sector as a growth-led sector in the coming years. In terms of types of financing, the bulk of financing extended as at end-June 1999 was concentrated on three main facilities, namely term financing (35.7%), house financing (23.2%) and hire-purchase (9.9%).

Besides the performance of Islamic banking institutions, there exists performance of non-bank Islamic financial intermediaries, which contribute to the economic welfare of the country. There are Islamic insurance or takaful companies, savings institutions such as Tabung Haji, development financial institution and other financial intermediates, which offer Islamic banking services such as the housing credit institution, all of which already discussed in the foregoing chapters, i.e., chapter 3 and 6. These institutions, although not considered as banks, operate on the basis of Islamic banking and financial system. Their performances in terms of funds or deposits and financing mobilization are significant. For instance, at end-December 1998, the accumulated savings of the Tabung Haji accounted for RM 6.75 billion, with an asset of RM 7.3 billion whereas its total investment in the year 1998 alone stood at RM 5.7 billion. For the financial year ending in 1999, total assets of the family takaful and the general takaful funds amounted to RM 607 million and RM 227 million respectively. Total Islamic financing extended, on medium and long-term basis to promote industrial, investment and growth in industrial and agricultural sectors, by development finance institutions namely, Bank Industri, Bank Pembangunan dan Infrastruktur Malaysia and the Agriculture Bank of Malaysia as at end-June 1999 amounting to RM 164 million. Whereas the Treasury Housing Loan Division, a housing credit institution, provided house financing facilities to civil servants on Islamic basis as at end-June 1999 amounting to RM 2.8 billion. All these figures and magnitude of Islamic banking operations are obviously contributing directly or indirectly to the development of Malaysia.
Within the Islamic financial industry in Malaysia, the most significant contribution in various investment of different fields or sectors of economy that helps Malaysia succeeding in drawing up Malay Muslims or Bumiputera to join in the process of economic development has been rendered by a full-fledged Islamic bank, BIMB and saving institution, Tabung Haji. These two institutions own many subsidiaries in various sectors, representing their direct commitments in investment that result in employment generation, elimination of poverty and enhancement of GDP. With regard to development and infrastructure programmes, BIMB, aiming to play a meaningful role in fostering economic development and social progress of Malaysia, achieves in providing various financing facilities for the implementation of various infrastructure and development projects. BIMB has successfully syndicated the following financing packages in various capacities.58

1. Joint lead manager to the *musharakah* financing with participating certificate issuance facility of RM 600 million for Sarawak Shell Berhad (oil company).

2. Lead manager to the *bai' bithaman ajil* financing with notes issuance facility of RM 125 million for Sarawak MDS (Malaysia) Sdn. Bhd.

3. Arranger to RM 2.2 billion syndicated *bai' bithaman ajil* with notes issuance facility for Kuala Lumpur International Airport Berhad (KLIA) for the 1996 financial requirement (for the expansion and modernization of the KLIA).

4. Joint arranger to RM 2.2 billion syndicated *bai' bithaman ajil* with notes issuance facility for KLIA Berhad for the 1997 financial requirement.

5. Lead manager to the issuance of Islamic debt securities of Petronas Gas Berhad amounting to RM 800 million.

6. Co-manager to the issuance of RM 300 million Islamic debt securities for Petronas Dagangan Berhad (Petronas Merchandise Limited)
7. Co-manager to syndicated *bai’ bithaman ajil* of RM 200 million for Lebuhraya Shapadu Sdn. Bhd. (a highway concessionaire)

8. Co-manager to syndicated *bai’ bithaman ajil* of RM 160 million for Miri Port Authority.

9. Manager to RM 65 million syndicated *bai’ bithaman ajil* facility for Chase Perdana Berhad (Chase Fund Limited)

10. Arranger to RM 45 million syndicated *bai’ bithaman ajil* for Shell MDS (Malaysia) Sdn. Bhd.

11. Co-arranger and Shari’ah advisor to RM 1 billion *istikbalijara* project financing for Projek Usahasama Transit Ringan Automatik Sdn. Bhd. (PUTRA) or Light Rail Transit in Kuala Lumpur.

