



# Effect of interest rate on bank deposits: Evidences from Islamic and non-Islamic economies

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## Abstract

Banking sector is the backbone of any country's economy and bank deposits are the major tool of success for banking sector. Bank deposits are also a major part and determinant of country's saving. According to economic theories and practical considerations, interest rate is considered one of the major elements that can affect savings as well as bank deposits. But as we know that in Islam interest is considered forbidden and Muslims try to avoid interest income, so the basic purpose of this study is to know the fact that either religious factors have any effect on Muslim's decision while keeping their saving in banks. We used panel ARDL (Autoregressive Distributed Lag) method by using 23 non-Islamic and 23 Islamic countries data from 1999 to 2014 for this study. Results showed that in Islamic countries interest rate doesn't have any impact on bank deposits both in long run and short run. But in the case of non-Islamic countries interest rate has positive significant impact on bank deposits. Hence there is a need for Islamic banks in countries with more Muslim population and there should be different economic policies for Islamic countries as religious factors affect the decision of Muslims and interest rate doesn't have any impact on bank's deposits.

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## Introduction

Interest is an inseparable part of today's economic activities and it is also the main reason of fluctuation and hurdles in economic development because of interest rate money is considered as a commodity rather than a medium of exchange and it creates unequal distribution of wealth within the society as concentration of money remains in few hands hence rich becomes richer and poor becomes poorer (Farooq, 2012).

If we define interest rate then it is the amount of money that lender receives or borrower pays in excess of actual money or we can say it is the cost of capital.

However, Islam is against all such practices of usury and riba. Riba is an Arabic word which means increase or addition. Allah Almighty, as a creator of human beings, wants peace and justice. In the Holy Quran, Allah clearly says:

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“O you who believe! Be mindful of God and give up what remains of al-riba if you are believers. If you do not do so, then receive a declaration of war from God and his Messenger. But if you repent, you shall have your capital sums (ru'us alamwal). You do not deal unjustly and you are not dealt with unjustly (2:278–279)”.

“God brings riba to destruction, but gives increase (yurbi) to sadaqah. God loves not anyone ungrateful and wicked. (2:276)”.

Prophet Muhammad (PBUH) in his last sermon eliminated this evil and denounced interest from society, Prophet said:

“All interest and usurious dues accruing from the times of ignorance stand wiped out. And the first amount of interest that I remit is that which Abbas ibn Abd-al Muttalib had to receive. Verily, it is remitted entirely.”

Interest rate affects all sectors of economy but it has a major impact on banking sector because they directly deal with money. Bank deposits are considered as major part of any country's saving and has major impact on any country's economic performance, bank deposits are defined as the amount of money that a customer of bank keeps in his account either in form of cash, cheque or sent through a wire transfer. In return bank pays some amount of interest according to prevalent rate to the customer. The basic purpose for this study was to investigate the impact of interest rate on banking sector's deposits. As deposits are back bone of banking sector, interest rate is an effective tool to attract customers. In this study we tried to investigate the fact that in countries where Muslim population is in majority, what is the response of Muslims towards interest rate while depositing their money in to any bank. Whether they considered interest income while depositing or their purpose of keeping money in banks is just for business or saving purpose not for earning interest income.

Bank deposit is a type of saving hence all theories related to saving will be true for banks deposits. As interest rate is prohibited in Islam so Muslims should not consider interest rate as a major factor while placing their money in any place for saving purpose that's why there should be a big different between Muslims and non-Muslims behavior towards interest rate. Muslims savings in bank should not be affected by interest rate so by doing this study we want to see that either Muslims considers interest rate as an important factor which affect their savings in banks or the purpose of keeping their money in banks is just for saving purpose and not for earning interest income. We are expecting insignificant effect of interest rate on bank deposits in Muslim countries however positive significant effect in non-Muslim countries.

This study is conducted by using panel data after categorizing countries into Muslims and non-Muslims on the basis of population by religion. We used banks deposits to GDP (%) as proxy of banks deposits.

In literature there are many studies about significance of Islamic banks, their comparison with conventional banks, and their deposit determinants etc., but this is the first study which considered effect of Muslims religious factor on their decision of depositing money in banks. As interest is forbidden in Islam, so Muslims deposits should not effect by interest rate fluctuations.

Mushtaq and Siddiqui (2016) did study on same concept using GMM and Random effect model but their study was about real interest rate, saving and investment relationship in the presence of other independent variables but in this study we are only considering relationship between interest rate and bank deposits without any other variable, and also studying long term and short term relationship between interest rate and bank deposits in Muslim populated and Non-Muslim populated countries groups separately which was not considered before in literature by any researcher.

The organization of paper is Section 1: introduction, Section 2: review of literature, Section 3: empirical analyses and Section 4 conclusion and recommendation.

## Review of literature

Interest rate is a function of saving according to classical economist. There are two effects of interest rate on saving, income effect leads to inverse relationship between interest rate and saving and substitution effects leads to direct relationship between interest rate and saving. Usually substitution effect dominates the income effect so we are expecting positive relationship between interest rate and bank deposits.

Keynes (1936) described saving as remaining part of income after consumptions but Jalaluddin (1992) defines saving is not just remaining part of income but according to him there is some social and ethical values that are

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