Working Paper No. 555

Financial Stability: The Significance and Distinctiveness of Islamic Banking in Malaysia

by

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January 2009

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ABSTRACT

This paper explores the significance of Islamic banking in Malaysia for stability in the country's economy as a whole. Neither conventional theory nor Islamic economics puts forward a systematic explanation of financial intermediation; consequently, neither is capable of identifying destabilizing elements in the system. Instead, a flow- of-funds approach similar to Minsky's own is applied to the (post-) modern consumption-led) business cycle and financial (and asset) market.

Malaysia's structural current account surplus contributes to the overcapitalization of domestic firms. This in turn finances a financial (as opposed to an industrial), consumption-led (instead of investment-led) business cycle, where banking favors destabilizing asset price inflation. Islamic banks operating interdependently with conventional ones contribute to economic destabilization channeling surplus funds from the corporate to the household sector.

Keywords: Credit, Islamic Banking, Financial Stability
JEL Classification: E44, E32, P5, Z12

I. INTRODUCTION

Islamic banking is perceived to be at its "tipping point" turning from a niche market phenomenon into a mainstream product (BBC 2005, 2006, Credit Suisse 2006). Although the total international assets of Islamic banks — estimated at 0.5% of the world's banking assets (The Economist 2008) — are still marginal, growth rates are phenomenal especially in the Middle East and Southeast Asia.

Yet, Islamic banking still seems incomprehensible to Western economists. As discussed in section 2 due to the prohibition of interest and collateral, Islamic banking is hardly reconcilable with Western economic theory dominated by the asymmetric information paradigm. Islamic scholars, however, claim that it is superior to conventional banking due to (1) the morality of the *homo Islamicus* surmounting moral hazard and adverse selection problems, (2) the developmental character promoting growth and wealth redistribution and most importantly, (3) the inherent stability of Islamic banking in reducing economic fluctuations and reoccurring crisis. Section 3 shows that these claims are questionable.

This paper explores the significance of Islamic banking in Malaysia for stability of the domestic economy as a whole. Neither conventional theory nor Islamic economics — which surprisingly do not differ significantly in their methodological approach — offers a suitable methodology. Both fail to put forward a systematic explanation of financial intermediation and are consequently incapable in identifying destabilizing elements in the system.

Section 4 shows that Malaysia's structural current account surplus causes the over-capitalization of domestic firms. This in turn results in the emergence of a financial (as opposed to an industrial), consumption-led (instead of investment-led) business cycle where banking favors destabilizing asset price inflation. Islamic banks operating inter-dependently with conventional ones contribute to economic destabilization channeling surplus funds from the corporate to the household sector, feeding asset inflation.

The paper's application of financialization and excess capitalization to the Malaysian economy is groundbreaking since it extends both theories — originally developed for advanced economies — to emerging markets. Thereby, it exposes key links between asset inflation and the banking system under special consideration of Islamic banks. The paper reveals the hitherto undiscussed dynamic interaction between the Islamic and the non-Islamic economy in Malaysia. It shows how Islamic banking contributes to asset inflation in the economy. Due to Malaysia's international integration, this interaction is paramount since

the country is a paradigm of the financial structures into which Islamic banking is emerging globally. In this way, the paper contributes toward the understanding of Islamic banking as a financial phenomenon providing a systemic account — incorporating a macroeconomic as well as a microeconomic analysis — of its functioning and economic significance.

II. ISLAMIC BANKING IN CONVENTIONAL ECONOMIC THEORY

Banks are understood in a generic sense as financial intermediaries. Their main task is to provide indirect finance — in contrast to direct finance through financial markets. Households, business firms, the government and foreigners can in principle possess a surplus or a deficit in funds and consequently supply or demand credit. However, households are identified as most important "lender-savers" while businesses and the government are the major "borrower-spenders" (Mishkin and Eakins 2006; 18). Typically, economic analysis deals initially with a simplified setting of a closed economy without government and only subsequently loosens these restrictions. Banks are understood to channel surplus funds from the household sector into the corporate sector facing a deficit, as it invests more than internal or direct finance would allow for. Hence, banks play a vital role in the economy enabling more productive investment than would be possible merely on the basis of profits and financial market funds. So far Western and Islamic understandings of banking do not differ significantly.[1] Major differences become apparent examining the rationale, explaining why financial intermediaries exist.

An asymmetric information understanding of the functioning of banks must lead to the conclusion that Islamic banks are not viable. The distinguishing features of these banks are the prohibition of charging or paying interest, the impermissibility of demanding collateral and, to a small extent, compulsory charitable spending (Khan and Mirakhor 1992; Dhumale and Sapcanin 2004). This does not mean that Islamic banks are constrained to be non-profit organizations. Profit merely has to be generated by primary and secondary modes of Islamic finance (Chapra 2000a). Primary modes include profit-sharing arrangements such as *mudharabah* (partnership) and *musyarakah* (equity participation).[2]

[1] Consensus in Islamic economics regards banks as financial intermediaries, mobilizing savings from the public and making advances to entrepreneurs (Siddiqi 1981).

[2] Three partners can be identified in an Islamic finance contract: the depositor, the bank and the borrower. Concerning the supply of savings and capital, there is the depositor entering either into a not remunerated safeguarding agreement or into a remunerated partnership agreement with the bank. While the bank is not obliged to share profits with holders of current or savings deposits it must encash these deposits on demand. Investment and special investment accounts are entitled to a share in profit but typically demand a long-term commitment and also a share in losses.

Concerning the demand for finance, the entrepreneur receiving credit is only liable as to her time and effort invested. The profit (or loss) is shared at a predetermined ratio between the bank and the entrepreneur. While in the case of *mudharabah* projects the bank does not possess any direct influence on the investment a *musyarakah* arrangement entitles it to rights of the type a joint venture partner possesses (Chapra 2000a; Dhumale and Sapcanin 2004; Van Greuning and Iqbal 2008). Secondary financing modes are meant to take a subordinate position since they are essentially mark-up pricing or leasing arrangements, and in that sense not "truly Islamic" because there is less emphasis on the productive element of the investment (Sundararajan and Errico 2002; 18; Chapra 2000a). As to the supply side of funds, depositors can choose to put their savings into demand deposits, which are held by the bank possibly against a fee without yielding any return, or into *mudharabah* deposits, which generate a profit depending on the bank's financing (Van Greuning and Iqbal 2008).

It is the prohibition of interest *combined* with the common belief that banks channel funds towards productive investment, which makes Islamic banking and Western economic theory inconsistent with each other. The supply price of credit disappears in a profit-and-loss sharing (PLS) framework because the absolute profit is not known to the bank until the investment is realized. A predetermined return to the lender, dependent on the borrowing period and independent of the borrower's uncertainty, is not permissible under Islamic banking.[3] Hence, primary modes of Islamic banking are incomprehensible for Western economists using models with a supply price for credit. This might explain why there is little genuine Western theory applied and developed. Alternatively, many attempts exist to make Islamic banking resemble conventional banking schemes. This includes the claim that the majority of Islamic lending has a debt-like character (Aggarwal and Youssef 1996).[4] The above theoretical conception of banking and the phenomenon of Islamic banking are very much reconcilable for secondary modes of Islamic finance resulting in predetermined debt servicing, which in fact constitute the majority of Islamic banking transactions and in Malaysia almost their totality (table 2.1).

[3] Mostly, it is genuine uncertainty that the entrepreneur faces since an investment project – especially greenfield investment – entails too many unknowns to generate probabilities for all possible outcomes and in that way to turn it into quantifiable risk.

[4] This observation makes Islamic banking fit nicely into the New Keynesian paradigm again. Given the uncertainty of PLS arrangement and asymmetry of information, it is arguably rational for Islamic banks to use debt-like instruments in order to reduce moral hazard and the destabilizing effect of an uncertain interest rate. Such reasoning reveals that the New Keynesian approach is firmly rooted in the GE framework.

Table 2.1: The Islamic Banking System in Malaysia — Major Financing Concepts as % of Total Islamic lending

Year	2001	2002	2003	2004	2005
Primary Modes of Finance (Mudharabah & Musyarakah)	1.40%	0.70%	0.50%	0.50%	0.30%
Other Islamic Concepts (Bai' Bithaman Ajil, Ijarah, Ijarah Thumma Al-Bai', Istisna', Murabahah & other Islamic Concepts)	98.60%	99.30%	99.50%	99.50%	99.70%

Source: BNM, Annual Reports, 2001-2005.

III. ISLAMIC BANKING IN ISLAMIC ECONOMIC THEORY

As far as Islamic scholars are concerned Islamic banks should engage primarily in PLS activities (Chapra 2000a; Siddiqi 1981, 1983). They, but also an increasing number of Western economists, regard Islamic banking to be superior to conventional banking. This superiority manifests itself in three aspects:

(1) The morality of the *homo Islamicus*. Despite some dissent expressed[5] the abolition of interest from all financial transactions in Islamic finance constitutes the orthodox and consensual view of Islamic scholars (Khan 1985; Chapra 2000a). The rationale behind this prohibition does not need to be questioned from an Islamic perspective, since it is demanded by the Qur'an. The absence of interest constitutes the moral dimension of Islamic economics (Chapra 2006). Morality is inherent to the *homo Islamicus* whose values do not tolerate the injustice of charging interest. Injustice in the case of interest on consumption credit results from the exploitation of the needy and on production credit from the absence of sharing the uncertainty embodied in every enterprise. Obviously, Islamic economic teaching adheres to the idea of "natural law" providing a society that is just and unexploitative. "Natural law", however, implies the universal nature of humanity, society, and economy excluding the possibility of their evolutionary development.

(2) The developmental character of the Islamic economic system. The developmental dimension of Islamic economics does not merely center on high or optimum growth rates but explicitly refers to social welfare including need fulfillment and full employment (Chapra

[5] See for example El-Gamal (2006).

2006; Lewis and Algaoud 2001). This dimension also possesses an aspect of justice because the notion of development embraces a (more) equitable wealth distribution. *Zakat*, an Islamic compulsory contribution towards charity, and Muslim inheritance law are the main instruments of redistribution (Khan 1968). Yet, *zakat* is typically fixed at a level of approximately 2.5% of unused savings, which justifies severe doubts as to its redistributive nature (Lewis and Algaoud 2001). As it is not mandatory for invested funds *zakat* might exert an inflationary effect on commodity or capital markets because it penalizes investors' liquidity preference, favoring funds inflow into assets perceived as highly liquid such as *sukuk*, Islamic bonds. This observation raises stability issues.

(3) Increased stability. Financial and economic stability is perceived to be an original feature of the Islamic economic system conceptually ensured by morality, development and a relatively equitable wealth distribution and practically by the abolition of interest and promotion of wealth redistribution in accordance with divine law.

These three dimensions simultaneously reflect the objectives and the characteristics of the Islamic financial system. In the following, this study focuses on the theoretical consequences for the banking sector of these dimensions.

III.1. The Moral Dimension Of Islamic Economics

Interestingly, the Islamic economy in its ideal state does not differ from an Arrow-Debreu economy (Arrow and Debreu 1954) concerning lending and borrowing. The information and incentive alignment problems that New Keynesians stress are addressed referring to behavioral norms.[6] Leading Islamic economists mainly criticize the concept of the *homo economicus* in neoclassical economics. The moral dimension of Islamic economics is regarded to be the discipline's *raison d'être* (Siddiqi 2000; Chapra 2000b). In the ideal Muslim community collateral would not be needed since religious norms prevent moral hazard problems from arising. Equally, the existence of asymmetric information would not be relevant since trust among borrowers and lenders would align borrowers' and lenders' interests through PLS perceived to be fair by both sides. Consequently, the economy of perfect competition, information and market clearing is a parallel world to the perfect Muslim community (Dar and Presley 1999). In both worlds, neither a premium for external

[6] Such reasoning is in fact not unique to Islamic thought as Max Weber's work on the Protestant ethic demonstrates. Weber argued that in modern Europe Protestants – as opposed to Catholics – own an over—proportional share of capital since their religious values call for diligence and fulfilment of obligations in their worldly and especially professional life (Weber 1969).

finance nor collateral is necessary to reach the socially optimal level of lending and borrowing.

However, the assumption that credit supply is infinitely elastic — reflected in the horizontal credit supply curve — is questionable in models where Islamic banks are required to hold 100% reserves for demand deposits. [7] Here, only funds held in investment and special investment deposits are allowed to be transformed into loans. Banks' discretionary disposal of credit is consequently limited. In these models credit rationing can arise if more funds are demanded than available from investment deposits. This might explain why the majority of Islamic scholars seem to follow a fractional-reserves system.