During the economic crisis that struck in Malaysia, Islamic financial institutions have been emerged as an active rescue for those companies, which have been hurt by the economic slump. Tabung Haji, for instance, has set aside RM 250 million to buy assets of several subsidiaries within Diversified Resources Berhad (DRB) that have been hit by the economic downturn.59

Another major contribution of Islamic banking in the economic development of Malaysia has been towards the tourism sector.60 In line with the government’s effort to promote tourism in Malaysia, BIMB recently launched its Cuti Cuti Malaysia Bersama Bank Islam campaign that was officiated by the Deputy Minister of Culture, Arts and Tourism, Dato’ Ng Yen Yen. This campaign is aimed at promoting the bank’s Islamic financing facilities, namely its Tour Financing Package, Golf Club Membership Financing and Personal Financing Schemes. It also supports the re-launch of the Cuti Cuti Malaysia campaign at the national level by the Culture, Arts and Tourism Ministry. Cuti Cuti Malaysia Bersama Bank Islam allows anyone who intends to go on domestic holiday to select an appropriate tour package from travel agencies approved by the ministry and registered with the BIMB. One will also be able to
submit an application for bank's Tour Package Financing at any BIMB's branch. The launch of this campaign will not only present an opportunity to introduce its Islamic financing products such as tourism-related financing facilities to the public, but will also benefit both tourism and the financial sector of the country. Through its dedicated promotion of tourism in Malaysia, it will consequently contribute to the country's economy by facilitating more revenue through tourism.

Transaction in the Capital Market

The establishment of Islamic Money Market in 1994 provides facilities for Islamic banking sector in adjusting portfolio and gaining significance in mobilizing resources for financing economic activities. Moreover, the establishment of Islamic capital market also provides another platform for the efficient utilization of funds (i.e., raising additional capital and making investment based on Islamic Shari'ah). As at end-June 1999, Islamic debt securities (comprising Islamic bonds and commercial papers) valued at RM 17.1 billion. As regard trading in the stock market (Islamic equity market), the Securities Commission has issued a list of permissible counters in the Kuala Lumpur Stock Exchange (KLSE), updated three times a year. As on 28th April 2000, 566 securities or 74% of total counters in the KLSE have been approved as permissible counters. All these hub of activities surely provide the magnitude of capital mobilization in the country.

External Islamic Development Finance

The major external source of Islamic development finance for Malaysia is the Islamic Development Bank (IDB). IDB provides support for trade and project finance for all Muslim countries, and in many respects functions as a type of World Bank for its subscribers. Malaysia was a founding member of the IDB in 1974, with an initial subscription of US$ 16 million. Since then as all the IDB's authorized capital was paid up, Malaysia increased its subscription to US$ 40 million, representing just over 2% of the total paid-up capital of the
Malaysia remains an active member of IDB but the possibilities for receiving substantial development finance form this source are limited, given the bank’s funding criteria and its priorities.

However, until the end of 1984-85 (1405A.H.) the IDB had approved seven projects/operations amounting to US$ 55.12 million. Out to these, three projects were financed through loans (interest-free basis), one was equity-based, one was in the form of line of leasing, and one was based on line of equity/leasing. A sum of US$ 6.0 million was approved for one foreign trade financing operation. One project was approved for the purpose of the extension of a line of leasing amounting to US$ 9.7 million to the Malaysian Industrial Development Bank for the IDB’s participation in small and medium industrial projects in the form of lease financing.

The establishment of Labuan International Offshore Financial Center (IOFC) and development of International Islamic Money Market are expected to deepen the offshore capital market which will benefit investors and other offshore players, Muslims and non-Muslim as an avenue to take advantage of the wide spread investment opportunities based on Islamic Shari’ah. The government of Malaysia with the assistance of Bank Islam (L) Limited (BILL), a wholly-owned subsidiary of BIMB Holdings Berhad, has plan to turn Labuan into an International Islamic Offshore Center in the near future, complementing and capitalizing on the growth of the Islamic financial system in the Asian region and the worlds at large. The enormous potential in the establishment of an International Islamic Money Market, estimated at approximately US$ 152 billion (in 1997) would also ensure that BILL as well as others will be playing a bigger role in the advancement of Islamic banking in the near future, a clear prosperity for Malaysia.

