

What may Fuel the Growth of Islamic Banking?

Syeada Irfath Jahan and Sarah Zuhryati Hussain
Management Center, International Islamic University Malaysia
53100 Kuala Lumpur, Malaysia

Abstract

The price of commodity into the international market is speeding up, which creates the volatile economic issues in the world. Among the different categories of commodity, the widely traded and significantly influential commodity is the oil. On the other hand the reason behind the increase of commodity price is the fall of dollar. This sudden fall of dollar at the end, is affecting the growth of Islamic Banking. The change of the International stock market return has causal relationship to divert the investment capital to the equity based shariah financial institution. All this inherent reason finally fuelling the growth of Islamic Banking. This oil as natural resources is the option of huge revenue for the particular geographical beneficiary, which requires transaction through financial institution. According to the International Energy Outlook 2007, the highest reserve of oil in the world is in Saudi Arabia that is 262.3 billion barrels; following this Iran, Iraq, Kuwait, United Arab Emirates, Kazakhstan and Qatar have the significant position in the world ranking of oil reservation. All these geographical areas are the drive for the growth of Islamic financial institution on the emergence of halal transaction and safe keeping of the wealth. On the contrary, the existence of Islamic banks in these areas are still not well conversant on the extent of there product facility and service facility to the trader and business community. There are different constraints existing in this world which is resisting the whole oil capital to transact through the Islamic banks, these constraints will be discussed with facts and figures in this paper. Oil as an opportunity and potential resources require making precise policies and here is the effort to find the bottle neck of the system.

Key word: Oil, Growth of Islamic banking, Petrol money, constraints for Islamic Banks.

1.0 Introduction

The growth and operation of Islamic Financial Institution is now a day's very attractive issue into the recent economic crisis of the world. Dollar crisis is one of the major factors which may influence the economy of whole world. The establishment of this currency as an international monetary unit took places after the collapse of Breton Wood System. Standardization of this paper based currency makes the rest of the world dependant on the economy of particular country. The value of Dollar is falling, which has significant influence in pricing the commodity and services all over the world. Commodity price is rising very fast in world commodity market, where the oil is the widely traded commodity and major factor for industrialization as well as world economy. Due to peak of commodity price, causes enormous revenue to the country that reserves and export the oil with sound market share. According to the information and study, the major geographical possession of oil existed in the Middle East where much petro wealth may park due to the peak price of oil. At the past the petro money used to keep in the different prominent bank of US and UK by the Arab oil trader, but after 11th September many of them prefer to avoid US bank due to lots of hassle and procedural complexity. On the contrary, due to sub prime effect and its significant damage in money market made many investors reluctant to invest traditional financial services which causes surge in the world stock market. On such extent, these Middle East oil traders initiated and searching for investing in local and Shariah based banking system to keep the capital in their own arena. These are the new horizon to boost a new financial system, by facilitating the clients with more precise shariah compliant banking system.

According to Arab news, Saleh Kamil, a prominent Saudi businessman and a pioneer personality stated at 2 June 2008 in Jeddah that Islamic banking is growing at an annual rate of 35 percent worldwide with assets of Islamic financial institutions amounting to a staggering \$600 billion last year¹. Apart from this there are many initiatives to expand the Islamic banking and also to increase of capital transaction. From the report of Asian Banker Research on positioning of Islamic banks 40 (IB40)², it has been found that the top 40 Islamic bank's assets grow 20.9 percent which is amounting \$40 US billion in 2005. This statistics supports the stand of Islamic Banking to the remarkable growth from 2005 to 2008 which turn out 35 percent form 20.9 percent within small period.

Mostly argued and analyzed factor to fuel this growth is the Oil; this is being beneficiary of geographical resources into the Muslim sovereign area. Moreover the zone of oil is been discovered by good rate than the consumption rate. According to Santis (2003), the world proven crude oil reserves were 64 in 2000, which increased by 8% greater than those in 1980 and 1990. It says the possibility to enhance the export and utilization of energy to produce for the economy, which eventually may transacted through Islamic Banks. Nevertheless, the oil is not only the one pillar for

¹Ghafour,P.K.A.(2008). Islamic Banking Growth at 35% . Retrived from the website at 20/07/08 <http://www.arabnews.com/?page=6§ion=0&article=110508&d=2&m=6&y=2008>

² Banks in six countries of Asia Pacific made the IB40 ranking: Bangladesh, Brunei, Indonesia, Malaysia, Pakistan and the Philippines.

Islamic Bank the international Stock has significant influence to divert the public from commercial financial transaction to equity based shariah transaction. In this paper we are trying to analyse the link and the potential area in the world economy that may fuel the growth of Islamic Banking. To draw a strategy and policy for the advancement of future competent Islamic Financial System, this effort has been made to follow up the scope.

2.0 Research Objectives

To continue the sustainability of the recent trend of Islamic Banking, requires scrutinizing the resources and following up the stages; to be facilitated from International economic events. The Objective that we tried to inspect for the growth of Islamic Banking will be describing by particular incidents that may give clear flow of causal relationship with each factors.

1. To observe the indirect relationship of the dollar crisis on the growth of Islamic Banking.
2. To find out the impact of dollar crisis that has direct influence to the commodity market as a whole.
3. To identify the causal relation ship of dollar fall and the Oil price, into the commodity market which has eventual influence on the growth of Islamic Banking.
4. To analyze the dollar crisis with the affect on the World stock market and Inflation all over the world.

With the descriptive methodology of supporting the existing research a diagram will be drawn to summarize the mostly discussed factors that finally may influence the growth of Islamic Banking.

3.0 Significance of the Study

The analysis on this causal relationship with sufficient investigation would contribute and facilitate the further research with the quantitative prove. So this infant stage of research will take ahead the subjects to be analysed further, to boost the growth and exposure of Islamic Banking in the world. The area of focus which will be facilitate through this research are stated below.

- Dollar has a significant influence on economy of all over the world, there are many research has been done to observe the effect on different sectors. As the Islamic banking now a day is the raising industry, this is very much important to dissect all possible factors that may constraint or stimulate the growth of this sector. It will facilitate to make proper strategy for the upcoming competition.

- We can observe the price of all commodities is increasing regardless Grain, Gold and Oil etc. Different research shows the significance of different commodity sector in terms of influence, but in this research the channel of influence by the dollar to all these commodities will be illustrated. Which sector of commodity effected seriously than the others and how to utilize this speed of commodity price will be facilitated through this study.
- Oil as a widely traded and most demanded commodity, it has greater contribution and opportunity to fuel the growth of Islamic Banking. As the Oil as natural resources geographically possess by the middle east after 11September, to avoid the hazard of procedure many Arab oil supplier are now reluctant to keep their capital in US and now they are more determined to invest in Shariah based institution. So this is the bigger opportunity to develop the separate financial system with more facilitate shape to the human well being.
- On the contrary, the dollar crisis is affecting the world capital market and simultaneously increasing the world wide inflation. It is very important to observe the other significant component of financial market which has ultimate interdependence effect on Islamic Banking as well. So the dollar fall and oil boom both effecting the world stock market in what extent and how, it requires investigation to establish a well structure and competent Islamic Banking.

4.0 Analyses

To identify the stage of research about where we are and how far to go, to fuel the growth of Islamic Banking require scrutinizing the existing literature and evidence. Now a day it is inevitable to be acknowledged about the strength that we have, to confront for achievement of the desired objectives. Further advancement of research will be leaded through current descriptive studies and reviews. This inception will facilitate the establishment of Islamic Banking as an independent system, instead of existent as sub-system in the realm of financial environment.

4.1 Growth of Islamic Banking all over the World

Growth of Islamic Banking is now days noteworthy irrespective in Muslim and non-Muslim world. In Muslim world this financial system is now trying to be emphasized to make the monetary affairs more compliant with the Shariah, though some fluctuation taking place to inhabit a new system to operate independently from the conventional system. Yet these Islamic Banking needs, numerous research and innovation to establish the widely accepted device of mechanism; as current shape of subsystem may turn into full independent system. Admitting all these circumstances, this Islamic Banking System moving forward with the growing aptitude which is more obvious from the increasing numbers of Islamic Banks that is 176 irrespective the expansion through branch in more than 60 countries.