III.2. The Developmental Dimension Of Islamic Economics

The similarity of the Islamic economic system with the Arrow-Debreu economy leads to the claim that Islamic finance is developmental since more investment will be undertaken than under financial repression — at least in a fractional-reserves framework (Dhumale and Sapcanin 2004). Arguably, the supply of funds will increase with the establishment of Islamic banks because faithful Muslims were previously reluctant to place their savings in interest-bearing deposits. Increased savings are in turn perceived to raise growth rates due to the savings-growth nexus (Chapra 2006). Yet, even in developed countries self-confessed Muslims often seem unaware of Islamic finance options (Dar and Presley 1999) and can therefore be almost certainly assumed to possess conventional bank accounts. The idea that rising savings automatically lead to increased investment and growth finds its origins in hydraulic growth models such as the Harrod-Domar one (Harrod 1939; Domar 1946). Despite being discredited on grounds of over-simplification and bad empirical performance the conviction — inherent in these models — that causality runs from savings to investment is still present in economic theory. Yet, as John Maynard Keynes pointed out investment determines savings and not the other way around (Fontana 2003).

The existence of similarities between Islamic banking and microfinance further nurture the idea that the former is inherently developmental. Doubtlessly elements of microfinance can be considered consistent with the broader goals of Islamic banking (Ferro 2005). Conceptually, enterprise and social welfare occupy a central role in Islamic economic thinking just as in microfinance (Chapra 2000a; Siddiqi 1981; Iqbal and Khan 1981; Grameen Bank 2008). Practically, a common feature is the absence of collateral usually demanded for conventional credit. Instead many microcredit lending schemes are

[7] Mainly models based on Monzer Kahf's work (Khan 1985).

significantly based on social networks and trust, especially in traditionally organized communities. It is claimed that this kind of "character-based" lending is also behind Islamic lending (Dhumale and Sapcanin 2004). Furthermore, the fact that microfinance institutions like the Grameen Bank are accepted in Islamic countries such as Bangladesh is interpreted as evidence for the developmental character of Islamic banking (UN-HABITAT 2005). Whether these observations suffice to establish that Islamic banking is developmental is contestable, as section 4 will show. Islamic banking and microfinance definitely share the conviction that credit is primarily designated to finance productive investment rather than consumption. In this light, the discovery that borrowed funds are mainly used to satisfy consumption needs might be the paramount commonness.

III.3. The Stability Dimension Of Islamic Economics

Since stability is one of the main — if not the single main — preoccupations of Islamic economics, existing literature on the topic is extensive. This paper reviews the most salient Islamic arguments in light of their Western counterparts starting with microeconomic considerations and moving towards increasingly comprehensive macroeconomic theory of economic instability.

Given the dominance of interest-based banking, some Islamic economists address the question whether a financial system based on PLS would be stable and could perform as well as an interest-based one. Since Islamic financial systems on a national level emerged only in the late 1970s[8] answering might have been impeded by the absence of real examples against which theory could be verified. Yet, M. Ali Khan and M. Nejatullah Siddiqi, using a GE framework, assert that Islamic finance is stable. However, according to Iqbal and Khan the work refuting the destabilizing possibility of *ex ante* undetermined credit price presented by their fellow Islamic economists was merely intuitively convincing while lacking the formal rigor of GE analysis (Iqbal and Khan 1981).

As to the supply side of financial funds, Waqar Massod Khan, applying a microeconomic partial equilibrium analysis, claims to show formally that Islamic lending schemes are superior to non-Islamic ones. Calculating the expected utility from a variable rate of return (the Islamic and thus equity contract) and the expected utility from a fixed one (the non-Islamic and thus debt contract) the former is higher and will be preferred by the lender. A paradox arises because of the factual prevalence of an interest/debt-based banking system. Reasons are given in the form of tax deducibility — meaning governmental

[8] In 1979 in Iran and Pakistan and in 1984 in Sudan (Khan and Mirakhor 1989; Central Bank of Sudan 2008).

distortions of the price mechanism — and incentive and information based explanations (Khan 1985).

Considering the demand side of financial funds, it is argued that Islamic banks are more run-proof than conventional ones. If the bank value declines there is supposedly less incentive to withdraw funds invested on a PLS base (Lewis and Algaoud 2001). Nonetheless, a substantial loss in funds would force the bank to withdraw already granted loans if it does not hold 100% reserves. Given the favorable conditions granted to *mudharabah* clients enabling them to withdraw funds on short notice[9], an already expected fall in profitability could cause a bank run since competing conventional banks might offer a higher (interest) return.

A recent IMF working paper suggests that Islamic banks are indeed stronger than conventional ones but only if their assets do not exceed US$1 billion (Cihak and Hesse 2008). As to large banks — those exceeding US$1 billion in assets — conventional ones prove to be more stable according to the IMF. Such a result fits neatly into the asymmetric information paradigm, which is acknowledged by many Islamic scholars.[10] The IMF study implies that small banks can operate on the principle of "character-lending" possessing a manageable amount of borrowers whom they can assess monitor and control effectively meaning collateral might be unnecessary. As the number of borrowers increases, such a business model, based on intense generation of information, becomes inefficient. Hence, the typical policy recommendation from the Bretton Woods and other institutions evolves around improving banking regulations in order to increase transparency.[11] The result of this IMF study appears to be more grounded on New Keynesian presumptions than on reliable facts. Methodologically, the work is more than dubious. The paper assesses bank stability via the so-called z-score. Using data from the commercial BankScope database it calculates the z-score summing up equity capital, reserves as percent of assets and the bank's average return as percent of assets dividing this sum by the standard deviation of return on assets. The calculated ratio represents the "number of standard deviations a return realization has to fall in order to deplete equity" (Cihak and Hesse 2008; 7). The higher the z-score the more stable a bank is believed to be. The study is based on observations from 20 countries including 77 Islamic and 397 commercial banks for the period 1993 to 2004. Using panel

[9] Often a notice of one month suffices (Cihak and Hesse 2008).
[10] Arguably, to counter possible incentive problems Islamic banks are required to gather more information than conventional banks. This, however, is perceived as potential strength and comparative advantage of Islamic banks towards their conventional counterparts (Lewis and Algaoud 2001).
[11] See for example Sandararajan and Errico 2002 and Hassan, Shanmugan and Perumal 2005.

data, observations across time and countries are treated equally.[12] This methodology is even more problematic since the term "bank" appears to be understood generically. But countries with different regional and developmental backgrounds as those making up the sample are very likely to define banks differently. Furthermore, in the case of Islamic banking the problem of fungibility occurs. Islamic banks in mixed financial systems such as in Malaysia are in some cases subsidiaries of conventional banks. Hence, their profitability is hard to measure independent of the conventional bank's profit since funds are likely to be transferred between the holding company and the subsidiary. Although such a practice is usually forbidden under legislation regulating Islamic banking, the problem is undeniable when Islamic banks do not even possess separate balance sheets from their mother companies. Consequently, the regression undertaken by Martin Cihak and Heiko Hesse is questionable, which seems to be reflected in the results since the z-scores calculated were statistically significant in a sample of large Islamic banks only (Cihak and Hesse 2008). This did not stop the authors drawing conclusions from the statistically insignificant and methodologically questionable study.

As to the macroeconomic perspective, W. M. Khan considers the work of a wide range of Western economists to support his microeconomic case against interest and the inherently unstable fractional-reserve banking system, most prominently Friedrich A. von Hayek and Milton Friedman (Khan 1985). [13] It is peculiar that Khan refers to such distinctly different theoretical approaches. It explains, however, why he does not elaborate on them. While Friedman[14] advocated a 100%-reserves system for commercial banks (Friedman 1959) but was generally convinced that exogenous shocks — and not interest rate changes — altering the quantity of money in the economy contributed substantially towards economic disturbances, Hayek presented a more elaborated theory of the trade cycle. For him the idea that the disturbing influence of money only emerges with changes in the price level — as pronounced by Knut Wicksell — was extremely naive (Hayek 1929). PLS financing modes could indeed eliminate disturbances in Wicksell's economic theory since

[12] On the one hand, the sample contains high-income countries such as the United Arab Emirates and on the other hand, least developed countries such as Gambia and Mauritania. Countries with a completely Islamized financial system such as Iran, Pakistan, and Sudan are present together with countries like Malaysia where Islamic banking exists alongside conventional banks.

[13] Henry C. Simons – who had an important influence on Hyman Minsky – is also cited by W. M. Khan. Simons advocated the abolition of fractional—reserve banking in order to prevent economic and social chaos since he regarded a discretionary management of currencies by state authorities as dangerous rulelessness (Simons 1934).

[14] Friedman can be regarded to write in a Wicksellian tradition starting from an equilibrium position and considering changes in the quantity of money. But contrary to Wicksell, Friedman did not attribute any importance to the rate of interest.

the disturbing influence emanates from the misalignment of interest charged by banks and the marginal productivity of capital (Wicksell 1907). If interest — as in PLS arrangements — is paid in the form of a share of the actual profit, the real rate and the money rate of interest would always be equal. Economic fluctuations à la Wicksell would be substantially smaller under PLS finance because the equivalent of the money rate of interest would always adjust to the marginal return on capital.

Nonetheless, Wicksell's analysis did not concentrate on the actual source of the trade cycle focusing on interest instead of money and credit creation. According to Hayek, the reason for the shortcomings in Wicksell's work lies in the marginalist methodology applied regarding the interest rate as the price equilibrating supply of savings and demand for credit — the loanable funds theory (Hayek 1929). In reality, growing economies can be observed to possess interest rates below those equilibrating demand and supply of funds since the former exceeds the latter. Credit is created above the level of savings supplied. Economic up- and downswings are due to misalignments between the equilibrium rate and the money rate of interest caused by changes in the volume of effective money present in the economy. However, credit expansion and subsequent contraction is understood as endogenous to the financial system and cannot be remedied (Hayek 1929).

In contrast to Khan, Hayek did not advocate the elimination of credit. Without credit businesses are completely exposed to the destabilizing effects of the household saving leakage. Therefore, Islamic scholars, in their majority, advocate fractional-reserve banking put forward by Siddiqi, Uzair and Ahmed (Siddiqi 1983; Khan 1985).[15]

[15] Based on Monzer Kahf and others some Islamic economists such as Masudul Alam Choudhury and Mohammad Ziaul Hoque advocate 100%—reserve banking until today (Choudhury and Hogue 2004). The authors assume that stabilization in the fractional—reserve system is undertaken by the central bank using the reserve ratio. Furthermore, reserves are positively correlated with interest rates "in that as the savings increase with higher interest rate the central bank reserve increases by the amount of the new deposits" (Choudhury and Haque 2004; 166). Monetary policy attempting to stabilize the economy can be pursued via an increase in the interest rate and/ or the reserve ratio. Using both channels will lead to monetary contraction. The quantity of money — and its difference — is assumed to be positively related to the demand for investment or spending — and their differences — and negatively to the reserve ratio. Hence, the attempt to increase reserves via a rise in interest rates will in fact affect reserves adversely due to monetary contraction.

Such an understanding of the economy is highly hydraulic trying to establish automatic causalities from savings to investment. The financial system is reduced to the central bank whose policy options are limited to changes in reserve ratios and interest rates. Financial institutions, such as commercial banks whose reserves and willingness to engage in the interbank market determines the degree of liquidity present in an economy, are left out completely. Applying methodological individualism and reducing the financial system to a central bank with tightly circumscribed financial options Choudhury and Hoque follow the present consensus on monetary policy expressed by Michael Woodford in his "Interest and Prices" (Woodford 2003). However in Woodford's model, the main policy instrument of central banks is the setting of the interest rate. Hence, some economists perceive the abolition of interest to weaken monetary policy (Iqbal and Mirakhor 1987). Econometric analysis by M. M. Metwalli (Metwalli 1989) shows that interest rate manipulation is impotent as a policy tool. The question why changes in reserve ratio requirements should be a more potent policy — especially since in their understanding the ratio would have to remain unchanged at 100% – remains open.