Islamic Banking as a Social Welfare System

Apart from commercial activities, Islamic banking and financial institutions also assume the role of social responsibility and duties as an Islamic
corporate citizen. This social religious obligation is carried out through various financing facilities with social dimension and other financial assistance to those from the lower social strata.

The establishment of Malaysia Islamic Economic Development Foundation or Yayasan Pembangunan Ekonomi Islam Malaysia (YPEIM) on 13th October 1976 and its activities enlarged on 20th July 1984, aimed to help the poor Muslim. Half of YPEIM halal investment profit is meant for charity and welfare activities, which in turn increase the economic performance of the Muslim community. Its investment activities in collaboration with Islamic banks include:

a) investment with Bank Islam Malaysia Berhad (BIMB) through investment account. The total investment with BIMB, for instance, for the year ended 31st December 1990 was RM 4,450,000;

b) buying shop houses and rented it to certain parties such as the branch of BIMB, Syarikat Takaful, etc; and

c) investment through portfolio management by Al-Wakalah Nominees Sendirian Berhad, a subsidiary of BIMB, by buying the listed share.70

YPEIM's Economic Development Programme constitutes the provision of 'loan capital project' through Amanah Ikhtiar Malaysia (AIM) established in 1988 and BIMB.

1. Amanah Ikhtiar Malaysia (AIM)

Under this scheme, the district which has the highest degree of poverty will be selected as a district operation. The members of this AIM are those families who earn income less than RM 250 or RM 50 per capita each month. Each of the members must plan his own economic project based on his ability. First loan will be given not more than RM 500. The member who has succeeded in his project will be entitled to get more
loans, viz, RM 1,000 for the second loan, RM 1,500 for the third loan and so forth. Interest will not be rendered, guarantor is not needed and no court legislation will be used in getting the loan back. The loan will be entirely written off when the debtor dies. The AIM can be proven successful through the rate of repayment of loan until 31st January 1990 was 99.55% and it has enlarged its activities to cover more districts.

2. Loan capital also has been given by YPEIM to BIMB for the scheme of ‘qard hasan’. This scheme has already been implemented by BIMB to all of its branch throughout the country. Those poor people who are entitled and interested can apply for this loan.\(^7\)

YPEIM's loan capital projects particularly through AIM and generally through BIMB is clearly a good way of bringing poor people out of vicious circle of poverty and be self-reliance as their skills and entrepreneurship are utilized through Islamic banking method of finance. YPEIM as a social organization has targeted the scheme for the lower income group, especially in meeting their financial needs. The role of BIMB here complements that of YPEIM in meeting this social goal. For the BIMB, other financing scheme by its own with social dimension include the Vendor Development Programme, the Exchange Programme with the Entrepreneurial Development Corporation, Financing Scheme through the Credit Guarantee Corporation Guarantee, Financing Scheme through Bank Negara Malaysia, and others.\(^7\)

In Malaysia many of such institutions as YPEIM were set up to help the poor people in particular such as Amanah Saham Bumiputera (ASB) which provides loan called poor people development scheme without interest and the maximum repayment period is 15 years. Another institution being Terengganu Islamic Foundation (Yayasan Islami Terengganu) starting operating in 1978 with the objective not only in spreading and preaching of Islam but also in the development of economics, investment, and finance. It has a department of ‘Development and Investment’ and is a very potential Islamic financing body.\(^7\)
In addition to the above, various Islamic banking and financial institutions have continuously rendered financial assistance through their zakat funds to the poor and needy and others who are deemed qualified by the banks' Shari'ah council. Zakat is a religious obligatory that helps improving social and economic status of the community especially the poor and needy. All Islamic banking and financial institutions are religiously obliged to render this socially welfare function. As for instance, in 1999 the BIMB Holdings Berhad had contributed over RM 1 million form its zakat fund to those in need.74 The most prominent among Islamic financial institutions in terms of zakat payment must be Tabung Haji. In 1997, Tabung Haji contributed RM 13.9 million or 42% increased from previous year, as zakat funds to the people of Malaysia.75 This provision will obviously play a crucial role in developing a caring developed society in Malaysia.