Let alone all over the world, even from the recent reporting of *The Business Times Singapore, 2007* it has been found that the top 40 Islamic Banks in the Asia-Pacific region reported 20.9 percent asset growth nearly \$40 US billion in 2005, more than three times of average 6.6. percent growth of the region's 300 largest banks³.

According to the research of Mokhter, Abdullah & Alhabsi, 2008, they presented a table (see appendix-I) where the vivid picture of rapid growth of Islamic Banking in Malaysia has depicted. From the table we can see the trend behaviour of Islamic banking industry in Malaysia by the variables of total assets, deposits and financing of Islamic Banking System. We can say that in terms of total asset the encompass figure of full fledge and windows has rose outstandingly from 17.8 billion at 1997 to 77.4 billion at the end of 2003. This shows the success in transactions which leading and attracting more capital in the Islamic banking industry that would affect the growth sustainability for the upcoming time. Besides the well sign of total asset in Islamic bank's growth performance, the other variable of deposit shows the tremendous performance that is from RM9.9 billion in December 1997 to RM55.9 billion in December 2003. It is ensuring the continuous growth of the Islamic banking practice through the increased reliability of customer to deposit into the Islamic banks. Other final variable of financing by these Islamic banks is getting wider and larger which shows the capability and contribution of Islamic bank in the economy is nowadays very important. The growth through this financing variable is RM 10.7 billion to RM48.6 billion during the similar time gap.

In Malaysia this sector of Islamic banking is growing significantly faster in comparison of rest part of the world; while they have set 2010 as the year when Islamic banking assets would represents 20 percents of the total industry assets. This commencement shows the output that at the end of 2006, the figure stood at 13.4 percent from only 6.58 percent in 2001. In terms of financing growth, Islamic banking expanded 12.26 percent in 2006; almost double the entire banking system's 6.25 percent.⁴ Other prominent conventional like ALLIANCE Malaysia Bhd. & HSBC want to expand the Islamic Bank more widely. ALLIANCE Bank Malaysia Bhd, said it wants to expand its Islamic Banking products to tap an increasingly profitable market and support Malaysia's efforts to become an Islamic financial centre, they improved their non performing loan through Islamic banking benefits⁵. HSBC Bank Malaysia Bhd is looking at opening of 15 Islamic bank branches over next 2 years⁶.

³ This survey made only on banks of six countries in the Asia –Pacific: Bangladesh, Brunei, Indonesia, Malaysia, Pakistan and Phillipines. These banks have either have stand alone Islamic Banking operations or Islamic windows as a part of conventional commercial bank. Asian Banker 300 survey which examined the regions 300 largest and strongest banks from this 40 Islamic Bank's Report picked in this newspaper report, that survey result was actually published after the survey in September 2006. (Danial Buenas, "Region's top 40 Islamic bank's asset grow 20.9%; But return on assets in 2005 not impressive: survey, *The Business Times Singapore*, January 8, 2007 Monday)

⁴ This report was published at "Sector growing at strong pace, assets target within reach", *New Straits Times (Malaysia)*, June 19, 2007.

⁵ From the report

⁶ In this report chief executive officer Irene M Dorner said "There is marvelous opportunity in Islamic Banking sector as well, either through the merger of banking groups or through foreign banks buying stakes in local players". Reported by Surin Murugiah, "HSBC may open 15 Islamic bank branches over two years", *The Edge Malaysia*, July 20, 2007

In the non Muslim country like Singapore, where from the census of 1990 it has found that there were about 350,000 Muslims in the resident population of some 2.3 million. Still it is possible that Islamic Banking will be introduced into the country and already positive aptitude studied to grab the opportunity of Islamic banking industry. Gerred, P & Cunningham, J.B.,1997, in their research on Singapore asked a question about what they would do if an Islamic Bank did not make sufficient profit to make a distribution in one year,62.1percent of Muslims they said that they would keep their deposits within the Islamic banking movement which is quite positive to the growth of Islamic banking in Singapore and the opportunity operation is not too far. Two main reason behind this growth potentiality of Singapore is identified by Gerred, P & Cunningham, J.B.. *First*, neighbouring Malaysia and Indonesia have already successfully introduced the Islamic banking in their service sector. Singapore as major financial service provider in South East Asia,to compete for Muslim sourced deposit require to practice the Islamic banking facility. *Second*, Singapore's Finance Minister,in mid-June 1994, announced that commercial banks would be permitted if they felt it was viable to do so , to set up a Islamic banking operation. So Opportunity of growing the Islamic banking is now being spread all over the world.

Beside this, the South Asia alone has 47 Islamic Banks accounting for nearly a quarter of total assets and the third of deposits of the 144 Islamic banks of the world. The 144 islamic Banks had around six billion dollar in capita, more than 166 billion dollars in asset and 77 billion dollrs of deposits at the end of 1995.Apart from the 47 units of South Asia, 22 in Middle east,17 in the six nations Gulf Cooperation Council (GCC), and 4 in Europe and North Ameriaca (Source: International association of Islamic Banks into Hassan.K, (1999).

In the recent years, if we look at the progress and incentives to the growth of Islamic Banking for stimulating the speed; we can see the effort is beyond expectations. According to Channel NewsAsia (25/02/08), in recent budget Singapore announced 5 percent concessionary tax on Shariah-compliant product where the global Islamic Banking sector worth around US\$500 billion⁷. In Malaysia, in compare to all other part of the world has significantly stepping forward to the growth and expansion of Islamic Banking.

If we look at the Table-3 of Appendix-II, we can see within a year from end 2006 to June 2007 the growth by Total asset changed by 8%, by deposits the change is 8.4% and in terms of financing the growth for the manufacturing the change is 10%. The view of the total financing to the Malaysian economy is enormous by the separate sector, as shown in graph-3 Appendix-II. The continuous growth of Islamic Banking by the Asset and Financing is tremendous in the limited period of time that is from 1997 to 2005 (Graph-1 and 2, Appendix II). In the Malaysia context where Islamic Banking is privileged simultaneously with the conventional; the birth of conventional product is old enough but still the performance of Islamic product and its achievement towards market share is worth mentioning according to Graph-4, Appendix-II.

⁷ <http://luxuryasiahome.wordpress.com/2008/02/26/singapore-icreases-efforts-to-position-itself-as-islamic-banking-hub/> retrieved at 12/05/2008.

In the Europe or Western part of the world the first full fledged Shariah compliant retail bank launched in UK, named Islamic Bank of Britain authorized by the FSA in 2004. At the same time European Islamic Investment Bank also authorized by the same body. Even London became an important financial centre with major international companies and financial institution; the biggest financial companies of Middle-east are offering the shariah compliant products from London. Total Assets controlled by Islamic banks at the global level are estimated to be \$200-500bn and are growing at a pace of 10-15% per year⁸. According to media reports, currently there is one full-fledged Islamic bank and four Islamic investment banks in the UK and the local government intends to convert the capital region into a global hub for the financial industry. It is reported that Britain plans to roll out a program worth GBP2 billion to issue its own sovereign sukuk debt.

From this scenario we can see the potential growth of Islamic Banks all over the world. These tendencies became incentive, for the demand of the halal transaction with the riba free dealings. To put forward the effort of halal transaction, the growth of Islamic banking will be potential along with the increasing research and development into the transaction by the Shariah screening.

4.2 Oil price as an opportunity to strengthen the growth of Islamic Banking

Oil price increase is the forthcoming opportunity for the oil resource owner, to boost their investment and finance. According to Aseambanker Research, with oil prices averaging US\$70 per barrel in 2007, the six countries making up the Gulf States, namely Saudi Arabia, Kuwait, United Arab Emirates (UAE), Qatar, Oman and Bahrain, should reap a total of US\$320 billion in oil exports in 2007⁹. If we look at the continuous demand of this energy consumption and sustainability of this oil export we can get the clear view at Appendix-III, graph-5, where the consumption of energy has been predicted until year 2030 by International Energy Outlook, 2007. This shows the huge oil money needed to park, and the revenue needed to transact through the Islamic Financial transaction, as the owners are the concern on halal transaction. According to the Appendix III, Table-5, we can see the top oil reserve countries are Saudi Arabia, Iran, Iraq, UAE, Nigeria, Qatar in the list of 2007. All these are the majority in Muslim and they concern about the riba free transaction. In graph 6 and 5 we can find the major source of oil all over the world is the Middle East where 739 billion barrels exist into the total 1,317 billion barrels reserve of the world. SO this oil resource is a huge opportunity to transact through the Islamic Banking and stimulate the growth.