The latter, Shaikh Mahmud Ahmad, took up Keynes's concept of the marginal efficiency of capital to explain why interest rates destabilize the economy and cause cycles of booms and busts (Ahmad 1952). Keynes recognized that the money rate of interest impedes investment, production, and full employment.[16] Yet according to Ahmad, Keynes failed to draw the decisive conclusion that could eliminate economic crisis: the abolition of interest. This is because Keynes understood interest as inherent to every commodity not only money. It is composed of the output an asset produces minus its carrying cost and plus its liquidity premium, the amount of money individuals are willing to pay for the convenience to possess the commodity. Money is a unique commodity since it is the only one for which the liquidity premium exceeds the carrying cost by definition. Therefore, the money rate of interest is the determinant rate of interest (Keynes 1936).[17] Replacing interest entirely by PLS would mean that return on money did not include the liquidity premium. This would under certain conditions — as in a liquidity trap — either deter agents to put funds into Islamic investment accounts since they would lose liquidity or transfer the liquidity premium from demand deposit holders to the Islamic bank.

Ahmad's proposition is supported by Muhammad Akram Khan and Sayyid Abdul A'la Mawdudi's ideas. It is argued that depression and stagnation occur because interest rate payments introduce an imbalance between production and consumption. Wealth and purchasing power are transferred from the debtor to the creditor. By definition the former has a higher propensity to consume. Hence, while demand for consumption goods decreases, since the debtor has to serve interest payments on the debt, supply increases as the creditor is assumed to invest the funds obtained into production. In the case of entrepreneurial credit, debt servicing causes prices for consumption goods to rise, which again transfers funds from those with a relatively high propensity to consume to those with a relatively low one (Khan 1968; Siddiqi 1981). Evidently, this analysis introduces consideration about the income distribution within society showing that high income inequality can be destabilizing. Ahmad's work explicitly refers to John A. Hobson and Thorstein Veblen (Ahmad 1952). However, while Hobson identified high income inequality levels favorable to speculation and the emergence of a rentier class living of unearned profit (Hobson 1938) — Veblen's "Captains of Industry" (Veblen 1904) — as economically destabilizing, according to Ahmad

[16] "The money rate of interest by setting the pace for all the other commodity rates of interest, holds back investment in the production of these other commodities without being capable of stimulating investment for the production of money, which by hypothesis cannot be produced" (Keynes 1936; 235).
[17] "There is no remedy but to persuade the public that green cheese is practically the same thing and to have a green cheese factory (i.e. central bank) under public control" (Keynes 1936; 235).

the sheer existence of interest is destabilizing. It encourages unproductive and speculative activity making capital for productive undertakings consequently scarce. Interest is seen to play a role in bringing about economic crisis. During a boom period credit expansion takes place and due to interest payments the marginal cost of production increases. Profit rises and, while wages stagnate, productive and speculative investment increases raising capital demand for both kinds of investment. Increased capital demand in turn pushes interest rates upwards, squeezing profit margins. Over-confidence is understood to cause over-production. Recognizing that more production is financed than the volume that promises returns, the central bank increases interest rates. Commercial banks follow with a raise in interest rates and furthermore, try to withdraw loans. Confidence falls and consumption is postponed exacerbating the economic downturn (Ahmad 1952).

Yet, it is unclear what the systemic causalities behind booms and busts are. Mohamed Ariff sums up accurately stating that none of the Islamic scholars "really succeeded in establishing a causal link between interest, on the one hand, and employment and trade cycles, on the other (Ariff 1988; 50).

Since interest rates influence the debt servicing for a given project and consequently its costs, the mere existence of debt in the form of interest is perceived to be destabilizing (Chapra 2000a). Hence, Islamic banking arguably eliminates a source of volatility through PLS since financial commitments are undertaken on an interest-free and long-term basis aligning financial obligations and accrual of profit (Siddiqi 2000, 2002).

It can be at least doubted whether a PLS-based credit system will be more stable than a debt-based system particularly because debt proves to possess stabilizing influence on the financial system. In a situation of overcapitalization, a steady inflow of funds into stock and real estate markets can inflate those markets increasing the fragility of the economic system as a whole (see section 4). Debt obligations can merely inflate to a limited extent since they are characterized by a maturity span and an underlying fixed value (Toporowski 2000). Assets, in contrast, can inflate substantially. In the case of Islamic banking (and PLS arrangements) this inflation is especially destabilizing since investment deposit holders exercise control over their funds invested also bearing the investment risk usually absorbed by banks. If excepted Islamic return is low, investors can withdraw their funds on relatively short notice. This means inflation of asset markets is stopped abruptly and reversed into deflation. In times of crisis, an ad hoc switch to non-Islamic investment can cause a greater fall in asset prices causing even greater losses for those investors who do not withdraw deposited funds.

Generally, Islamic economic thought seems to differ significantly from Western thought merely on one aspect: the *homo Islamicus* maximizing his profit in a moral way compliant with the Qur'an. Despite the great repertoire of Islamic analysis concerning economic stability the methodology applied does not differ fundamentally from Western economics.[18] A mere reduction to individual choice and a focus on trust and its betrayal — also characteristic of the New Keynesian approach — cannot provide a comprehensive theory of the workings of the economy. Nonetheless, a comprehensive theory is essential in identifying factors destabilizing to the system. Islamic economics contributes little original thought towards the question of economic stability and mainly borrow from Western economic theory since economic and financial instability are phenomena of Western economies rather than the societies from which the doctrine of Islamic banking emerged. Those borrowed concepts are often absorbed superficially resulting in the intuitive claim of a superior Islamic alternative.

Typically Islamic banking does not exist in isolation from conventional finance. It is crucial to place Islamic finance in the context of domestic and global economic and financial flows dominated by non-Islamic finance. Minsky's methodology (Minsky 1986) and its developments by Toporowski (2000) offer a systemic way to analyze financial sector dynamics examining the flow of funds. This makes it superior to New Keynesian approaches based on restrictive assumptions about markets subject to information, moral sentiments, or data manipulation.

[18] This claim can be reinforced by pointing toward the vast literature produced by economists, sociologists and political economists on bounded rationality and collective action, which allow for individual motivations other than the exclusively selfish, materialistic ones of the *homo economicus* (Weber 1969, Elster 1989). Hence, the assumption of a morally guided individual can be hardly claimed as unique to Islamic economics.

IV. ISLAMIC BANKING IN MALAYSIA FROM A SYSTEMIC PERSPECTIVE

In an open economy without government activity the saving identity takes the following shape (Steindl 1989, Toporowski 2008):

$$S \equiv S_H + S_F \equiv I + (X — M) \qquad (1)$$

where S = total saving,

S_F = retained profits of firms,

I = gross investment

$(X — M)$ = trade surplus.

Thus, retained profits are composed of the sum of investment and the foreign balance minus household saving:

$$S_F = I + (X — M) — S_H \qquad (2)$$

In an economy which possesses a structurally positive foreign balance due to the dominance of export-oriented corporations such as in Malaysia the saving leakage is less likely to induce "enforced indebtedness" (Steindl 1989) because it is off-set by a balance of payments surplus.[19]

In the international setting the surplus of one country constitutes the deficit of another one as Steindl points out (Steindl 1989). The case of emerging markets is interesting since many of them — particularly China, India and Southeast Asia — are accumulating vast balance of payments surpluses. But these surpluses are typically held in US$ or US-treasury bonds. Hence, although emerging markets seem powerful in exporting commodities or (relatively low-skill) manufactured goods, it is the developed world that dominates the international financial architecture. Simultaneously, financialization is the most advanced aspect of globalization[20]. Thus, emerging markets face international financial institutions

[19] If $(X – M)$ is positive, retained profits (S_F) increase. In corporations listed on the stock exchange this means that firm's assets and its liabilities to the shareholders grow. Since shareholders are mainly interested in selling shares at a higher price it is logical that their main focus lies on the firm's balance sheet, which is commonly regarded as indicator of its profitability. Increased liabilities to the shareholders will bring the firm under pressure to constantly improve its balance sheet. As productive investment only generates income in the long run, financial operations are more suitable to meet expectations of increased profitability. Hence, a structural balance of payments surplus might favor the accumulation of further excess capital.

[20] Globalization refers in economic terms to the increase in and liberalization of international factor movements — i.e. finance, trade, and migration.

that are determined by the financially advanced countries and are to a big extent forced to copy those institutions in the course of financial catching-up. In this context, Islamic banking is an interesting phenomenon since it explicitly tries to break with the Western financial dominance banning interest. The question is whether the autonomous development of this market segment — for a long time regarded as niche market — is possible. The answer might differ for financially isolated countries such as Iran and internationally integrated ones such as Malaysia. This paper reviews the latter case.

The role banks, and more specifically Islamic banks, play in the modern setting highly depends on the purpose of their activity. It can no longer be assumed that funds simply flow from households to firms since households engage in investment activities and firms hoard funds in the form of excess capital. Therefore, it is necessary to analyze the origin and direction of bank lending to assess its overall impact on economic stability.

Islamic banking in Malaysia exposes key economic and financial issues in Islamic banking. Malaysia possesses a comprehensive Islamic banking and financial system including an Islamic capital market, insurance companies, savings and developmental finance institutions. Simultaneously, non-Islamic companies are allowed to offer Islamic products. Furthermore, Malaysia is an export- and foreign direct investment (FDI)-oriented country and therefore strives to ensure openness towards the international economic and financial system. Consequently, Malaysia's domestic and international conditions make the country a paradigm of the effects that Islamic banking and international finance exert on each other. Hence, although this study focuses on the significance of Islamic banking for Malaysian economic stability it can be taken as an indicator of the role Islamic banking will play in international finance once it leaves its niche.

Malaysia possesses a structural current account surplus as is shown in table 4.1. This surplus grew constantly during the last 10 years from RM36.8 billion in 1998 to RM91 billion and an estimated RM93 billion in 2007. Admittedly, the years 2000, 2001, and 2002 are exceptions when the surplus fell to around RM30 billion. Nonetheless, with a GDP of RM642 billion in 2007 the estimated surplus accounts for an impressive 14.5% of GDP (Department of Statistics Malaysia 2008). Malaysia's international trade position is determined by its large commodity exports — particularly rubber, palm oil and forestry products — which in turn are a legacy of fertile land and the colonial past. Remarkably, the private sector holds at least two thirds of the foreign surplus. In 2005 and 2006, private corporations and households together actually received 86.2% and 77.8% of the non-financial balance surplus.

Table 4.1: Flow of Funds (in RM billion)

Year		1998	1999	2000	2001	2002	2003
Sector	**Transactions**						
Public Sector	Disposable Income	72.5	80.5	92.7	96.4	113.5	129.5
	Consumption	-28.5	-33.5	-36.2	-42.9	-50	-54.9
	Investment	-32	-34.5	-43.6	-48.8	-53.7	-57.2
	Change in Stocks	0.2	-0.2	-2.1			
	Balance	12.2	12.4	10.8	4.7	9.8	17.3
Private Sector	Disposable Income	186.8	192.4	211.8	204.4	211.5	232.9
	Consumption	118.1	-124.8	-145.2	-150.6	-159.5	-172.4
	Investment	44.3	-32	-43.5	-34.5	-30.1	-29.9
	Change in Stocks	0.2	-0.2	-2	3.7	-1.3	2.8
	Balance	24.6	35.5	21.1	23	20.7	33.5
Non-Financial Balance		36.8	47.9	31.9	27.7	30.5	50.8
Rest of the World	Exports of Goods and Services	-325.3	-365.4	-427.5	-389.3	-415	-450.6
	Imports of Goods and Services	263.3	290.1	359.5	327.8	348.9	367.9
	Net Factor Payment Abroad	15.3	20.9	28.6	25.6	25.1	22.5
	Net Transfers	9.8	6.5	7.5	8.2	10.6	9.3
	Balance	-36.8	-47.9	-31.9	-27.7	-30.5	-50.8

Table 4.1: Flow of Funds (in RM billion) - continued

Year		2004	2005	2006	2007
Sector	**Transactions**				
Public Sector	Disposable Income	131.1	n/a	n/a	n/a
	Consumption	-59.3	n/a	n/a	n/a
	Investment	-53.4	n/a	n/a	n/a
	Change in Stocks		n/a	n/a	n/a
	Balance	18.4	8.8	20.2	29.2
Private Sector	Disposable Income	279.3	n/a	n/a	n/a
	Consumption	-192.8	n/a	n/a	n/a
	Investment	-38.4	n/a	n/a	n/a
	Change in Stocks	-10	n/a	n/a	n/a
	Balance	38.2	67.2	70.8	63.8
Non-Financial Balance		56.5	76	91	93
Rest of the World	Exports of Goods and Services	-545	-611	-668	-726
	Imports of Goods and Services	449.3	495	540	595
	Net Factor Payment Abroad	24.5	24	20	22
	Net Transfers	14.6	17	17	16
	Balance	-56.5	-76	-91	-93

As equations (1) and (2) show a positive foreign deficit can result in domestic firms' overcapitalization. Nevertheless, households may be the main beneficiaries of the surplus instead of companies. In order to shed light on the question whether Malaysian firms are overcapitalized the balance sheets of a representative sample of large Malaysian companies will be examined. Since large non-financial companies typically undertake the bulk of fixed capital investment and not SMEs the 25 companies holding the largest stocks at the Kuala Lumpur Stock Exchange (KLSE) by market value are considered (Bloomberg 2008). Public Bank, Malayan Banking, Bumiputra Commerce Holding, RHB Capital, AMMB Holdings, and Hong Leong Bank being financial companies are excluded from the list. Furthermore, Genting Group, PETRONAS, and YTL Corporation all figure twice in the list due to their subsidiary structure. Only the group as a whole will be considered. From the remaining sample of 16 firms 14 publish financial statements with annual reports on their websites. UMW Holdings — number 25 in the list of largest stocks by market value — is excluded since the firm's financial statements are available only for one year.