Islamic Banking and the Priority Sectors.

Regarding small and medium industries (SMIs) in Malaysia, surveys, which were conducted in 1975, revealed that most of SMIs complained of inadequate finance and lack of access to commercial bank credit. There is difficulty in getting loans from commercial banks due to the need for collateral, guarantors or preparation of financial statements.76 But since the late 1980s, after the government introduced its privatization programme, the emphasis has changed. Nowadays, SMIs are receiving continual financial assistance from various government agencies. Recently Bank Negara Malaysia (BNM) has set up the Fund For Small and Medium Industries (FSMI) in October 1997, to

a) ensure that this sector of economy would continue to have access to credit at reasonable (or no) cost;

b) resuscitate ailing but viable business enterprises or industries (during economic downturn); and
c) promote investment in this priority sector, thereby, raising domestic productive capacity in this sector.

On 2nd January 1998, BNM set up initial allocation of RM 1 billion to enhance the role of SMIs in the eligible sectors and to complement government's efforts to assist the SMIs to penetrate the export market. The eligible sectors under the FSMI are the manufacturing, agro-based and services. The allocation of FSMI increased further by RM 500 million to RM 1.5 billion on 8th May 1998 and again to RM 1.85 billion with effect from 4th August 1999. Borrowers can apply for the loans from the institution appointed by the government to implement the fund or collectively known as participating financial institutions (PFIs). FSMI is disbursed through all commercial banks, 10 finance companies, BIMB, and four development finance institutions. The lending rate was reduced from 10% to 8.5% on 5th December 1998 and further reduced to 6.5 % per annum with effect from 3rd May 1999. FSMI through BIMB is non-interest and is the advantage for Bumiputera Muslims willing to take part in the development process of the country.

Besides FSMI, BNM also set up several funds to other priority sectors namely Fund for Food, New Entrepreneurs Fund, Bumiputera Industrial Fund, Ship Financing Facility, Special Scheme for Low and Medium Cost House, and Industrial Adjustment Fund. It is interesting to note that not all of these funds are available and allocated through Islamic banking institution such as BIMB, as they carry some interest-based lending rate and would not be appropriate if options (interest-based and non-interest based) are open for the same fund, because such arrangement may lead to several complaints and conflicts. The fund allocated through BIMB may be targeted for a certain group of people or sectors and will not create such conflict.

Islamic Banking Educational Institutions & the Process of Development.

The development of an efficient Islamic banking system operating along side the conventional one has been identified as an important factor in
promoting economic growth and sustaining social equilibrium in Malaysia. This development involves the formulation and implementation of policies to steer and nurture the growth of the new system as well as to foster and develop a sound diversified Islamic financial structure with equally developed Islamic money and capital markets.

In this connection, the setting up of Islamic and financial educational and training institutes can be significant either as an effort of Islamic bank itself or of various academic institutes and universities. In 1993, Malaysia witnessed the first Islamic Management Center set up within the International Islamic University (IIU), Malaysia, dedicated to the study of Islamic as well as conventional management science. As far as Islamic management is concerned, the Center focuses on the four main areas, namely (a) executive education, (b) training of trainers, (c) consultancy and advisory services, and (d) research and dissemination. In 1998 BIMB established a college of Islamic Banking and Finance or Kolej Perbankan dan Kewangan Islam (KPKI), as a private institution of higher learning managed by BIMB Institute of Research and Training Sendirian Berhad (BIMB-IRT). Many of such efforts have been taken up by various institutes. This development, no doubt, contributes in a meaningful manner to the development of knowledge and expertise in Islamic banking and finance in Malaysia, which in turn leading to social and economic development of the people.

Thus it is difficult to measure the role of Islamic banking as well as conventional banking contribution precisely to economic development of the country, as already pointed out that some kind of development such as social and cultural can never be calculated in mathematical term. For the country like Malaysia, market penetration remained a continuing concern for Islamic banking. Although the target of 5% in terms of deposits and financing could be achieved for each banking institution offering Islamic banking services by the end of 2000, the main thrust is to garner a respectable share in the banking system. Therefore, the challenge over the next 5 to 10 years, as pointed out
earlier, would be to position Islamic banking as a significant player in the banking system and hence the process of socio-economic development. Such attainment would only be possible if the market penetration is more than 30% of the banking system. The attainment of this target would make the existence of Islamic banking as a commercial-cum-development institution more meaningful.  