According to James, S (2008), considering sustainable price of oil US\$80 per barrel, there is actually US\$ 38.7 trillion worth inventory sitting in the Arabian Peninsula. Interestingly, these petro money are also arriving at Malaysia shores as Middle East investors diversify their risks, acquiring significant stakes in construction-related groups in the country over the past two years.

⁸ <http://abdullahharon.blogspot.com/search/label/UK> retrieved at 02/05/2008

⁹ James, S., (2008) "Good prospects for Islamic banking", *Malaysian Business*, March 1. http://findarticles.com/p/articles/mi_qn6207/is_20080301/ai_n24977546 retrieved at 03/05/08

So if the Islamic bank can play significant role being stakeholder of this petro money, it will be the main stream to boost the sector itself in compare to the conventional banking. According to Stephenwell,T. (2007)¹⁰, the six Gulf Cooperation Council (GCC) states have recorded their balance of payments surpluses in excess of \$500 billion over the past five years. A new energy has arisen in the Gulf region's economy; as a blessing of oil surpluses fuel the creation of unparalleled investment and **banking** opportunities. The past booms of the 1970s and 1980s and the strength of regional institutions have created a financial powerhouse. Which has strengthen the base of Islamic banking, as Top 500 Islamic Financial Institutions ranking, showing the growth of almost 30% in this specialised area. With higher oil prices, Gulf financial assets estimated at more than \$4000billionn, increasingly sophisticated Arab financial institutions are taking full advantage of the regional opportunities now available with further strong growth expected this year as well. Oil price is not only, growing confidence in expanding the capabilities of Arab financial institutions but also expanding the **Islamic** banking. The increasing focus on **Islamic** banking in the Gulf and other area will improve the research and development on shariah supervision towards the financial transaction. From past experience of **oil price** booms in which bloated revenue streams were frittered away and lost in the West, this extant now changed for refocusing on investing at home rather than abroad. And the better strategy have taken by the GCC states in running their governments and financial infrastructures have led to improved to compete for the 21st century.

From the reporting of Wayne Arnold (2007)¹¹, in *The International Herald Tribune* it has been found that approximately 300 **Islamic** financial institutions hold at least \$500 billion in assets, an amount that is increasing more than 10 percent a year. He mentioned **Islamic** finance is mostly an effort to acquire an estimated \$1.5 trillion of funds floating around the Middle East, largely from higher **oil prices**. Although a lot of this oil money was parked in the United States, Britain and Switzerland before Sept. 11, 2001, bankers say many wealthy Arabs are investing closer to home, in part to avoid the hassle of increased scrutiny. In his report he mentioned there are estimated, \$800 billion of Arab money has moved from the United States and Europe to other regions. Those investments have helped ignite an economic revival throughout the Muslim world at a time of increasing religious conservatism among Islam's 1.6 billion faithful.

On the other hand, form the religious and historical tradition it has been found that Interest is repeatedly condemned in the Qura'n, and Bible. Apart from the Muslim believe, Aristotle denounced it, the Roman limited it, and the early Christian Church prohibited it. Finally this interest was re-introduced to Christians and Muslims around the time of the Renaissance.

¹⁰ Timewell, S. (2007), "Gulf's New Energy - Finance Is Taking Over From Oil As The Fuel That Drives The Engine Of Economic Growth In The Gulf Region", *The Banker*, November 1, 2007.

¹¹ A. Wayne (2007), "**Islamic banking rises on oil wealth, drawing non-Muslims**", *The International Herald Tribune*, November 23, 2007

Now again people are aware about their welfare and religiously prudent; so the rising oil wealth is a blessing lifting Islamic banking which adheres to the laws of the Qur'an and its prohibition against charging interest into the financial mainstream. All these demands and issues can be resolved by Islamic Banking, which is the reason of fuel towards the growth.

4.3 Dollar Index, Commodity price and the World economy

At 1973 the Bretton Woods International monetary system broke down which creates disagreement and issues to settle a new set of rules to regulate international trade and monetary relations. Now, the U.S. dollar has become the standard and core reserve currency instead of gold. In such an avenue, the dollar standard has globalized by allowing the rest of the world to sell their products to the United States on credit (Duncan, R., 2003). According to Richard Duncan, there are three flaws of this dollar standard into the World economy which is now increasingly apparent. *First*, it established a situation where the health of the global economy depends on the United States going steadily deeper into debt to the rest of the world. For example, Japan and Asian crisis, where these countries were able to avoid complete economic depression only their government went deeply into debt to bail out the depositors of the bankrupt banks. *Secondly*, the system creates an asset price bubble which dampens the banking sectors and government finances of the particular countries of the world. *Thirdly*, it creates deflationary pressure to undermine the profitability and trade deficit in the core system; eventually it ended up with excessive credit creation. So the economy of the US is crucial which influences the rest by their trade and transactions with so-called stable monetary units. Past 35 years, the United States has moved into deficit in balance of payments in an appearance of the world's most heavily indebted nation. The international trade of the US with debt instruments instead of real assets as payment will force the financial or corporate ability for the service of debt to draw their limit. This causes individual entities would be liable to pay their own credit while the debt service provider stops to provide any more debt and results in the bankruptcy or collapse of the entity. "Sub prime effect," which causes deflation in the real estate business at the US that makes many individuals to compensate more than they are worth. Now the biggest trade partners of the US like China, Japan and others started to convert their dollar assets that were replaced as real value of payment for their exports. This excessive demand of conversion of this debt instrument ended up with the falling international exchange value of the dollar.

According to *CRS Report of 2008* regarding the dollar crisis, last 5 years on a real trade weight basis the currency is down about 29%. For most of this time the fall of the dollar was about 3.0% to 4.0% annually. Again recently the acceleration took place, falling nearly 10% between January to December of 2007. Craig K. Elwell (2008) predicted in this report that most probably 15% to 20% fall of the dollar might take place for several years, and causes significant negative shocks of the US and the global economies. The economist Paul Krugman (2007) has calculated a range of estimates of US external debt accumulation and trade deficit. According to his study on the experts' consensus that further real depreciation of the dollar would be a minimum 35%.

The recession with the dollar depreciation made the real estate business sudden fluctuation of price and huge damage into the bond market, in US as well as rest part in the world, therefore investment flow moving into the commodity market where price is increasing for the recent boom into the commodity market. There are three most significant commodity boom took places in the history of commodity market. The first boom explored at 1950 and followed by two years, second boom held at 1973 but price fell sharply at 1975 and final boom is going on now from 2006 still going up (Radetzki, M.,2006).

In 2001, the imports into the United States fell by US\$79 billion, or 6.3%,to US\$ 1,180 billion. The reduction of US demand for foreign product had a significant influence to the world economy. As a result, the economic growth of the major trading partner of US has declined abruptly; the slowdown rate of growth is from 24% to 91% mostly to the newly industrial countries. Japan, Taiwan, Korea, and Singapore all were having two digit drops in export. China fared best with only a 9% reduction in growth. Global commodity market heat significantly started at 2001 which is continuing still, due to the fall of demand by the US market immediately the commodity fuel decreased but non fuel increased (Duncan, R. 2003)¹². So it is obvious that the dollar was overvalued and it creates many problems into the world economy, since it has established as standard of stable monetary unit. At 1982, Bergsten et al. (p.1) (into Frankel,1993) warned:

The dollar is overvalued by at least 20 percent.....These imbalances are as great as those in the final, breakdown stage of the Bretton Woods system of Fixed Exchange rates. They add significantly to national growth problems, both in countries with overvalued countries (which suffer competitive losses) and the countries with undervalued currencies (which are driven to adopt restrictive monetary policies).