For the 13 companies assets and liabilities are considered. Excess capital is typically held in marketable securities and short-term investment but also as deposits, cash equivalents, and bank and cash balances. Table 4.2 shows total assets (1.) and total liabilities (2.) — which are equal by definition — as well as banking and financial assets (3.) of the representative firms. The most interesting parameter for this paper's purpose is, however, the calculated percentage of banking and financial assets as share of total liabilities (4.). In marginalist theory companies hold liquid assets only to the extent that marginal revenue covers marginal cost of capital. This implicitly assumes that banks mainly generate profit via the interest rate spread that exists between the interest rate paid on deposits (borrowing) and that received from credit servicing by firms (lending). Liability management by companies (and banks) leading to speculative return on liquid assets — deriving from the increase in value of financial assets — is excluded (Toporowski, 2008). Hence, in the marginalist worldview it is costly for firms to hold banking and financial assets. The only reason to do so is to meet unexpected needs of the production process.

Table 4.2: Financial Accumulation of the Largest Malaysian Quoted Companies Since 1998 (in RM'000)

Year	1998	1999	2000	2001	2002	2003	2004
Sime Darby Berhad							
1. Total Liabilities	n/a	n/a	n/a	n/a	n/a	14,738,600	15,537,900
2. Total Assets	n/a	n/a	n/a	n/a	n/a	14,738,600	15,537,900
of which							
3. Banking and Financial Assets[1]	n/a	n/a	n/a	n/a	n/a	2,676,000	2,862,900
4. Banking and Financial Assets as % of Total Liabilities	n/a	n/a	n/a	n/a	n/a	18.16%	18.43%
IOI Corporation Berhad							
1. Total Liabilities	n/a	n/a	n/a	4,664,676	5,599,268	7,579,723	8,845,950
2. Total Assets	n/a	n/a	n/a	4,664,676	5,599,268	7,579,723	8,845,950
of which							
3. Banking and Financial Assets[2]	n/a	n/a	n/a	431,559	505,688	501,896	697,907
4. Banking and Financial Assets as % of Total Liabilities	n/a	n/a	n/a	9.25%	9.03%	6.62%	7.89%
Tenaga Nasional Berhad							
1. Total Liabilities	n/a	n/a	47,573,100	54,584,800	57,065,500	59,956,500	63,381,600
2. Total Assets	n/a	n/a	47,573,100	54,584,800	57,065,500	59,956,500	63,381,600
of which							
3. Banking and Financial Assets[3]	n/a	n/a	827,800	918,000	1,164,700	2,801,800	4,220,300
4. Banking and Financial Assets as % of Total Liabilities	n/a	n/a	1.74%	1.68%	2.04%	4.67%	6.66%
MISC Berhad							
1. Total Liabilities	n/a	n/a	n/a	n/a	n/a	14,726,303	22,355,514
2. Total Assets	n/a	n/a	n/a	n/a	n/a	14,726,303	22,355,514
of which							
3. Banking and Financial Assets[4]	n/a	n/a	n/a	n/a	n/a	1,034,758	1,859,018
4. Banking and Financial Assets as % of Total Liabilities	n/a	n/a	n/a	n/a	n/a	7.03%	8.32%

[1] Cash held under housing evelopment accounts, bank balances, deposits and cash.
[2] Short term funds, deposits with financial institutions, cash and bank balances.
[3] Short term investment, marketable securities, deposits, bank and cash balances.
[4] Marketable securities, cash, bank deposits and bank balances.

Table 4.2: Financial Accumulation of the Largest Malaysian Quoted Companies Since 1998 (in RM'000) - continued

Year	2005	2006	2007	2008
Sime Darby Berhad				
1. Total Liabilities	16,235,000	17,539,400	19,555,800	n/a
2. Total Assets	16,235,000	17,539,400	19,555,800	n/a
of which				
3. Banking and Financial Assets	2,618,000	3,212,400	4,718,600	n/a
4. Banking and Financial Assets as % of Total Liabilities	16.13%	18.32%	24.13%	n/a
IOI Corporation Berhad				
1. Total Liabilities	10,505,059	10,311,686	13,680,842	n/a
2. Total Assets	10,505,059	10,311,686	13,680,842	n/a
of which				
3. Banking and Financial Assets	1,968,767	1,230,370	2,735,195	n/a
4. Banking and Financial Assets as % of Total Liabilities	18.74%	11.93%	19.99%	n/a
Tenaga Nasional Berhad				
1. Total Liabilities	63,494,800	65,092,100	67,724,600	n/a
2. Total Assets	63,494,800	65,092,100	67,724,600	n/a
of which				
3. Banking and Financial Assets	2,871,400	3,971,500	5,322,500	n/a
4. Banking and Financial Assets as % of Total Liabilities	4.52%	6.10%	7.86%	n/a
MISC Berhad				
1. Total Liabilities	25,431,412	27,623,105	27,916,771	n/a
2. Total Assets	25,431,412	27,623,105	27,916,771	n/a
of which				
3. Banking and Financial Assets	4,377,381	3,429,556	2,218,415	n/a
4. Banking and Financial Assets as % of Total Liabilities	17.21%	12.42%	7.95%	n/a

Table 4.2: Financial Accumulation of the Largest Malaysian Quoted Companies Since 1998 (in RM'000) - continued

Year	1998	1999	2000	2001	2002	2003	2004
Genting Group Berhad							
1. Total Liabilities	8,340,100	9,438,800	9,300,800	10,221,100	11,445,800	14,207,400	16,596,500
2. Total Assets	8,340,100	9,438,800	9,300,800	10,221,100	11,445,800	14,207,400	16,596,500
of which							
3. Banking and Financial Assets[1]	1,872,300	2,392,500	1,393,500	2,241,400	2,895,700	4,384,600	5,912,700
4. Banking and Financial Assets as % of Total Liabilities	22.45%	25.35%	14.98%	21.93%	25.30%	30.86%	35.63%
Petroliam Nasional Berhad (PETRONAS)							
1. Total Liabilities	n/a	n/a	109,019,218	124,681,979	129,325,952	159,629,322	182,222,266
2. Total Assets	n/a	n/a	109,019,218	124,681,979	129,325,952	159,629,322	182,222,266
of which							
3. Banking and Financial Assets[2]	n/a	n/a	45,604,970	53,734,478	51,335,830	64,586,315	67,584,624
4. Banking and Financial Assets as % of Total Liabilities	n/a	n/a	41.83%	43.10%	39.69%	40.46%	37.09%
DiGi Telecommunication Berhad							
1. Total Liabilities	n/a	n/a	2,077,263	2,410,361	3,008,517	3,247,432	3,580,082
2. Total Assets	n/a	n/a	2,077,263	2,410,361	3,008,517	3,247,432	3,580,082
of which							
3. Banking and Financial Assets[3]	n/a	n/a	211,473	157,663	245,672	338,516	634,719
4. Banking and Financial Assets as % of Total Liabilities	n/a	n/a	10.18%	6.54%	8.17%	10.42%	17.73%
Kuala Lumpur Kepong Berhad							
1. Total Liabilities	n/a	n/a	n/a	3,738,122	4,071,108	4,524,442	4,896,361
2. Total Assets	n/a	n/a	n/a	3,738,122	4,071,108	4,524,442	4,896,361
of which							
3. Banking and Financial Assets[4]	n/a	n/a	n/a	426,759	409,686	606,545	636,264
4. Banking and Financial Assets as % of Total Liabilities	n/a	n/a	n/a	11.42%	10.06%	13.41%	12.99%

[1] Restricted cash, short term investments, bank balances and deposits.
[2] Cash, fund investment and other investment, other current assets.
[3] Cash and cash equivalents.
[4] Cash and cash equivalents.

Table 4.2: Financial Accumulation of the Largest Malaysian Quoted Companies Since 1998 (in RM'000) - continued

Year	2005	2006	2007	2008
Genting Group Berhad				
1. Total Liabilities	18,553,700	28,224,700	30,178,900	n/a
2. Total Assets	18,553,700	28,224,700	30,178,900	n/a
of which				
3. Banking and Financial Assets	6,079,100	8,078,300	9,745,300	n/a
4. Banking and Financial Assets as % of Total Liabilities	32.76%	28.62%	32.29%	n/a
Petroliam Nasional Berhad (PETRONAS)				
1. Total Liabilities	214,389,358	252,481,519	290,348,806	361,292,900
2. Total Assets	214,389,358	252,481,519	290,348,806	361,292,900
of which				
3. Banking and Financial Assets	92,450,151	111,438,309	127,509,930	161,257,949
4. Banking and Financial Assets as % of Total Liabilities	43.12%	44.14%	43.92%	44.63%
DiGi Telecommunication Berhad				
1. Total Liabilities	4,232,319	4,123,031	3,877,491	n/a
2. Total Assets	4,232,319	4,123,031	3,877,491	n/a
of which				
3. Banking and Financial Assets	1,182,962	869,549	577,144	n/a
4. Banking and Financial Assets as % of Total Liabilities	27.95%	21.09%	14.88%	n/a
Kuala Lumpur Kepong Berhad				
1. Total Liabilities	3,556,813	5,692,760	7,003,292	n/a
2. Total Assets	3,556,813	5,692,760	7,003,292	n/a
of which				
3. Banking and Financial Assets	644,754	460,471	495,634	n/a
4. Banking and Financial Assets as % of Total Liabilities	18.13%	8.09%	7.08%	n/a

Table 4.2: Financial Accumulation of the Largest Malaysian Quoted Companies Since 1998 (in RM'000) - continued

Year	1998	1999	2000	2001	2002	2003	2004
PLUS Expressway Berhad							
1. Total Liabilities	n/a	n/a	n/a	16,796,338	9,980,384	10,478,293	10,782,763
2. Total Assets	n/a	n/a	n/a	16,796,338	9,980,384	10,478,293	10,782,763
of which							
3. Banking and Financial Assets[1]	n/a	n/a	n/a	562,954	930,057	1,251,499	1,371,263
4. Banking and Financial Assets as % of Total Liabilities	n/a	n/a	n/a	3.35%	9.32%	11.94%	12.72%
PPB Group Berhad							
1. Total Liabilities	n/a	n/a	4,958,795	5,211,283	5,338,335	5,805,156	6,133,912
2. Total Assets	n/a	n/a	4,958,795	5,211,283	5,338,335	5,805,156	6,133,912
of which							
3. Banking and Financial Assets[2]	n/a	n/a	480,756	492,913	478,532	724,579	2,435,225
4. Banking and Financial Assets as % of Total Liabilities	n/a	n/a	9.70%	9.46%	8.96%	12.48%	39.70%
YTL Corporation Berhad							
1. Total Liabilities	n/a	n/a	n/a	n/a	n/a	n/a	n/a
2. Total Assets	n/a	n/a	n/a	n/a	n/a	n/a	n/a
of which							
3. Banking and Financial Assets[3]	n/a	n/a	n/a	n/a	n/a	n/a	n/a
4. Banking and Financial Assets as % of Total Liabilities	n/a	n/a	n/a	n/a	n/a	n/a	n/a
Telekom Malaysia Berhad							
1. Total Liabilities	n/a	25,630,100	27,266,900	27,388,100	28,935,400	36,040,300	37,675,200
2. Total Assets	n/a	25,630,100	27,266,900	27,388,100	28,935,400	36,040,300	37,675,200
of which							
3. Banking and Financial Assets[4]	n/a	1,206,700	2,381,900	2,742,600	2,032,500	3,609,500	8,951,800
4. Banking and Financial Assets as % of Total Liabilities	n/a	4.71%	8.74%	10.01%	7.02%	10.02%	23.76%

[1] Short term investment, short term deposits with licensed banks, cash and bank balances.
[2] Deposits, cash and bank balances.
[3] Short term investments, fixed deposits, cash and bank balances.
[4] Short term investments, cash and bank balances.