NOTES & REFERENCES


8. Ibid.


15. According to Volker Nienhaus, entrepreneurial talents are widespread and by no means confined to the established economic elite of a country (including the capitalists). Economic elites are relatively small by number - hardly more than 10% of the population. If talents are distributed by nature rather than evenly among people, simple arithmetic suggests that - in absolute figures - more entrepreneurial talent should be found outside than inside the established elite. People outside of the elite are usually not very rich. If they have entrepreneurial talents, their own
resources (including contribution of relatives and friends) are usually too modest to realize their innovative ideas. Thus, a new 'entrepreneurial class' and a broad based development can emerge only if talented people get access to financial resources exceeding their present means by far. [Nienhaus, Volker, “The Potential of Islamic Banking and Financing for the Promotion of Economic Development ...”, op.cit., p. 334.]


31. *Asiaweek*, Hong Kong, Asiaweek Limited, Vol. 26, No. 34, September 1, 2000, p. 64.

32. Ariff, Mohamed, “The Malaysian ....", op.cit. The capital account of the Balance of Payment (BOP) had always been sufficient to finance the
current account deficit in the last decade (1989-99) except in 1994-95 and 1997. The net outflows of official long-term capital during this period were more offset by high net inflows of private long-term capital, mainly in the form of foreign direct investments (FDIs). Private long-term capital which recorded a net inflow of RM 4.5 billion in 1989, increased significantly to RM 13.2 billion in 1992. The FDI was concentrated mainly in the manufacturing and oil sectors, with smaller amounts in the property and agricultural sectors. The net private capital inflow, however, declined slightly to RM 12.9 billion in 1993 and further to RM 10.5 billion in 1995, mainly due to the increasing outflows for overseas investment by the Malaysian-owned companies. The East Asian financial crisis caused significant capital outflows due to weak investor confidence resulting from the successive depreciation of Malaysian ringgit and uncertainty in the financial markets led to large liquidation of shares by the foreigners who had purchased shares in the domestic market earlier years. The overall BOP recorded a deficit of RM 10.9 billion in 1997. However, in 1998, the surplus in the current account was sufficient to offset the net outflow (of short-term capital account) and the overall BOP turned around to record a significant surplus of RM 40.3 billion in 1998. The BOP was expected to strengthen further to record a surplus of RM 26.1 billion in 1999. [Bank Negara Malaysia, op.cit., pp. 29-32].


35. These two major programmes were coincident with the national plan of economic development from the Second Malaysian Plan (1971-75) to the end of the Seventh Malaysia Plan (1996-2000). The main aim and strategies of various plans are as follows: The main aim of the First Malaysia Plan (1966-70) was to promote agricultural and industrial activities so as to diversify the economy and create employment.
Accordingly, the focus was on labour-intensive import substitution and export promotion. The Second Malaysia Plan (1971-75) paid much attention to export-oriented industrialization, in addition to increased direct government participation in commercial and industrial activities, which signaled a radical departure from the earlier practice. Under the Third Malaysia Plan (1976-80), resource-based industries were given a boost, primarily to the discovery of oil and gas. Education and training in the field of industrial engineering were given much emphasis, to relieve shortage of skilled manpower. The main task of the Forth Malaysia Plan (1981-85) was to boost productivity, expand the industrial base and modernize the service sectors. In addition, small-scale industries were promoted through the provision of training and financing facilities. The Fifth Malaysia Plan (1986-90), launched in the aftermath of the recession, introduced reforms such as the removal of restrictions on private investment and foreign equity participation in the economy. Research & Development (R&D) activities were given new emphasis, especially in high-technology areas including microelectronics, laser technology and electro-optics, biotechnology and materials technology. The principal objective of the Sixth Malaysia Plan (1991-95) was to enhance the competitiveness of Malaysian manufactures through technological upgrading, industrial restructuring and innovation in production, design and marketing. The Seventh Malaysia Plan (1996-2000) has laid much stress on productivity-driven growth via integrated production in higher value-added activities, especially technology-intensive and knowledge-based industries [Tan, E.C. and Ariff, M., “Structural and Sectoral Change in the Malaysian Manufacturing Industry", a paper presented at the Australia-Malaysia Conference, Australian National University, Canberra, 1997, as quoted in Ariff, Mohamed, op.cit., p. 8-9]. In the Eight Malaysia Plan (2001-2005), growth in the medium-term needs to be productivity-driven, greater
emphasis will be placed on skills development [Bank Negara Malaysia, 
*Annual Report 1999*, foreword].