Source: Frankel, 1993 (pp.135)

All this warn turn out to be truth by the test of correlation with different researcher. P. Hua (1998) derive the conclusion from the econometric result on the hypothesis; the stationary long-run relationship between the levels of commodity prices and the levels of economic activities and real effective exchange rate of dollar cannot be rejected. From the result it can be confirmed equilibrium adjustment in commodity price to macroeconomic monetary shocks through a feedback mechanism which illustrate the source of coincidence of non-oil primary commodity price variations with the fluctuations of economic activities and he real effective exchange rate of dollar over the last 2 decades. To analyse the result on the theoretical basis he mentioned the economic environment to favour the increase of commodity price are the downturn of the US dollar, the low level of interest rate, and the increase of economic activities both in the developed and developing countries.

¹² Duncan, R.(2003), Global Recession: Why, When, and How Hard? In John Wiley & Sons (Asia) Edition, *The Dollar Crisis: Causes, Consequences,Cures* (pp 184-186).

In the recent most significant change in the commodity market by the price of food grain is overwhelming which heats most to the developing economy world. If we look at the monthly average data at Appendix-III, table-5 and graph-8, we can see that as long as the rate of dollar in exchange of euro decreased the price of oil and rice increased. This became tested by the degree of relationship at table-6; both the price of oil and the rice is negatively correlated with the dollar rate. Simultaneously, both the commodity have positive correlation among themselves. This indicates increase of one commodity has significant influence to the overall commodity market. Apparently, as the dollar depreciated 41% against euro during January 2001 to April 2008, but the price of grain increased almost 4 times. According to Meera (2008)¹³, the recession of the US economy made the equity and bond markets unattractive for investment, thereby causing money to leave these financial market and flow into the commodity markets. This is the reason for what the price of all commodities across the board to soar, thereby causing the food crisis all over the world.

4.4 Dollar Index, Oil price and Inflation effect

Dollar Index began to fall in April, 1933 and there were extensive international trade with US and different countries of the world. Zagroff (1978), investigated in his paper the internal and external price of dollar; he admitted in small extant that fall of dollar has influence not only into the price disparity but also fall of external price of dollar may effect on the fall of another country currency. He explained that when the currency like dollar depreciates there is the higher probability to enter more commodities into international trade and of having a greater volume of export. The outflow of goods and inflow of money will then tend to bring about a rise in the general price (Zagroff, 1978).

Since the collapse of Bretton Wood, United States having cumulative current account deficits by last 3 decades. Consequently as the dollar enters into the banking system and reach to the other countries current account where there is surplus with the United States, it set in motion in process of credit creation. That creation of credit backed only by paper reserves has generated a world wide credit bubble characterised by economic overheating and severe *asset price inflation*. But during the gold standard trade balances were both unsustainable and self-correcting. They were unsustainable due to the recessionary pressure they brought about in the deficit country. At the same time, they were self correcting through changes in the relative prices between the countries (Duncan, 2003).

Due to dependency on the US dollar, a real depreciation of dollar would increase the world commodity prices accepted by many scholar like, Ridler and Yandle (1972) , Sachs (1985), Dornbusch (1985), Radetzki (1985), Côté (1987), Adams and Vial (1988), Gilbert (1989), Hua and Collange (1994). In compare to the past record of inflation in recent boom, the aggregate commodity index reached a peak due to the higher influence of energy price. The energy index, reaching almost 200 at its peak,

¹³ Meera,AKM,(2008), Weak dollar and the global food crisis, *The Edge*, June 9,pp 54.

recorded as strongest price increase where the dominant category is the oil (Radetzki,2006).

Oil price remained at very high level still first quarter of this 2008, despite virtually full capacity utilization by OPEC. According to Meera (2008), the reason of this oil peak is because oil is priced in dollar, anything which is measured in dollar would go up as the currency falls in values. He analysed, the global fuel and food inflation is the price the world pays for accepting and international unit that is dollar possess no intrinsic value of its own. On the other hand, the deficits of US is being subsidised by the rest of the world with the high inflation than the normal rate. Even countries that peg their currencies facing the same; for which the oil exporting gulf is having double digit inflation as well.

4.5 Influence of Dollar Index and Commodity to change Price of World Stock Indexes

The currency of US and their excessive debt creation causes asset price bubbles, deflation, and systematic banking crisis around the world. Their major trading partners are in slow pace of their economic growth. Stock markets spiraled downward, commodity market volatile and government finances came under strain. In some commodity market like real estate, non mineral commodity fell by price which is two-third of the commodity market. The price of fats and oil, timber, fertilizer, metal and mineral were under pressure at 2000. Price of grain and other food increased heedlessly. The stock market at 2001 were a disaster, share price fell 10 out of 14 in the market. At August 2002, 12 out of 14 markets were experiencing loss, even Japan's stock market fell by half. Germany, France, Brazil, India, and the Netherlands fell by more than 40% and US, UK and Spain dropped by one-third (Duncan,2006).

So stock market has significant sensitivity to the exchange rate, particular against the international rate of USD. Nakamura and Small (2007), tested the correlation in variability of stock indices and exchange rates and they concluded that the financial market is not independent it varies on the exchange rate from the return of EUR/USD, GBP/USD and JPY/USD. Moreover, they illustrated that there is a triangular arbitrage opportunity into foreign exchange market and that generates an interaction with the capital market.

Due to the increase in the commodity price and fall of dollar and subprime effect people are sort of reluctant to invest into money market. As a result the money is flowing in into the commodity market which is boosting the price and weakening the commodity market. If we look at the more focused commodity that is oil; Hammoudeh and Li (2004) tested that there is a negative bi-directional dynamic relationship between the oil future price growth and the return of the world capital market as represented by Morgan Stanley Capital International (MSCI). They interpreted that higher oil price is negative for world capital market as a whole. So from there conclusion there is a probability of effect on growth of Islamic Banking as this is also a part of the Financial Market.

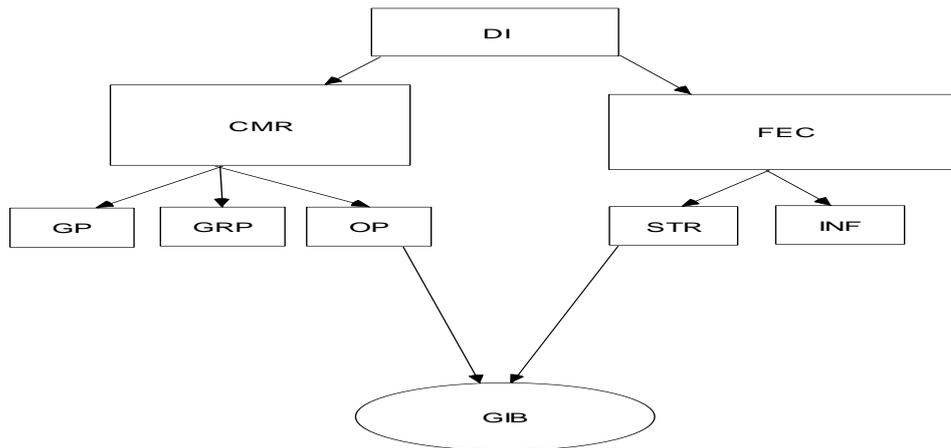
Summary Findings of the channel and factors to fuel the Islamic Banking

From the above existing flow of the factors if we sort out the events, we can draw the following flow which is influencing the growth of Islamic Banking. The first and foremost problem starts from the collapse of International Monetary unit, which took place due to many long term chronological factors into US with the rest of the world. Following these crises the value of dollar falling which created abnormal inflation rate all over the world. As dollar is the so called stable monetary unit, so in such extent whatever will be priced in dollar will be highly inflated. So the most effected area is the overall commodity market, which includes the major and inevitable commodities like food grain, gold, oil etc. On the other hand, starting from the dollar crisis the position of money market became volatile due to different incidents like subprime effect and getting defaulted by the big traditional banks.