Table 4.2: Financial Accumulation of the Largest Malaysian Quoted Companies Since 1998 (in RM'000) - continued

Year	2005	2006	2007	2008
PLUS Expressway Berhad				
1. Total Liabilities	12,007,791	12,588,363	15,893,005	n/a
2. Total Assets	12,007,791	12,588,363	15,893,005	n/a
of which				
3. Banking and Financial Assets	2,555,419	2,634,764	2,480,944	n/a
4. Banking and Financial Assets as % of Total Liabilities	21.28%	20.93%	15.61%	n/a
PPB Group Berhad				
1. Total Liabilities	6,369,313	7,288,922	11,984,045	n/a
2. Total Assets	6,369,313	7,288,922	11,984,045	n/a
of which				
3. Banking and Financial Assets	752,839	762,712	700,658	n/a
4. Banking and Financial Assets as % of Total Liabilities	11.82%	10.46%	5.85%	n/a
YTL Corporation Berhad				
1. Total Liabilities	28,213,103	30,370,822	33,912,520	n/a
2. Total Assets	28,213,103	30,370,822	33,912,520	n/a
of which				
3. Banking and Financial Assets	5,787,093	5,578,020	9,033,066	n/a
4. Banking and Financial Assets as % of Total Liabilities	20.51%	18.37%	26.64%	n/a
Telekom Malaysia Berhad				
1. Total Liabilities	41,184,300	41,843,500	44,221,300	n/a
2. Total Assets	41,184,300	41,843,500	44,221,300	n/a
of which				
3. Banking and Financial Assets	6,690,300	5,000,500	4,549,900	n/a
4. Banking and Financial Assets as % of Total Liabilities	16.24%	11.95%	10.29%	n/a

Table 4.2: Financial Accumulation of the Largest Malaysian Quoted Companies Since 1998 (in RM'000) - continued

Year	1998	1999	2000	2001	2002	2003	2004
MMC Corporation Berhad							
1. Total Liabilities	n/a	2,227,067	2,146,686	2,967,411	2,977,823	7,294,006	7,485,300
2. Total Assets	n/a	2,227,067	2,146,686	2,967,411	2,977,823	7,294,006	7,485,300
of which							
3. Banking and Financial Assets[1]	n/a	455,667	628,510	806,292	364,394	251,530	551,307
4. Banking and Financial Assets as % of Total Liabilities	n/a	20.46%	29.28%	27.17%	12.24%	3.45%	7.37%
Average							
1. Total Liabilities	**8,340,100**	**12,431,989**	**28,906,109**	**25,266,417**	**25,774,809**	**28,185,623**	**31,624,446**
2. Total Assets	**8,340,100**	**37,295,967**	**28,906,109**	**25,266,417**	**25,774,809**	**28,185,623**	**31,624,446**
of which							
3. Banking and Financial Assets	**1,872,300**	**1,351,622**	**7361272.779**	**6,251,462**	**6,036,276**	**6,897,295**	**8,143,169**
4. Banking and Financial Assets as % of Total Liabilities	**22.45%**	**10.87%**	**25.47%**	**24.74%**	**23.42%**	**24.47%**	**25.75%**

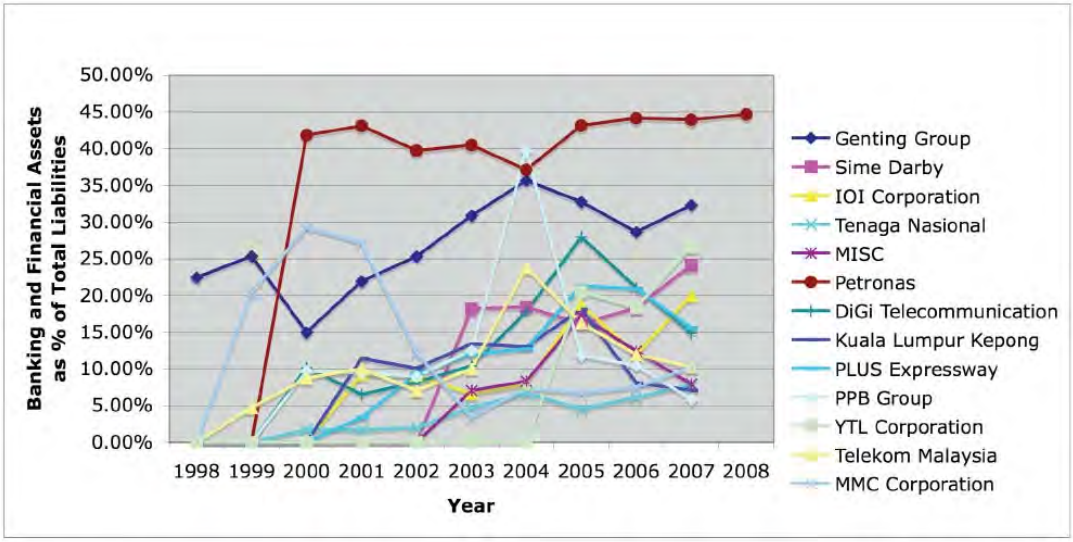
[1] Marketable securities, deposits, bank and cash balances.

Table 4.2: Financial Accumulation of the Largest Malaysian Quoted Companies Since 1998 (in RM'000) - continued

Year	2005	2006	2007	2008
MMC Corporation Berhad				
1. Total Liabilities	7,908,049	9,997,404	32,898,978	n/a
2. Total Assets	7,908,049	9,997,404	32,898,978	n/a
of which				
3. Banking and Financial Assets	532,694	751,691	3,371,980	n/a
4. Banking and Financial Assets as % of Total Liabilities	6.74%	7.52%	10.25%	n/a
Average				
1. Total Liabilities	**34,775,463**	**39,475,178**	**46,092,027**	**361,292,900**
2. Total Assets	**34,775,463**	**39,475,178**	**46,092,027**	**361,292,900**
of which				
3. Banking and Financial Assets	**9,885,451**	**11,339,857**	**13,343,020**	**161,257,949**
4. Banking and Financial Assets as % of Total Liabilities	**28.43%**	**28.73%**	**28.95%**	**44.63%**

As chart 4.1 demonstrates some Malaysian firms hold a significant share of their liabilities in financial and banking assets. Particularly striking is the high level of liquid financial assets that the Malaysia-based multinational PETRONAS possesses, namely between 35% and 45% of its total liabilities for the period 2000 to 2008. Also the Genting Group holds constantly (with the exception of 2000) more than 20% of its total liabilities in different kinds of short-term investment and cash (equivalents) for 2000 to 2007.

Chart 4.1: Financial Accumulation of the Largest Malaysian Firms Listed at KLSE (as % of Total Liabilities Held as Financial Assets, 1998-2008)

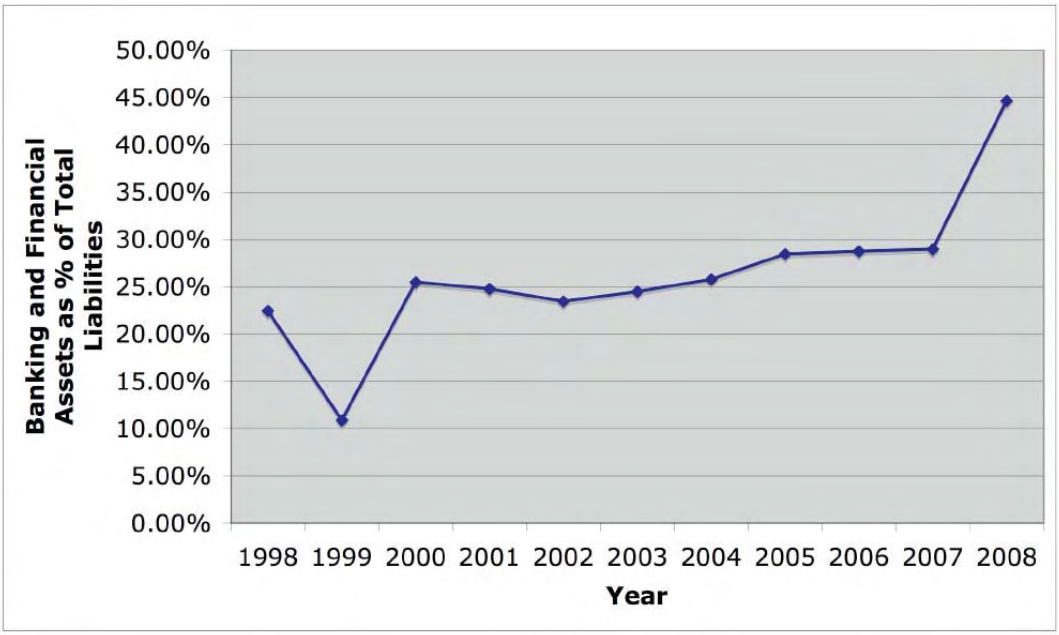


Source: Annual Reports of Sime Darby Berhad, IOI Corporation, Tenaga Nasional Berhad, MISC Berhad, Genting Group, PETRONAS, DiGi Telecommunication, Kuala Lumpur Kepong Berhad, PLUS Expressway Berhad, PPB Group Berhad, YTL Corporation Berhad, Telekom Malaysia, MMC Corporation Berhad, various years.

On average, the sample of Malaysian companies holds an increasing share of liabilities in banking and financial assets as chart 4.2 reveals. This trend is even more apparent if the first observation (1998) and the last one (2008) are excluded. Since in both cases the average is based on one firm, Genting Group and PETRONAS respectively, this exclusion is advisable. From 1999 to 2007 the average percentage of liabilities held as types of short-term investment and cash (equivalents) grew from 10.87% to 28.95%.[21]

[21] Evidently, the data presented — as all data — is prone to error. In many cases companies restate their balance sheets in corrected form in subsequent annual reports. If such corrections were implemented the restated figures are used for the present calculations. In big conglomerates which are company groups composed of a number of subsidiaries owned by a holding company the occurrence of incorrect data is even more likely since mistakes are added up while putting together the group's financial statement. Furthermore, balance sheets face problems additional to those data collection in general is experiencing. By definition assets and liabilities have to match. Deviations are often arbitrarily eliminated which can be suspected to have an adverse effect on the presented data. However, the increasing trend of Malaysian companies to hold financial

Chart 4.2: Average Financial Accumulation of the Largest Malaysian Firms Listed at KLSE (as % of Total Liabilities Held as Financial Assets, 1998-2008)



Source: Annual Reports of Sime Darby Berhad, IOI Corporation, Tenaga Nasional Berhad, MISC Berhad, Genting Group, PETRONAS, DiGi Telecommunication, Kuala Lumpur Kepong Berhad, PLUS Expressway Berhad, PPB Group Berhad, YTL Corporation Berhad, Telekom Malaysia, MMC Corporation Berhad, various years.

If Malaysian companies are overcapitalized the question arises what role banking — traditionally believed to supply undercapitalized firms with loanable funds — fulfils in the economic system. This paper argues that the effects of financialization — particularly the inversion of the direction (thus, the change in the origin) of loanable funds — is not merely a characteristic of certain developed economies (as argued in Toporowski 2008) but equally arises in emerging markets. The large unmet demand of individuals for durable consumption goods and housing enables households to take on the role of the investing sector in the overall economy. Yet, this is only possible if the corporate sector shows signs of overcapitalization and relinquishes this role to households. Excess capital puts firms in a position where they can acquire a source of profit alternative to commercial and industrial activity. While the emergence of excess capital in the OECD world is often linked to monopolistic (and oligopolistic) profits a structural current account surplus is likely to be at the origins in emerging markets. As frequently pointed out such a combination of balance of payments surplus and unmet demand favors volatile commodity markets (The Economist

and banking assets is not only supported by individual firms' balance sheets but also by the above considered current account figures.

2007). Hence, bank credit especially if used by households to invest in real estate or purchases of securities destabilizes the economic system.

Despite its claim to affect the economic system in a stabilizing way promoting productive investment, Islamic banks in Malaysia channel funds from the corporate to the household sector financing mainly vehicle and residential property purchases.