37. Vision 2020 sees Malaysia as a united nation made up of one Bangsa Malaysia (Malay National), confident, psychologically liberated, moral and ethical. It sees Malaysia as a mature democracy with a society, which is not only scientific and progressive but also liberal, tolerant and caring. It envisages an economy, which is industrialized, developed and prosperous, fully competitive, dynamic, robust and resilient in addition to being equitable and fair. [Sulaiman, A.A.H., “Keynote Address on Islamic Management” in Al-Junaid, A.H. and Anwar, A. (eds.), *Report of the Meeting Experts on Islamic Management Center*, Jeddah, IRTI/IDB, First edition, 1995, p.25.


40. Ibid, pp. 15-16.

41. Ibid, pp. 16-17.

42. Ariff, Mohamed, op.cit., p.4.

43. Ibid, p. 5.

44. Ibid.

45. Lim, C.P., “Study and Evaluation of Existing Fiscal and Financial Policies and Support for Small and Medium Businesses in Malaysia”, in James,


48. Bank Negara Malaysia, *The Central Bank*, op.cit. This figure is rather a bank credit ratio to GDP, which was high at 149% of GDP in 1997. Nevertheless, the ratio of deposits to GDP was also high, as mentioned, at 154%. The banks, therefore, have financed their own lending operations from their own domestic mobilization of savings, which is non-inflationary, primarily from deposit. If the capital of the banking system is taken into account, the total fund base (deposit and capital)/GDP, was higher at 173%, exceeding the loans/GDP ratio, indicating that the banks do have the required resources to lend [Ibid].


51. Ibid.

52. Ibid., p 456.

53. Ibid.

54. Ibid.


56. Ibid.

57. Ibid, pp. 252-253.


60. Tourism is the latest focus and steps have already been taken towards this end, assures Abdul Kadir b. Haji Sheikh Fadzir, the Malaysian Minister for Culture, Arts and Tourism. The Malaysian initiatives in tourism did not come until the 1997 economic turnaround. The turbulence of 1997 made the country seek a solution to its wobbling pillar and it found the answer in tourism. [Sengupta, Ratnottama, "Malaysia Eyeing Indian Tourists", The Sunday Times, New Delhi, Bennett, Coleman&Co., Ltd., vol. 9 no. 21, June 30, 2001, p. 10]


66. Line of leasing refers to as when the leasing facility of the IDB in the procurement of necessary equipment and machinery for the production of various intermediary and capital goods in the member countries as well as for the acquisition of ocean-going vessels towards building up the necessary transportation facilities and foreign trade activities, is made indirectly through national development banks of the member countries. [Mannan, M.A., “Islamic Development Bank and Economics Development of Southeast Asia”, in Ariff, Mohamed (ed.), op.cit., pp. 179-180].

67. Line of equity refers to as assistance of IDB particularly to small and medium industrial projects in the private sector under which the national development finance institutions act as agencies of the bank for the purpose of the identifying, appraising and implementing local projects which are suitable for this type of financing (on the principle of musharakah) [Ibid, p. 179].

68. Ibid, p. 185.

69. Rahman, Dato’ Ahmad Tajudin Abdul, op.cit., p. 16.


71. Ibid, pp. 42-43.


74. Rahman, Dato’ Ahmad Tajudin Abdul, op.cit.

75. Tabung Haji, Annual Report 1997, p. 34.