The stock market return became negative and unattractive to the investors due to heavy fluctuation and low return or loss. Eventually, the investor became more attracted to the commodity which requires meeting the daily needs like food grain, oiling price etc. This causes many third world countries declared food shortage, which is just created out of transferring the debt of US to the other nation of the world. Due to the highly inflation and weak purchasing power in compare to increase of inflation appears unable to make the food grain available to all countries. So this causes the investment and money supply for oil as significant commodity also increasing notably. And this is the area where is the probability of sound transaction through the channel of Islamic Banking to increase and smoothening its growth.

So at the Figure-1 it has been shown pictorially that when the dollar index will fluctuate by value, it will affect the commodity market as a whole and the world financial economy. In the commodity market the most significant commodities are picked to observe like grain price, gold price and the oil price. On the other hand the stock market return and world inflation representing the condition of world financial economy. Finally the growth of the Islamic banking has channelled through the increased price of oil, as it is largely explored from the Muslim majority geographic area and the opportunity of the fluctuating the traditional financial market to move the investors into equity based Investment.

Figure 1 : Dollar, Oil price and the growth of Islamic Banking. (Here, DI=Dollar Index , CMP= Commodity Market Price, GP= Gold Price, GRP= Grain Price, OP= Oil Price, FEC= Financial Economy, INF= Inflation, STR= Stock Market Return, GIB= Growth of Islamic Banking.)



Conclusion

In this era of energy, money and power the world economy is very much volatile with its current politics of oil, inflation and exchange rate risk. Specially, Oil is the most widely traded assets by value and volume which is named as “hydrocarbon economy”. From the study, it has been more precisely examined that the cash and future prices for crude oil along with other traded commodities have a positive correlation. So the significant effect of oil price and dollar crisis on the global economy is going to be analysed in this report by the different channel. Global politics is very much influential through the ownership of great wealth like oil which changing the history from the beginning till now. This paper aims to represent the analysis of the influence of oil and other economic factors of world economy to the growth of Islamic banking and finance. This research is the initial attempts to precede further the accuracy of quantitative prove for investigating the dissected pros and cons to boost the shariah based financial system.

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Appendices

APPENDIX-I

Table 1-Total Asset, deposits and financing of Islamic banking system

| | 1997 | 1998 | 1999 | As at end of | | | |
|-----------------------------|----------|----------|----------|--------------|----------|----------|----------|
| | | | | 2000 | 2001 | 2002 | 2003 |
| Total assets RM' million | 17,881.3 | 21,183.1 | 33,558.7 | 42,725.3 | 55,605.4 | 63,321.9 | 77,390.6 |
| Full-fledged Islamic bank | 5,202.1 | 5,698.4 | 11,724.2 | 14,008.9 | 17,404.8 | 20,159.6 | 20,929.7 |
| Islamic windows: | | | | | | | |
| Commercial bank | 9,078.0 | 11,385.2 | 15,589.1 | 20,058.5 | 27,026.1 | 29,109.8 | 36,830.0 |
| Finance company | 2,924.4 | 3,321.4 | 4,806.1 | 7,149.9 | 9,821.6 | 12,622.9 | 17,915.1 |
| Merchant bank | 676.8 | 778.1 | 1,439.3 | 1,508.0 | 1,352.9 | 1,429.6 | 1,715.8 |
| Total deposits RM' million | 9,895.2 | 15,172.1 | 23,695.7 | 33,650.7 | 44,743.8 | 49,553.9 | 55,919.7 |
| Full-fledged Islamic bank | 3,223.4 | 4,039.7 | 9,685.2 | 11,301.6 | 14,375.6 | 16,421.2 | 17,583.7 |
| Islamic windows: | | | | | | | |
| Commercial bank | 5,153.2 | 8,415.2 | 10,576.0 | 16,089.4 | 22,031.0 | 23,353.9 | 26,518.7 |
| Finance company | 1,170.2 | 2,110.7 | 3,033.1 | 5,392.6 | 7,663.7 | 9,094.6 | 10,965.6 |
| Merchant bank | 348.4 | 606.5 | 401.4 | 867.1 | 673.5 | 684.2 | 851.7 |
| Total financing RM' million | 10,749.4 | 10,461.1 | 13,723.7 | 20,816.1 | 28,317.6 | 36,717.7 | 48,615.4 |
| Full-fledged Islamic bank | 3,350.7 | 3,471.4 | 5,029.5 | 6,423.4 | 7,671.0 | 9,158.2 | 9,764.5 |
| Islamic windows: | | | | | | | |
| Commercial bank | 4,705.8 | 4,702.8 | 4,920.5 | 8,533.6 | 12,257.6 | 16,706.4 | 22,324.3 |
| Finance company | 2,189.9 | 1,878.4 | 2,995.5 | 5,089.8 | 7,617.4 | 10,049.6 | 15,745.8 |
| Merchant bank | 503.0 | 408.5 | 778.2 | 769.3 | 771.6 | 803.5 | 780.8 |

Table 2-A grouping of major Islamic Bank of the world.

| | |
|--------------|--|
| Saudi Arabia | Islamic Development Bank Al Baraka Investment & Development Co. ICIEC |
| Kuwait | Al Rajhi Banking & Investment Corporation Kuwait Finance House The International Investor |
| Bahrain | ABC Islamic Bank (E.C) Faysal Islamic Bank of Bahrain |
| Jordan | Jordan Islamic Bank |
| Sudan | Al Baraka Bank |
| UK | Dallah Al Baraka |
| Switzerland | Faisal Finance Dar Al Maal Islami Group |
| Malaysia | Bank Islam |
| Indonesia | Bank Muamalat Takaful Islamic Insurance International |
| India | Al-Falah Investment Ltd Al Ameen Islamic Fin & Development Corporation |
| USA | Amana Mutual Funds Trust American Finance House, LARIBA Bank Failaka Investments Inc. Takaful USA MSI Financial Services Corporation Manzil USA |

Source: Islamic Finance (2003)

Source: Mokhter, H.S.A, Abdullah, N. & Alhabsi, S.M.(2008), "Efficiency and competition, of Islamic banking in Malaysia", *Humanomics*, Vol,24,No,1,pp28-48.

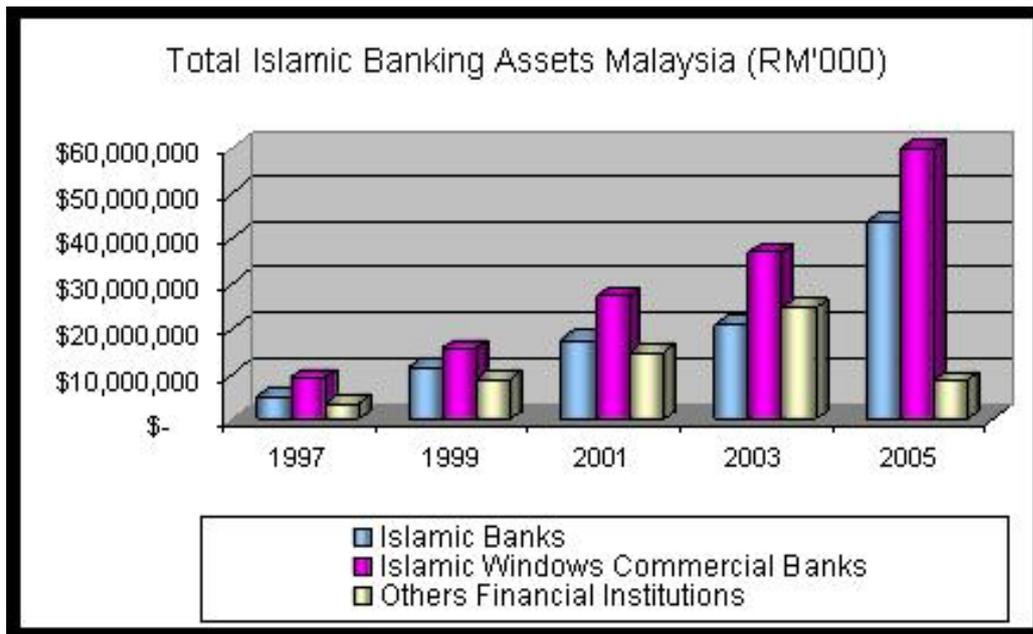
APPENDIX-II

Table 3- Asset and Financing as indicator for the changes of recent year in Islamic Banking of Malaysia.