According to BNM, there are 12 full-fledged Islamic banks active (Bank Negara Malaysia 2008). However, two of them being subsidiaries wholly owned by conventional banks — AmIslamic Bank Berhad incorporated in May 2006, wholly owned by AmBank Malaysia and CIMB Islamic Bank incorporated in January 2003, wholly owned by CIMB Bank — do not possess a separate balance sheet. Evidently, in financial systems where conventional and Islamic banking coexist alongside each other as in Malaysia it is questionable whether one type can isolate itself from certain features of the other. This coexistence is more likely to take the shape of interdependence as the incorporation of Islamic banks into conventional ones suggests. Fungibility issues blur the lines between Islamic and non-Islamic operations within the economy.

Reviewing the liability side of the ten Islamic banks with individual balance sheets for 2007, deposits of non-financial companies constitute a higher share in total liabilities than deposits of individuals (table 4.3). In 2007, the range of non-financial companies' deposits as share of total liabilities in the sample is huge starting with as little as 11.20% for Affin Islamic Bank and going up to as much as 92.10% for Al Rajhi Banking and Investment Corporation (Malaysia). As to deposits of individuals as share of total liabilities for 2007 the percentage tends to be much smaller.

Individual deposits account for only 0.26% of liabilities of Kuwait Finance House Malaysia and for 22.03% in Hong Leong Bank constituting the lower and the upper end of the range, respectively. All four banks were incorporated relatively recently; Al Rajhi Banking in 2006 and all others in 2005. Out of the group of 12, only three banks started operations before 2005. Bank Islam Malaysia (BIMB) was founded in 1983, Bank Muamalat Malaysia in 1999 and the already mentioned CIMB Islamic Bank in 2003. Since the last one does not provide a separate balance sheet BIMB and Bank Muamalat are more interesting as to detecting trends in Islamic banking liabilities.

Table 4.3: Assets and Liabilities of Malaysian Islamic Banks (in RM '000)

Year	2004	2005	2006	2007	2008
1. Affin Islamic Bank Bhd					
Total Liabilities			**3,706,190**	**6,031,419**	**5,906,852**
of which					
Deposits of Non-Financial Companies			651,413	675,484	1,097,957
Deposits of Non-Financial Companies as % of Total Liabilities			**17.58%**	**11.20%**	**18.59%**
Deposits of Individuals			204,675	262,781	261,715
Deposits of Individuals as % of Total Liabilities			**5.52%**	**4.36%**	**4.43%**
Total Loans			**1,251,948**	**1,767,810**	**2,249,937**
of which					
Loans to Companies			384,966	556,239	689691
(of which Loans to SME)			211,023	362,352	411,004
Loans to Companies as % of Total Loans			**30.75%**	**31.46%**	**30.65%**
(of which loans to SME as % of Total Loans)			**16.86%**	**20.50%**	**18.27%**
Loans to Households			756,622	1,093,088	1,315,779
Loans to Households as % of Total Loans			**60.44%**	**61.83%**	**58.48%**
By Purpose					
Purchase of Vehicles			278,087	496,390	614,750
Purchase of Vehicles as % of Total Loans			**22.21%**	**28.08%**	**27.32%**
Purchase of Landed Property			517,747	693,368	803,342
Purchase of Landed Property as % of Total Loans			**41.36%**	**39.22%**	**35.71%**
of which					
Purchase of Residential Property			470,279	636,864	714,957
Purchase of Residential Property as % of Total Loans			**37.56%**	**36.03%**	**31.78%**
Purchase of Non-Residential Property			47,468	56,504	88,385
Purchase of Non-Residential Property as % of Total Loans			**3.79%**	**3.20%**	**3.93%**
Purchase of Securities			0	5,405	26,041
Purchase of Securities as % of Total Loans			**0.00%**	**0.31%**	**1.16%**

Table 4.3: Assets and Liabilities of Malaysian Islamic Banks (in RM '000) - continued

Year	2004	2005	2006	2007	2008
2. Al Rajhi Banking & Investment Corporation (Malaysia) Bhd					
Total Liabilities			**66,489**	**2,112,913**	**2,436,876**
of which					
Deposits of Non-Financial Companies			29,018	1,945,941	2,235,436
Deposits of Non-Financial Companies as % of Total Liabilities			**43.64%**	**92.10%**	**91.77%**
Deposits of Individuals			12,315	113,399	132,595
Deposits of Individuals as % of Total Liabilities			**18.52%**	**5.37%**	**5.44%**
Total Loans			**2,444**	**1,896,916**	**2,013,790**
of which					
Loans to Companies			0	209,624	254,346
Loans to Companies as % of Total Loans			**0.00%**	**9.92%**	**10.44%**
Loans to Households			2,416	159,788	226,137
Loans to Households as % of Total Loans			**3.63%**	**7.56%**	**9.28%**
By Purpose					
Purchase of Vehicles			0	1,427	2,234
Purchase of Vehicles as % Total Loans			**0.00%**	**0.08%**	**0.11%**
Purchase of Landed Property			0	10,457	15,387
Purchase of Landed Property as % of Total Loans			**0.00%**	**0.55%**	**0.76%**
of which					
Purchase of Residential Property			0	10,457	n/a
Purchase of Residential Property as % of Total Loans			**0.00%**	**0.55%**	n/a
Purchase of Non-Residential Property			0	0	n/a
Purchase of Non-Residential Property as % of Total Loans			**0.00%**	**0.00%**	n/a
Purchase of Securities			0	1,509,118	1,524,420
Purchase of Securities as % of Total Loans			**0.00%**	**79.56%**	**75.70%**

Table 4.3: Assets and Liabilities of Malaysian Islamic Banks (in RM '000) – continued

Year	2004	2005	2006	2007	2008
3. Asian Finance Bank Bhd					
Total Liabilities			**361,899,146**	**906,319,456**	**991,139,703**
of which					
Deposits of Non-Financial Companies			0	822,490,358	707,603,638
Deposits of Non-Financial Companies as % of Total Liabilities			**0.00%**	**90.75%**	**71.39%**
Deposits of Individuals			0	6,209,213	10,589,860
Deposits of Individuals as % of Total Liabilities			**0.00%**	**0.69%**	**1.07%**
Total Loans			**0**	**93,304,970**	**133,899,402**
of which					
Loans to Companies			0	93,096,595	111,218,141
Loans to Companies as % of Total Loans			**0.00%**	**99.78%**	**83.06%**
Loans to Households			0	208,375	261,331
Loans to Households as % of Total Loans			**0.00%**	**0.22%**	**0.20%**
By Purpose					
Purchase of Vehicles			0	99,650	22,515,152
Purchase of Vehicles as % of Total Loans			**0.00%**	**0.11%**	**16.81%**
Purchase of Landed Property			0	65,968,830	66,720,807
Purchase of Landed Property as % of Total Loans			**0.00%**	**70.70%**	**49.83%**
of which					
Purchase of Residential Property			0	65,968,830	66,613,568
Purchase of Residential Property as % of Total Loans			**0.00%**	**70.70%**	**49.75%**
Purchase of Non-Residential Property			0	0	107,239
Purchase of Non-Residential Property as % of Total Loans			**0.00%**	**0.00%**	**0.08%**
Purchase of Securities			0	0	0
Purchase of Securities as % of Total Loans			**0.00%**	**0.00%**	**0.00%**

Table 4.3: Assets and Liabilities of Malaysian Islamic Banks (in RM '000) – continued

Year	1993	1994	1995	1996	1997	1998
4. Bank Islam Malaysia Bhd						
Total Liabilities	**1,694,301**	**2,736,508**	**3,015,111**	**3,352,349**	**4,231,032**	**3,976,501**
of which						
Deposits of Non-Financial Companies	282,535	377,157	454,513	573,225	827,748	1,163,727
Deposits of Non-Financial Companies as % of Total Liabilities	**16.68%**	**13.78%**	**15.07%**	**17.10%**	**19.56%**	**29.27%**
Deposits of Individuals	741,286	1,050,446	1,151,490	1,574,696	1,844,284	1,780,376
Deposits of Individuals as % of Total Liabilities	**43.75%**	**38.39%**	**38.19%**	**46.97%**	**43.59%**	**44.77%**
Total Loans						
of which						
Loans to Companies						
(of which SME)						
Loans to Companies as % of Total Loans						
(of which loans to SME as % of Total Loans)						
Loans to Households						
Loans to Households as % of Total Loans						
By Purpose						
Purchase of Vehicles						
Purchase of Vehicles as % of Total Loans						
Purchase of Landed Property						
Purchase of Landed Property as % of Total Loans						
of which						
Residential						
Residential as % of Total Loans						
Non-Residential						
Non-Residential as % of Total Loans						
Purchase of Securities						
Purchase of Securities as % of Total Loans						

Table 4.3: Assets and Liabilities of Malaysian Islamic Banks (in RM '000) - continued

	1999	2000	2001	2002	2003
4. Bank Islam Malaysia Bhd					
Total Liabilities	**5,797,698**	**7,513,853**	**9,338,008**	**11,384,235**	**12,604,029**
of which					
Deposits of Non-Financial Companies	1,480,091	2,190,427	3,079,043	3,398,141	3,813,361
Deposits of Non-Financial Companies as % of Total Liabilities	**25.53%**	**29.15%**	**32.97%**	**29.85%**	**30.26%**
Deposits of Individuals	2,606,659	1,188,837	1,355,097	1638431	1,780,557
Deposits of Individuals as % of Total Liabilities	**44.96%**	**15.82%**	**14.51%**	**14.39%**	**14.13%**
Total Loans			**5,462,885**	**6,144,323**	**7,194,386**
of which					
Loans to Companies				3,407,146	3,569,119
(of which SME)				223,119	312,136
Loans to Companies as % of Total Loans				**55.45%**	**49.61%**
(of which loans to SME as % of Total Loans)				**3.63%**	**4.34%**
Loans to Households				2,299,382	3,394,269
Loans to Households as % of Total Loans				**37.42%**	**47.18%**
By Purpose					
Purchase of Vehicles				298,641	533,068
Purchase of Vehicles as % of Total Loans				**4.86%**	**7.41%**
Purchase of Landed Property				2,000,347	2,619,987
Purchase of Landed Property as % of Total Loans				**32.56%**	**36.42%**
of which					
Residential				1,386,971	1,957,964
Residential as % of Total Loans				**22.57%**	**27.22%**
Non-Residential				613,376	662,023
Non-Residential as % of Total Loans				**9.98%**	**9.20%**
Purchase of Securities				163,493	158,627
Purchase of Securities as % of Total Loans				**2.66%**	**2.20%**

Table 4.3: Assets and Liabilities of Malaysian Islamic Banks (in RM '000) - continued

	2004	2005	2006	2007	2008
4. Bank Islam Malaysia Bhd					
Total Liabilities	**11,795,326**	**15,118,725**	**14,686,724**	**18,076,963**	**19,988,773**
of which					
Deposits of Non-Financial Companies	3,790,872	4,832,010	5,433,895	6,097,683	5,629,120
Deposits of Non-Financial Companies as % of Total Liabilities	**32.14%**	**31.96%**	**36.50%**	**33.73%**	**28.16%**
Deposits of Individuals	1,951,383	2,144,688	2,292,431	2,549,629	4,551,916
Deposits of Individuals as % of Total Liabilities	**16.54%**	**14.19%**	**15.40%**	**14.10%**	**22.77%**
Total Loans	**7,985,959**	**10,041,562**	**10,311,593**	**9,888,297**	**10,303,913**
of which					
Loans to Companies	3,386,093	3,102,573	2,761,928	2,515,603	2841419
(of which SME)	1,268,243	1,346,481	1,189,561	1,051,169	909,282
Loans to Companies as % of Total Loans	**42.40%**	**30.90%**	**26.78%**	**25.44%**	**27.58%**
(of which loans to SME as % of Total Loans)	**15.88%**	**13.41%**	**11.54%**	**10.63%**	**8.82%**
Loans to Households	4,360,151	5,419,025	6,507,234	6,471,960	6,620,477
Loans to Households as % of Total Loans	**54.85%**	**53.97%**	**63.11%**	**65.45%**	**64.25%**
By Purpose					
Purchase of Vehicles	919,526	1,309,112	1,965,984	1,772,269	1,545,061
Purchase of Vehicles as % of Total Loans	**11.51%**	**13.04%**	**19.07%**	**17.92%**	**14.99%**
Purchase of Landed Property	3,172,102	3,300,910	3,281,292	3,371,965	3239644
Purchase of Landed Property as % of Total Loans	**39.72%**	**32.87%**	**31.82%**	**34.10%**	**31.44%**
of which					
Residential	2,503,093	2,674,078	2,743,033	2,891,457	2,838,237
Residential as % of Total Loans	**31.34%**	**26.63%**	**26.60%**	**29.24%**	**27.55%**
Non-Residential	669,009	626,832	538,259	480,508	401,407
Non-Residential as % of Total Loans	**8.38%**	**6.24%**	**5.22%**	**4.86%**	**3.90%**
Purchase of Securities	182,495	572,266	487,421	221,905	172,763
Purchase of Securities as % of Total Loans	**2.29%**	**5.70%**	**4.73%**	**2.24%**	**1.68%**

