



# ROLE OF ISLAMIC BANKING IN ECONOMIC DEVELOPMENT

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### The review comments

1. Prepare abstract
2. Present previous research studies in review of literature
3. If possible present the empirical data to show in the analysis as role of islamica banking in economy. The concept of “Islamic banking” is mainly based on the

### **Fundamental principles of Islamic banking:**

➤ All forms of interest is prohibited and considered as “Haram” Which means un law full (Riba)

➤ Financing must be linked to real asserts (Materialitu)

The use of all conventional derivative instruments is impossible in Islamic banking and this banking is an example of full reserve banks, with banks achieving a 100% reserve ratio.

### Working of Islamic banks

principle of “Sharia” which means “Islamic law”. Sharia prohibits acceptance of “Interest” for loans of money, known as “Riba”. Though the Islamic banking is a modern concept of banking but it is as old as the religion. The fundamentals of this banking derived from the holy book “Quran”

➤ Prohibition on speculative transactions (Gharar)

➤ A Management in immoral businesses not allowed. Example- Arms manufacturing, Alcohol production

➤ F Returns must be linked to risks.

Islamic banks work on the principle of “interest free banking”. The investors should not make an “undue” profit from the hard work of the others. But it is permitted to follow a system of reasonable profit and return from investment where the investor takes a risk that is well

## ROLE OF ISLAMIC BANKING IN ECONOMIC DEVELOPMENT

calculated. Thus, Islamic banks make available accounts which provide profit or loss instead of interest rates. Acts as an agent by collections the money on behalf of customers, investing them in: Shariat” compliant projects and sharing profit or losses with them.

### **Islamic banking system lends the money to customers in two tiers**

**1. Mudarabah-** the bank would act as the capital partner i.e. the depositor on one side and the entrepreneur on the other side. It may be called Islamic mortgage transactions, instead of lending the buyer money to purchase the item; a bank might buy the item itself from the seller and re sell it to the buyer at a profit. While allowing the buyer to pay the bank in installments however, the banks profit cannot be made explicit and therefore there are no additional penalties for late payments.

**2. Eljara-** Islamic banking lends their money to companies by issuing floating rate of interest loans. The floating rate of interest of interest is pegged to company’s individual rate of return. Thus, the banks profit on the loan is equal to a certain percentage of the company’s profits. Once the principle amount of the loan is repaid

the profit sharing arrangement is concluded.

To know how the “Islamic banking” is useful in economic development first we have to know the factors which influence the economic development. In any country especially in developing countries like India the economic development is mainly based on

1. Agricultural development.
2. Social justice
3. Creation of employment.
4. Inflation control.
5. Stability in business.

### **Role of “Islamic banking” in economic development**

1. Agricultural development (murabaha and salam), **Murabaha** means a sale on mutually agreed profit, also known as cost plus sales, it is one of the most widely used instruments for short-term agricultural financing where the banks undertakes to supply specific goods at mutually agreed profit to the client. This concept is used to leasing of tractors, agricultural equipments, tube wells etc..

## ROLE OF ISLAMIC BANKING IN ECONOMIC DEVELOPMENT

**Salem-** it means a contract in which advance payment is made for goods to be delivered later on. The seller under takes to supply some specific crop /goods to the buyer at a future date in exchange of on advance price fully paid at the time of contract. It is an ideal product for agricultural financing. Through which a farmer can fulfill all the financial needs of whole crop circle. Example- seeds, fertilizer, pesticides, irrigation, transport and marketing etc..

2..The Islamic profit sharing concept helps to foster economic development by encouraging equal income distribution and which results in greater benefits for social justice and long term growth.

3. The profit loss sharing scheme improves capital allocation efficiency as a returns on capital depends on productivity and allocation of funds is based on the success of the project. The profit sharing scheme

encourages investments because investment depositors receive a share in the banks' profits. This increase in investments will implicitly results in the increase in employment.

4. The Islamic financial system is more stable than the conventional banking system due to the elimination of debt financing. It also reduces inflation in the economy as the supply of money is not permitted to go above the supply of goods.

5. Islamic banks are less risky than conventional bank as both investors and entrepreneurs share any risk that is involved in the business.

### Difference between Conventional banks and Islamic banks

S.No	Conventional banks	Islamic banks
1	Money is a commodity	Money is not a commodity
2	It can be sold at a price higher than its face value	It cannot be sold at a price higher than its face value
3	Time value is the basis for charging interest on capital	Profit on trade of goods is the basis for earning profit.

## ROLE OF ISLAMIC BANKING IN ECONOMIC DEVELOPMENT

4	Interest is charged even in case the organization suffers losses by using bank funds	Based on the basis of profit and loss sharing, if business man has suffered with losses the bank will share these losses,.
5	No agreement for exchange of goods and services	There agreement for exchange of goods and services
6	Money is not linked with the real asserts	Money is linked with the real asserts

### Islamic banking-Indian economy

At present there is no question of having Islamic banking in India. Because according to the “Banking and regulation act-1949” there cannot be a parallel banking system. So, instead of debating about possibilities of Islamic banking in India it is better to know the role of Islamic banking in economic development.

Accelerating economic development Islamic banking certainly have profit creation and growth as their objectives, for which they choose to invest in business based on their potential for growth and success , thus in the Islamic banking each bank will invest in promising business ventures and attempt out perform its competitors.

In order to attract more funds from its depositors, this will eventually results in a high return on investments both for the bank and the depositors. This is unlikely in

a conventional bank, where depositors redeem returns on their deposits based on a pre determined interest rate.

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