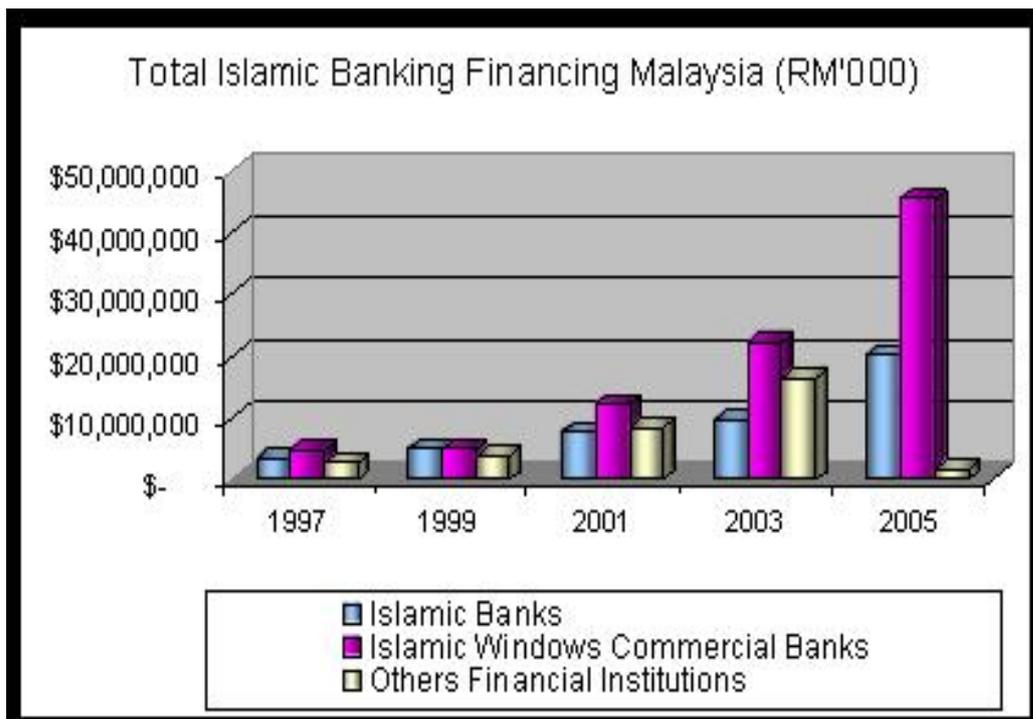
| | RM million | | Change (%) |
|--|------------|---------------|------------|
| | End-2006 | End-June 2007 | |
| Assets | 133,003.9 | 143,697.6 | 8.0 |
| Deposits | 99,176.4 | 107,467.7 | 8.4 |
| of which: | | | |
| Investment | 64,136.8 | 71,133.9 | 10.9 |
| Savings | 11,096.0 | 12,029.6 | 8.4 |
| Demand | 20,525.2 | 19,491.9 | -5.0 |
| Others | 3,418.4 | 4,812.2 | 40.8 |
| Financing | 78,518.3 | 81,532.1 | 3.8 |
| of which: | | | |
| Primary agriculture | 2,996.5 | 2,970.1 | -0.9 |
| Manufacturing (including agro-based) | 8,333.5 | 9,229.6 | 10.8 |
| Wholesale and retail trade, hotels and restaurants | 3,885.3 | 3,864.6 | -0.5 |
| Finance, insurance and business activities | 2,930.1 | 3,184.8 | 8.7 |
| Household sector | 50,339.6 | 51,737.5 | 2.8 |

Source: Bank Negara Malaysia.

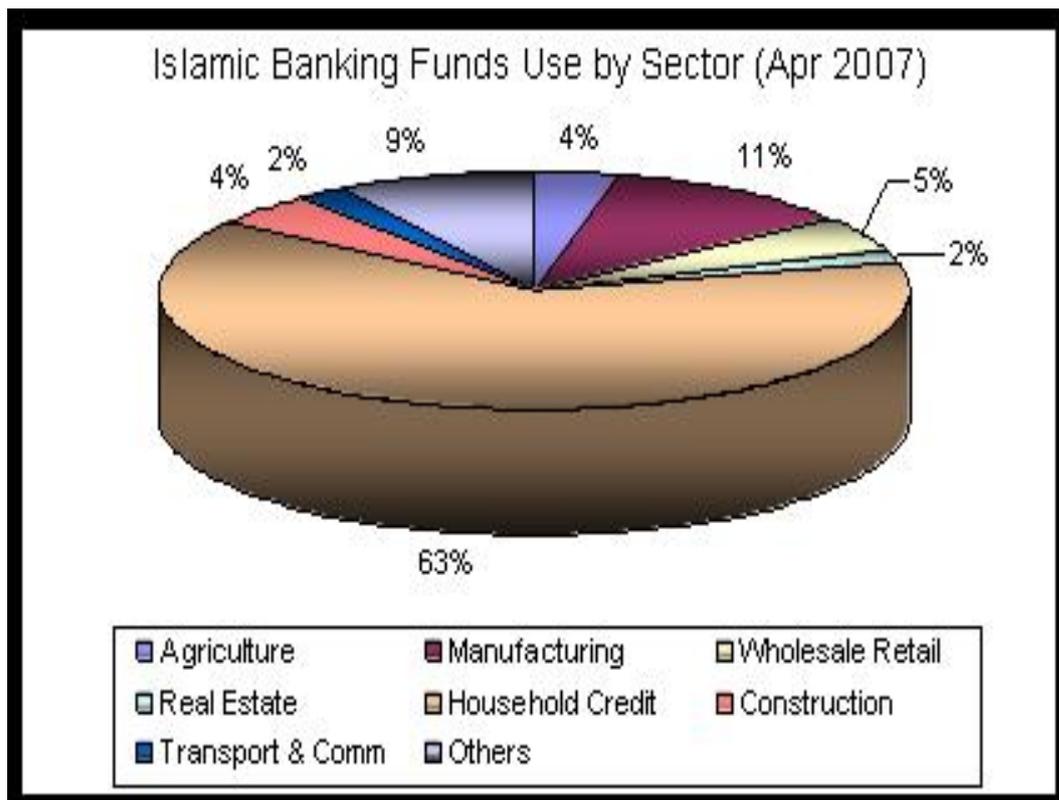
Graph 1- Islamic Banking by the Total Asset in Malaysia (1997-2005)



Graph 2- Islamic Banking by the Total Financing in Malaysia (1997-2005)