Table 4.3: Assets and Liabilities of Malaysian Islamic Banks (in RM '000) - continued

Year	2003	2004	2005	2006	2007	2008
5. Bank Muamalat Malaysia Bhd						
Total Liabilities	**6,962,922**	**7,563,267**	**9,745,964**	**12,750,283**	**13,814,692**	**12,472,880**
of which						
Deposits of Non-Financial Companies	2,506,642	3,020,004	5,133,138	5,749,625	5,747,947	5,310,917
Deposits of Non-Financial Companies as % of Total Liabilities	**36.00%**	**39.93%**	**52.67%**	**45.09%**	**41.61%**	**42.58%**
Deposits of Individuals	666,331	753,292	822,511	957,164	886,771	915,058
Deposits of Individuals as % of Total Liabilities	**9.57%**	**9.96%**	**8.44%**	**7.51%**	**6.42%**	**7.34%**
Total Loans	**2,272,526**	**2,887,415**	**4,154,021**	**5,373,343**	**5,870,585**	**6,336,185**
of which						
Loans to Companies	1,187,969	1,362,125	1,665,552	2,062,288	2631406	3254184
(of which SME)	554,763	557,929	748,468	594,538	923,564	1147331
Loans to Companies as % of Total Loans	**52.28%**	**47.17%**	**40.09%**	**38.38%**	**44.82%**	**51.36%**
(of which loans to SME as % of Total Loans)	**24.41%**	**19.32%**	**18.02%**	**11.06%**	**15.73%**	**18.11%**
Loans to Households	1,004,703	1,380,911	2,353,284	3,155,184	3,053,412	2,826,378
Loans to Households as % of Total Loans	**44.21%**	**47.83%**	**56.65%**	**58.72%**	**52.01%**	**44.61%**
By Purpose						
Purchase of Vehicles	63,497	128,261	706,155	1,239,719	1,399,305	1,407,281
Purchase of Vehicles as % of Total Loans	**2.79%**	**4.44%**	**17.00%**	**23.07%**	**23.84%**	**22.21%**
Purchase of Landed Property	956,710	1,131,287	1,486,493	1,841,364	1,635,945	1,700,703
Purchase of Landed Property as % of Total Loans	**42.10%**	**39.18%**	**35.78%**	**34.27%**	**27.87%**	**26.84%**
of which						
Purchase of Residential Property	772,994	938,126	1,279,587	1,574,975	1,346,710	1,396,726
Purchase of Residential Property as % of Total Loans	**34.01%**	**32.49%**	**30.80%**	**29.31%**	**22.94%**	**22.04%**
Purchase of Non-Residential Property	183,716	193,161	206,906	266,389	289,235	303,977
Purchase of Non-Residential Property as % of Total Loans	**8.08%**	**6.69%**	**4.98%**	**4.96%**	**4.93%**	**4.80%**
Purchase of Securities	37,961	39,496	32,332	25,678	4,714	1,796
Purchase of Securities as % of Total Loans	**1.67%**	**1.37%**	**0.78%**	**0.48%**	**0.08%**	**0.03%**

Table 4.3: Assets and Liabilities of Malaysian Islamic Banks (in RM '000) - continued

Year	2004	2005	2006	2007	2008
6. EONCAP Islamic Bank Bhd					
Total Liabilities			**4,724,271**	**5,678,114**	**6089452**
of which					
Deposits of Non-Financial Companies			2,099,168	2,096,528	1926115
Deposits of Non-Financial Companies as % of Total Liabilities			**44.43%**	**36.92%**	**31.63%**
Deposits of Individuals			483,452	512,222	546460
Deposits of Individuals as % of Total Liabilities			**10.23%**	**9.02%**	**8.97%**
Total Loans			**4,198,999**	**4,688,774**	**4741873**
of which					
Loans to Companies			1,049,985	1,145,406	1040646
(of which Loans to SMEs)			367,700	454,132	461402
Loans to Companies as % of Total Loans			**25.01%**	**24.43%**	**21.95%**
(of which Loans to SMEs as % of Total Loans)			**8.76%**	**9.69%**	**9.73%**
Loans to Households			3,134,973	3,427,078	3438014
Loans to Households as % of Total Loans			**74.66%**	**73.09%**	**72.50%**
By Purpose					
Purchase of Vehicles			1,664,208	1,558,425	1537781
Purchase of Vehicles as % of Total Loans			**39.63%**	**33.24%**	**32.43%**
Purchase of Landed Property			1,177,013	1,413,664	1460581
Purchase of Landed Property as % of Total Loans			**28.03%**	**30.15%**	**30.80%**
of which					
Purchase of Residential Property			1,096,736	1,324,042	1371464
Purchase of Residential Property as % of Total Loans			**26.12%**	**28.24%**	**28.92%**
Purchase of Non-Residential Property			80,277	89,622	89117
Purchase of Non-Residential Property as % of Total Loans			**1.91%**	**1.91%**	**1.88%**
Purchase of Securities			7,854	4,740	3683
Purchase of Securities as % of Total Loans			**0.19%**	**0.10%**	**0.08%**

Table 4.3: Assets and Liabilities of Malaysian Islamic Banks (in RM '000) - continued

Year	2004	2005	2006	2007	2008
7. Hong Leong Islamic Bank Bhd					
Total Liabilities			**5,892,378**	**5,624,155**	**6722743**
of which					
Deposits of Non-Financial Companies			3,572,117	3,060,132	3,939,899
Deposits of Non-Financial Companies as % of Total Liabilities			**60.62%**	**54.41%**	**58.61%**
Deposits of Individuals			925,347	1,239,059	1,286,107
Deposits of Individuals as % of Total Liabilities			**15.70%**	**22.03%**	**19.13%**
Total Loans			**4,031,824**	**3,758,749**	**4,329,988**
of which					
Loans to Companies			980,475	911,250	972,805
(of which Loans to SMEs)			304,939	290,564	303,876
Loans to Companies as % of Total Loans			**24.32%**	**24.24%**	**22.47%**
(of which Loans to SMEs as % of Total Loans)			**7.56%**	**7.73%**	**7.02%**
Loans to Households			2,985,206	2,768,069	3,249,786
Loans to Households as % of Total Loans			**74.04%**	**73.64%**	**75.05%**
By Purpose					
Purchase of Vehicles			2,568,499	2,144,169	2,448,681
Purchase of Vehicles as % of Total Loans			**63.71%**	**57.04%**	**56.55%**
Purchase of Landed Property			585026	793745	1,079,461
Purchase of Landed Property as % of Total Loans			**14.51%**	**21.12%**	**24.93%**
of which					
Purchase of Residential property			483,381	654,425	899,547
Purchase of Residential Property as % of Total Loans			**11.99%**	**17.41%**	**20.77%**
Purchase of Non-Residential Property			101,645	139,320	179,914
Purchase of Non-Residential Property as % of Total Loans			**2.52%**	**3.71%**	**4.16%**
Purchase of Securities			3,575	1,123	1,053
Purchase of Securities as % of Total Loans			**0.09%**	**0.03%**	**0.02%**

Table 4.3: Assets and Liabilities of Malaysian Islamic Banks (in RM '000) - continued

Year	2004	2005	2006	2007	2008
8. Kuwait Finance House (Malaysia) Bhd					
Total Liabilities		**134,781**	**2,630,883**	**5,555,984**	**6,720,237**
of which					
Deposits of Non-Financial Companies		100,106	861,964	2,016,878	2,264,211
Deposits of Non-Financial Companies as % of Total Liabilities		**74.27%**	**32.76%**	**36.30%**	**33.69%**
Deposits of Individuals		1627	13,637	14,503	22,934
Deposits of Individuals as % of Total Liabilities		**1.21%**	**0.52%**	**0.26%**	**0.34%**
Total Loans		**0**	**817,986**	**3,219,726**	**3,874,457**
of which					
Loans to Companies		0	752,159	2,558,550	2899467
(of which Loans to SMEs)		0	238,308	1,063,253	1,375,060
Loans to Companies as % of Total Loans		**0.00%**	**91.95%**	**79.46%**	**74.84%**
(of which Loans to SMEs as % of Total Loans)		**0.00%**	**29.13%**	**33.02%**	**35.49%**
Loans to Households		0	9,453	66,021	70,234
Loans to Households as % of Total Loans		**0.00%**	**1.16%**	**2.05%**	**1.81%**
By Purpose					
Purchase of Vehicles		0	1,510	2,674	2,648
Purchase of Vehicles as % of Total Loans		**0.00%**	**0.18%**	**0.08%**	**0.07%**
Purchase of Landed Property		0	430	14,031	20,629
Purchase of Landed Property as % of Total Loans		**0.00%**	**0.05%**	**0.44%**	**0.53%**
of which					
Purchase of Residential Property		0	430	14,031	20,629
Purchase of Residential Property as % of Total Loans		**0.00%**	**0.05%**	**0.44%**	**0.53%**
Purchase of Non-Residential Property		0	0	0	0
Purchase of Non-Residential Property as % of Total Loans		**0.00%**	**0.00%**	**0.00%**	**0.00%**
Purchase of Securities		0	16,871	94,928	93,273
Purchase of Securities as % of Total Loans		**0.00%**	**2.06%**	**2.95%**	**2.41%**

Table 4.3: Assets and Liabilities of Malaysian Islamic Banks (in RM '000)

Year	2004	2005	2006	2007	2008
9. Maybank Islamic Bhd					
Total Liabilities					**23,349,620**
of which					
Deposits of Non-Financial Companies					4,230,270
Deposits of Non-Financial Companies as % of Total Liabilities					**18.12%**
Deposits of Individuals					5,411,265
Deposits of Individuals as % of Total Liabilities					**23.17%**
Total Loans					**20,802,549**
of which					
Loans to Companies					7,138,969
(of which SME)					4,207,354
Loans to Companies as % of Total Loans					**34.32%**
(of which Loans to SMEs as % of Total Loans)					**20.23%**
Loans to Households					11,969,255
Loans to Households as % of Total Loans					**57.54%**
By Purpose					
Purchase of Vehicles					6,934,651
Purchase of Vehicles as % of Total Loans					**33.34%**
Purchase of Landed Property					6,170,717
Purchase of Landed Property as % of Total Loans					**29.66%**
of which					
Purchase of Residential Property					5,560,850
Purchase of Residential Property as % of Total Loans					**26.73%**
Purchase of Non-Residential Property					609,867
Purchase of Non-Residential Property as % of Total Loans					**2.93%**
Purchase of Securities					81,627
Purchase of Securities as % of Total Loans					**0.39%**

Table 4.3: Assets and Liabilities of Malaysian Islamic Banks (in RM '000)

10. RHB ISLAMIC Bank Bhd

Year	2004	2005	2006	2007	2008
Total Liabilities		**7,058,512**	**7,440,591**	**7,665,002**	**7,507,781**
of which					
Deposits of Non-Financial Companies		3,864,254	4,149,826	4,222,990	3,529,206
Deposits of Non-Financial Companies as % of Total Liabilities		**54.75%**	**55.77%**	**55.09%**	**47.01%**
Deposits of Individuals		702,101	723,189	770,047	817,983
Deposits of Individuals as % of Total Liabilities		**9.95%**	**9.72%**	**10.05%**	**10.90%**
Total Loans		**3,524,373**	**4,273,454**	**4,691,096**	**4,842,376**
of which					
Loans to Companies		2,221,072	2,496,765	2,596,281	2,472,383
(of which Loans to SMEs)		208,876	548,509	557,394	643,183
Loans to Companies as % of Total Loans		**63.02%**	**58.42%**	**55.34%**	**51.06%**
(of which Loans to SMEs as % of Total Loans)		**5.93%**	**12.84%**	**11.88%**	**13.28%**
Loans to Households		1,251,623	1,623,648	1,942,677	2,080,667
Loans to Households as % of Total Loans		**35.51%**	**37.99%**	**41.41%**	**42.97%**
By Purpose					
Purchase of Vehicles		23,225	140,519	359,898	515,660
Purchase of Vehicles as % of Total Loans		**0.66%**	**3.29%**	**7.67%**	**10.65%**
Purchase of Landed Property		1,241,303	1,543,217	1,732,443	1,739,784
Purchase of Landed Property as % of Total Loans		**35.22%**	**36.11%**	**36.93%**	**35.93%**
of which					
Purchase of Residential Property		1,199,980	1,461,866	1,610,779	1,613,650
Purchase of Residential Property as % of Total Loans		**34.05%**	**34.21%**	**34.34%**	**33.32%**
Purchase of Non-Residential Property		41,323	81,351	121,664	126,134
Purchase of Non-Residential Property as % of Total Loans		**1.17%**	**1.90%**	**2.59%**	**2.60%**
Purchase of Securities		343,173	366,627	185,180	399
Purchase of Securities as % of Total Loans		**9.74%**	**8.58%**	**3.95%**	**0.01%**

Source: Annual Reports of Affin Islamic Bank Bhd, Al Rajhi Banking & Investment Corporation (Malaysia) Bhd, Asian Finance Bank Bhd, Bank Islam Malaysia Bhd, Bank Muamalat Malaysia Bhd, EONCAP Islamic Bank Bhd, Hong Leong Islamic Bank Bhd, Kuwait Finance House (Malaysia) Bhd, Maybank Islamic Bhd, RHB ISLAMIC Bank Bhd, various issues.

BIMB was the first Malaysian Islamic bank. Available data about the composition of total liabilities goes back to 1993. Initially, the bank mainly drew on deposits of individuals to finance its lending. Hence, household saving in fact constituted 43.75% of total liabilities in 1993 while non-financial companies only contributed 16.68% to the bank's liabilities (table 4.3). "Others" deposited the residual. This category is likely to include institutional investors, which are highly developed in Malaysia.[22]

As to the composition of liabilities for BIMB it is noteworthy that until 1997 individual deposits constituted a share more than twice as big as company deposits. In 1998 and 1999 liabilities to households still exceeded those to companies. Yet the non-financial corporate sector increased their deposits with BIMB substantially from RM828 billion to RM1164 billion accounting for 19.56% of bank liabilities in 1997 and 29.27% in 1998. This surge in banking assets held by companies might be a precaution taken due to the Asian financial crisis of 1997-98. The interesting fact is that firms did not withdraw their money from BIMB in subsequent years. On the contrary, corporate deposits kept growing overtaking individual deposits as share in bank liabilities by 2000. From 2001 to 2007, non-financial enterprise contributed more than twice the amount of money to BIMB's liabilities than households. 2008 suggests that contributions by the two groups converge towards a share somewhere around 25%. Yet data for 2008 is derived from the latest Quarterly Report and is, due to its preliminary character, less reliable. Financial statements available for the second Islamic bank founded in Malaysia, Muamalat Bank Malaysia, support the evidence that on the liability side non-financial companies are the major depositors of Islamic banks in Malaysia. The figures available cover the period 2003 to 2008. While individuals contribute less than 10% and a decreasing share of bank liabilities, companies' deposits amount to 36% of liabilities in 2003 overall increasing to 42.58% in the first quarter of 2008.

These results also reflect the trends in most of the more recently established Islamic banks in Malaysia. With the exception of Maybank Islamic and BIMB before 2000, non-financial enterprises contribute significantly more to bank liabilities than households. For the period 2000 to 2008, enterprises' percentage share is typically 30% or more. Here, Affin Islamic Bank can be seen as exception. The share in question is 18.59% in 2008. However, the share of individual deposits in total liabilities also only amounts to 4.43%.

[22] Among them the employees' pension fund (EPF) managing the retirement savings of the majority of the population became an important investor as the requirement to hold funds in government securities was gradually relaxed since the mid-1980s (Suto 2001).

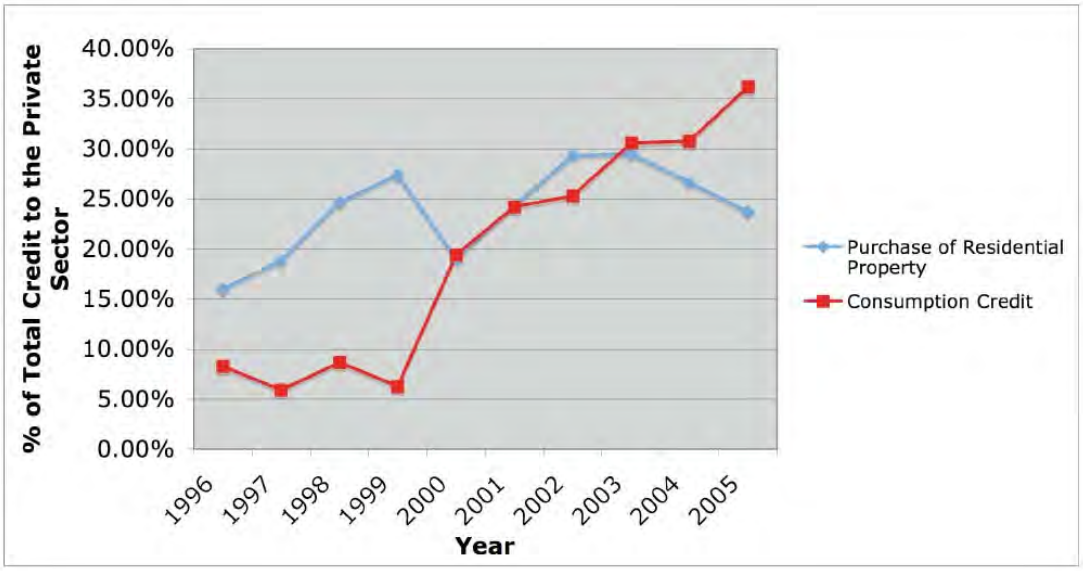
On the assets side, out of the ten banks examined only Asian Finance Bank and Kuwait Finance House focus their lending activity completely on non-financial companies.[23] Both banks channel more than 70% of their loans into the corporate sector lending less than 3% of their assets to individuals. Al Rajhi Banking, RHB Islamic Bank and Mualamat Bank Malaysia all provide approximately the same share of their assets as credit to households as to companies. The remaining five Islamic banks provide a significantly larger share of total loans to individuals than to non-financial companies. Hence, there is convincing evidence that funds flow in fact from companies to households and not the other way around (table 4.3).

Since there is little data available for the years before the Asian financial crisis firms' overcapitalization could admittedly be a cyclical phenomenon arising as precautionary measure after periods of economic distress. The effect on the housing market — or other markets where the surplus funds are channeled to — remains nonetheless the same. If anything, overcapitalization as cyclical phenomenon can only increase economic instability since a slowdown in the flow of funds into an inflated market makes prices stagnate and triggers a downward price spiral.

Analyzing the purpose of credit granted the purchase of transport vehicles and residential property figure most prominently for all Islamic banks with the exception of Asian Finance Bank, Kuwait Finance House and Al Rajhi Banking. This observation is in accordance with data collected by BNM on the direction of Islamic lending in Malaysia (chart 4.3). Since 1996, the sum of Islamic credit for purchase of residential property and consumption rose from 24.3% to 59.9% in 2005. Especially, consumption credit increased steadily while loans for property purchases experienced a less steady upward trend. Since 2000, BNM disaggregates consumption credit demonstrating that the major part of it is used for the purchase of transport vehicles confirming the results found analyzing individual bank balance sheets (table 4.4).

[23] Both banks are owned by Middle Eastern investors and are therefore likely to concentrate on Middle Eastern companies operating in Malaysia.

Chart 4.3: Islamic Lending for Residential Property and Consumption as % of Total Credit to the Private Sector, 1996-2005



Source: Annual Reports, Bank Negara Malaysia, various issues.

Table 4.4: Direction of Islamic Lending in Malaysia as % of Total Lending, 2000-2005

ear	000	001	002	003	004	005
Sector						
Real Estate	1.70%	2.00%	1.82%	1.67%	1.57%	1.44%
Construction	7.50%	6.00%	6.20%	6.03%	6.10%	4.95%
Purchase of Residential Property	19.00%	24.30%	29.31%	29.51%	26.66%	23.71%
Purchase of Non-Residential Property	7.60%	5.90%	5.52%	4.92%	4.46%	3.93%
Consumption Credit	19.40%	24.20%	25.29%	30.59%	30.76%	36.19%
of which						
Purchase of Consumer Durables	0.20%	0.20%	0.17%	0.11%	0.08%	0.06%
Purchase of Transport Vehicles	17.50%	21.50%	22.07%	26.79%	25.91%	29.89%
otal Credit to Private Sector (in RMmillion)	0,891	8,201	6,718	8,615	7,883	7,365

Source: Annual Reports, Bank Negara Malaysia, various issues.

Comparing the directions of lending for Islamic credit with those for overall credit in the Malaysian economy, it is striking that overall almost 30% of granted loans are used for investment in corporate securities (table 4.5) while most Islamic banks — with the exception of Al Rajhi Banking — lend a rather negligible share of total loans for security purchases. This can be, however, explained with the relative novelty of the Islamic capital market and Islamic corporate bonds in Malaysia. Hence, it can be expected that lending directions of Islamic banks will account for the new possibility to invest in Islamic securities and change, maybe through the emergence of banking companies such as Al Rajhi Banking focusing on this market segment.

Thus, the evidence suggests the initial hypothesis that Islamic banks in Malaysia channel funds from the overcapitalized non-financial corporate sector towards households investing into housing and durable consumer goods is valid. However, if this is the case Islamic banks — just as conventional ones — are far from exercising a stabilizing effect on the economic system. Housing markets inflate in a comparable way to capital markets especially if the buy-to-let mechanism is prevalent. Prices are determined by the inflow of liquidity. Price changes — if positive — tend to attract further inflow of funds as investors hope that the increase in value will continue. Dynamics work similarly in the opposite direction. If the household sector is unwilling to increase its borrowing for house purchase prices stop rising which might have a deflating effect. New investors stay away while current ones try to sell at a relatively favorable price destabilizing the housing market.

A secondary result of this study is the realization that the dominance of Western financial and economic patterns is paramount. Particularly a niche phenomenon such as Islamic banking which put a lot of effort into isolating itself from debt-based banking and its destabilizing impact should be able to shield itself from Western post-modern, financialized institutions. Yet, this is not the case. Inter-dependence is a characteristic of all elements that open up to the world economy and total isolation might not even be possible without total backwardness. The companies that are putting deposits into Islamic banks are earning their deposits in non-Islamic business.

Table 4.5: Direction of Credit to Major Sectors by the Financial System as % of Total Credit

Year	1996	1997	1998	1999	2000	2001	2002
Construction and Real Estate	12.20%	15.30%	15.60%	14.40%	12.98%	12.07%	9.96%
Housing	10.10%	10.50%	11.10%	11.90%	13.12%	15.94%	17.09%
Consumption Credit	8.70%	9.00%	8.50%	8.50%	8.81%	9.80%	11.26%
Investment in Corporate Securities	26.70%	23.30%	24.00%	26.30%	28.12%	28.09%	30.05%
Credit to Private Sector (in RM billion)	462.2	594.5	590.1	595.7	633.4	696.8	766.7

Year	2003	2004	2005
Construction and Real Estate	9.84%	9.07%	8.68%
Housing	17.98%	19.26%	19.31%
Consumption Credit	11.73%	12.66%	13.72%
Investment in Corporate Securities	31.50%	30.33%	29.72%
Credit to Private Sector (in RM billion)	822.1	878.3	972.5

Source: Bank Negara Malaysia, Annual Reports, 1996-2005.

V. CONCLUSION

Both mainstream Western economic theory and Islamic economists fail to provide a comprehensive picture of the economy explaining the role of banking. This lack of a systematic understanding of financial intermediation in New Keynesian and Islamic models means that neither theory convincingly explains financial dynamics. A flow of funds analysis reveals that (at least) since 1998 a current account surplus has been steadily channeled into the Malaysian economy resulting in the overcapitalization of domestic firms and the emergence of a financial business cycle. Contrary to the claims of Islamic scholars, Islamic banks channeling funds from companies to households play a destabilizing role in the economy as a whole. Credit granted to the household sector is used for housing purchases and therefore inflates this asset market, increasing the system's economic fragility and encouraging speculation. These trends, affecting the economy as a whole, are reflected by the Islamic banks' balance sheets.

Through financial inflation and overcapitalization, banking in emerging markets, in general and Malaysian Islamic banking in particular, are reproducing those features that give rise to Minskyan instability.

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