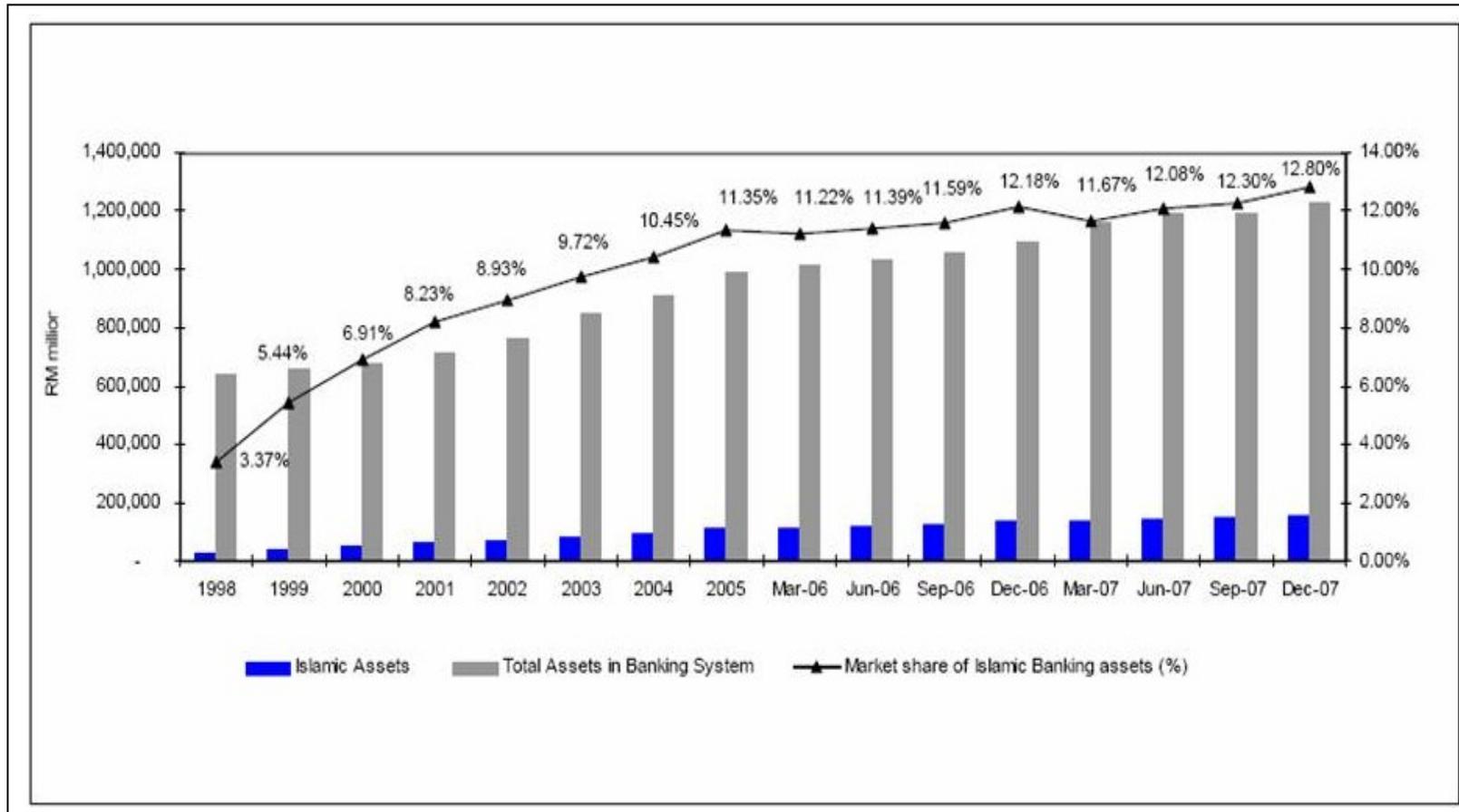


Graph 3- Sectors using the fund of Islamic Banking in Malaysia (April 2007)



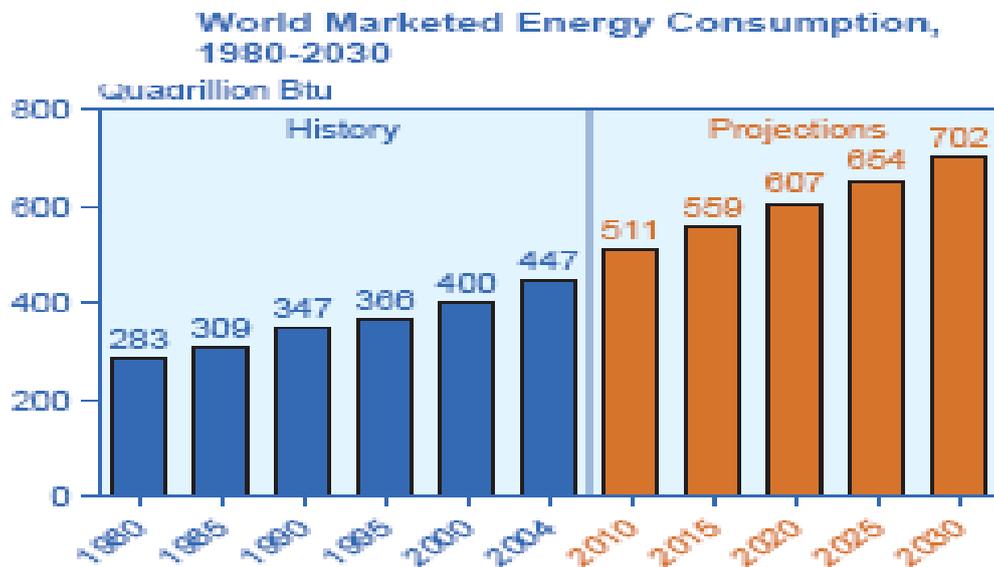
Source: <http://islamicbankers.wordpress.com/islamic-banking-statistics/> retrieved at 12/06/08.

Graph 4- Growth percentage by the market share of Islamic Banking Assets (1998-December, 07)



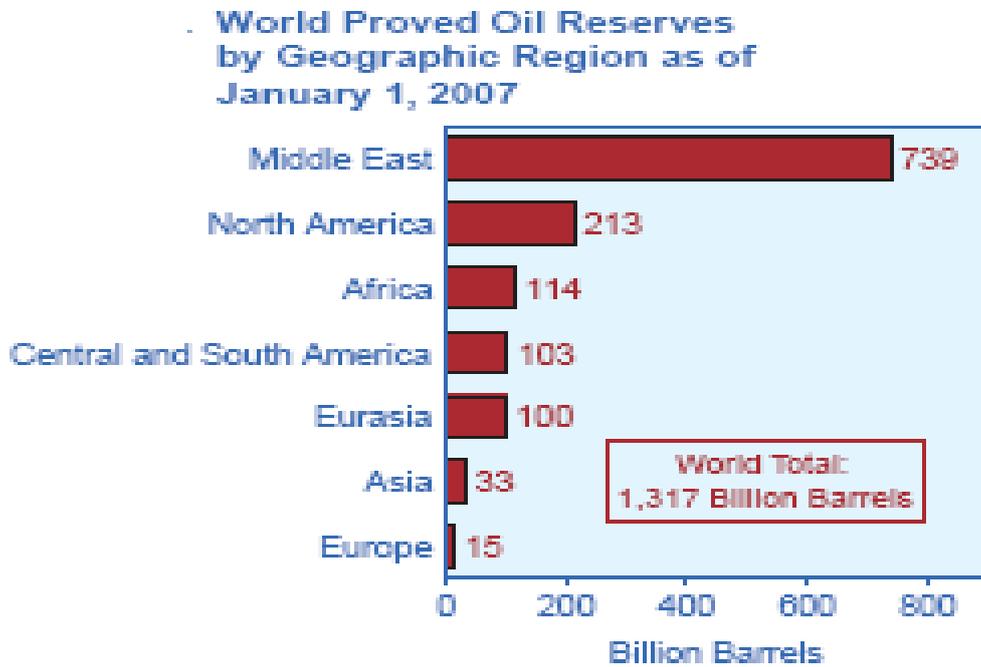
APPENDIX-III

Graph 5- The prediction of increasing demand for energy, from 1980 to 2030



Sources: History: Energy Information Administration (EIA), *International Energy Annual 2004* (May-July 2006), web site www.eia.doe.gov/iea. Projections: EIA, *System for the Analysis of Global Energy Markets* (2007).

Graph 6- Oil reserve by the Geographical Region



Source: "Worldwide Look at Reserves and Production," *Oil & Gas Journal*, Vol. 104, No. 47 (December 18, 2006), pp. 24-25.

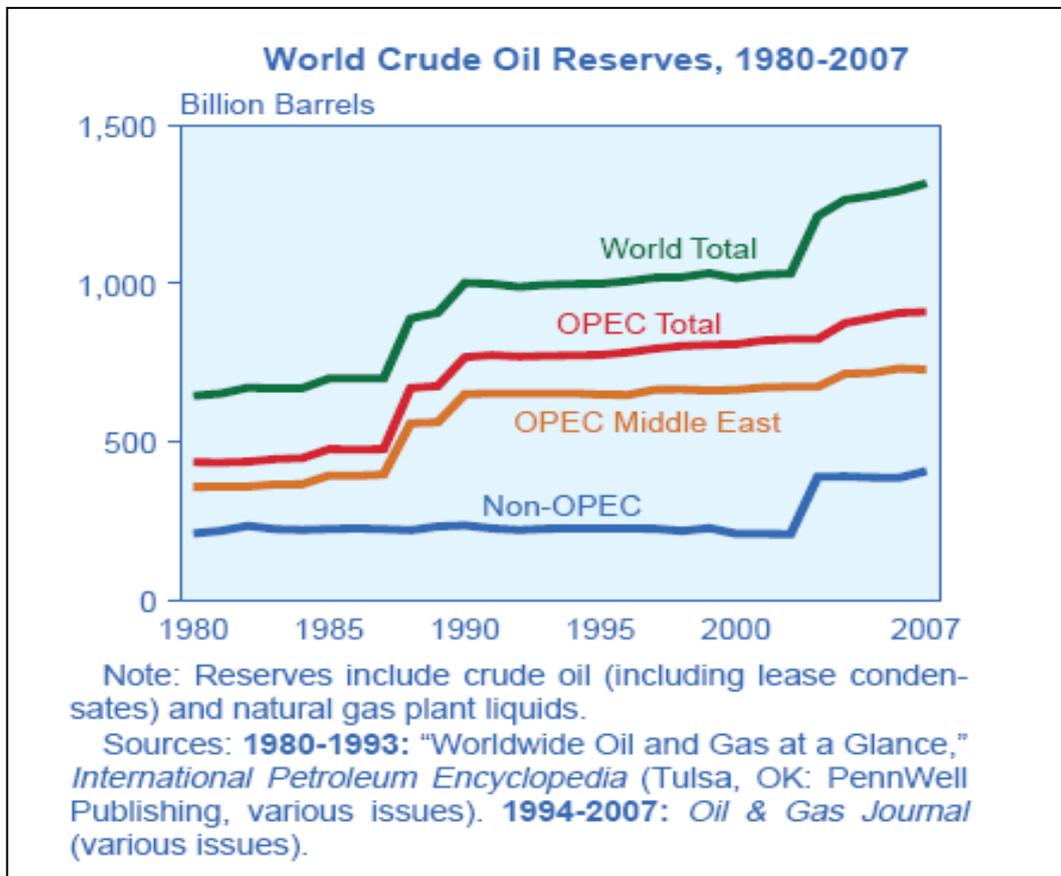
Table 4- World's top oil reserve countries

**World Oil Reserves by Country as of
January 1, 2007
(Billion Barrels)**

| Country | Oil Reserves |
|-------------------------------|----------------|
| Saudi Arabia | 262.3 |
| Canada | 179.2 |
| Iran. | 138.3 |
| Iraq. | 115.0 |
| Kuwait | 101.5 |
| United Arab Emirates. | 97.8 |
| Venezuela | 80.0 |
| Russia | 60.0 |
| Libya | 41.5 |
| Nigeria | 36.2 |
| Kazakhstan | 30.0 |
| United States. | 21.8 |
| China | 16.0 |
| Qatar | 15.2 |
| Mexico | 12.4 |
| Algeria | 12.3 |
| Brazil | 11.8 |
| Angola | 8.0 |
| Norway. | 7.8 |
| Azerbaijan | 7.0 |
| Rest of World. | 65.5 |
| World Total. | 1,317.4 |

"Worldwide Look at Reserves and Production," *Oil & Gas Journal*, Vol. 104, No. 47 (December 18, 2006), pp. 24-25.

Graph 7- The segregation total oil reserve by the regional block



APPENDIX –IV

Table 5- Date for the dollar rate in exchange of Euro, Price of oil and rice by US dollar

| Year | Month | Euro/\$rate | Price of rice | Price of oil |
|------|-------|-------------|---------------|--------------|
| | | | Us\$/tonne | US\$/barrel |
| 2001 | Jan | 1.06 | 184 | 29.59 |
| 2002 | Jan | 1.13 | 192 | 19.71 |
| 2003 | Jan | 0.94 | 201 | 32.95 |
| 2004 | Jan | 0.79 | 213 | 34.31 |
| 2005 | Jan | 0.76 | 287 | 46.84 |
| 2006 | Jan | 0.83 | 291 | 65.49 |
| 2007 | Jan | 0.77 | 315 | 54.51 |
| 2008 | Jan | 0.68 | 376 | 92.97 |
| | Feb | 0.68 | 465 | 95.39 |
| | Mar | 0.65 | 594 | 105.45 |
| | Apr | 0.63 | 907 | 112.58 |

Graph 8- Trend of oil and rice with the trend of dollar exchange

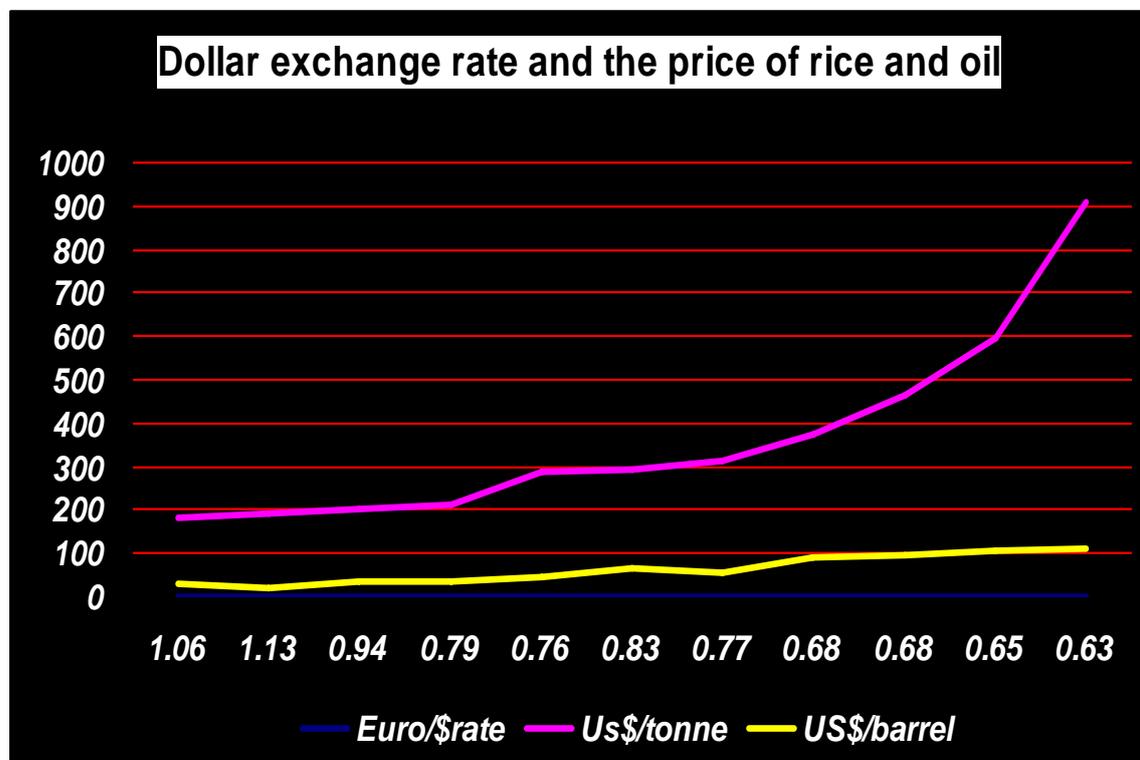


Table 6- Tested correlations with the three variables (Dollar rate, Oil price & Price of Rice)

Correlations

| | | DOLL | OIL | Rice |
|-------------|----------------------------|------------------|------------------|-----------------|
| DOLL | Pearson Correlation | 1 | -.860(**) | -.717(*) |
| | Sig. (2-tailed) | | .001 | .013 |
| | N | 11 | 11 | 11 |
| OIL | Pearson Correlation | -.860(**) | 1 | .874(**) |
| | Sig. (2-tailed) | .001 | | .000 |
| | N | 11 | 11 | 11 |
| Rice | Pearson Correlation | -.717(*) | .874(**) | 1 |
| | Sig. (2-tailed) | .013 | .000 | |
| | N | 11 | 11 | 11 |

**** Correlation is significant at the 0.01 level (2-tailed).**

*** Correlation is significant at the 0.05 level (2-tailed)**

