ECONOMIC RESEARCH FORUM

منتدى البحوث الاقتصادية

Working Paper Series

ISLAMIC FINANCE AND GCC ECONOMIC INTEGRATION

Russell Krueger

Working Paper No. 1381

ISLAMIC FINANCE AND GCC ECONOMIC INTEGRATION[1]

Russell Krueger

Working Paper No. 1381

January 2020

Special thanks are given to Erwin Nierop for his insights into the economic integration process, and to Zahid ur Rehman Khoker and Salim Al Mamun for their insights on Islamic finance and its contribution to soundness of financial systems.

Send correspondence to:
Russell Krueger
Economist
kruegerstatistics@gmail.com

[1] Originally presented at ERF GCC Economic Research Initiative (GCCeRI) Conference "GCC in the Midst of Global Changes" December 8-9, 2019, Muscat, Sultanate of Oman.

First published in 2020 by
The Economic Research Forum (ERF)
21 Al-Sad Al-Aaly Street
Dokki, Giza
Egypt
www.erf.org.eg

Copyright © The Economic Research Forum, 2020

All rights reserved. No part of this publication may be reproduced in any form or by any electronic or mechanical means, including information storage and retrieval systems, without permission in writing from the publisher.

The findings, interpretations and conclusions expressed in this publication are entirely those of the author(s) and should not be attributed to the Economic Research Forum, members of its Board of Trustees, or its donors.

Abstract

The GCC has a mixed conventional and Islamic financial system in which overall development prospects and potential cross-country integration can be affected by intrinsic differences in the structure and operations of conventional versus Islamic finance. This paper explores characteristics of Islamic finance that might tend to partially isolate it from the general financial system with consequences for overall financial integration prospects and financial stability, potentially resulting in partial bifurcation of the financial system. The differences can be seen to impair overall financial development prospects, complicate monetary policy options, and possibly hinder cross-country economic integration if the GCC monetary union project reactivates. The paper enumerates several areas where special actions might be needed to more effectively integrate Islamic finance into national and regional financial systems. Tt is recommended that separate "Working Group on Islamic Finance" with a macroeconomic and policy orientation be set up covering treatment of Islamic finance within the GCC regional setting and to strengthen Islamic finance growth, soundness, and public benefit.

Keywords: Islamic Banking, Islamic Finance, Gulf Cooperation Council, Gulf Monetary Council, Economic Development, Economic Integration, Financial Institutions.
JEL Classifications: B590, E02, E42, F02, F36, G29, G21, G29, O11, O53, P400.

The GCC economic integration process is taking place among countries that officially embrace Islam and with heavily Muslim populations. The thesis of this paper is that the GCC financial system is partially bifurcated into conventional and Islamic subsectors; intrinsic characteristics of Islamic finance might tend to partially isolate it from the general financial system in the GCC with consequences for overall financial integration prospects and financial stability. This paper enumerates several areas where special actions might be needed to effectively integrate Islamic finance in national and regional financial systems to support the economic and policy efforts of the integration program.

Higher degrees of regional financial integration such as a common market or monetary union require a high level of harmonisation of rules and practices in multiple spheres including financial market integration, which encompasses Islamic finance as well as conventional finance.

1. Introduction

The GCC Charter 1981 refers explicitly to Islam as one of the guiding principles for economic integration. It is therefore important to pay attention to the impact of Islam on the economic integration process.

The GCC region includes both conventional and Islamic financial institutions and instruments. This paper reviews some of the ways in which the two financial subsectors operate differently, how this can affect prospects for economic integration within individual countries and within the region, and institutional and policy steps that might be taken to reflect the presence of Islamic finance within the GCC financial system. The GCC economic integration blueprint must incorporate a number of items specifically related to treatment of Islamic finance; the productivity gains during the common market phase – and subsequent phases – of integration rest in part from the dynamic integration of financial markets, of which Islamic finance is an integral part.[2]

The reason for special consideration of Islamic finance in the GCC financial integration context is in one way rather simple – the populations and governments in the region place high importance on creating a system that reflects the ethical foundations of Islamic finance. But there are more specific reasons for the focus here. Islamic finance is systemically large within the GCC economy but has intrinsic characteristics that tend to partially isolate it from the full regional financial system, which implies that there are several ways in which it might affect overall macroeconomic performance – alter transmission of monetary policy signals, introduce different forms of macrofinancial soundness risk, or participate less fully in the multicountry financial integration process and dynamic unleashing of productive growth that can accompany broadening of regional markets (due, for example, from increased competition, better application of capital, economies of scale, diversification of risk, innovation in markets, etc.). For such reasons, this paper argues that

[2] Throughout, the shorthand phrase 'IFI' will be used for "Islamic banks and other Islamic financial institutions'.

the macroeconomic success of the GCC regional financial integration program will be enhanced by explicitly addressing the implications of Islamic finance.

A similar picture and conclusions might be drawn from examination of the ***micro***economic and structural conditions within the GCC. An important 2018 IMF Policy Paper "Gulf Cooperation Council: How Developed and Inclusive are Financial Systems in the GCC?" provides a comprehensive picture of the structure and effectiveness of GCC financial markets. The strongest element is the banking system, which is well-capitalized and growing but which is over-focused on financing large companies. Assets of Islamic banks grew about 11 percent annually over the past decade compared to 6 percent for conventional banks – the IMF paper partly attributes the growth in Islamic banking to it providing an acceptable alternative for Muslims who had previously tended to avoid conventional banks.[3] However, the mention of this positive point regarding Islamic banking is one of very few comments in the paper about Islamic finance, which is mentioned only in passing and without any discussion of special conditions affecting Islamic finance nor of any special policies that might be needed for Islamic finance.

Outside banking, the IMF paper describes the GCC as having many areas of underdeveloped financial institutions and infrastructure, limited financial inclusion, governance issues, and structural problems within the overall GCC financial system – again with virtually no mention of Islamic finance.

As will be argued below, many steps that can enhance Islamic finance within the regional macroeconomic integration process – common standards, development of monetary policy instruments, adherence to global best standards and practices, adjudication and bankruptcy mechanisms, cross-border trading, governance and supervisory oversight, etc. – apply equally well to the structural development of conventional financial institutions within the GCC.[4] In summary, largely parallel processes can be applied that while bolstering Islamic finance can simultaneously upgrade conventional financial systems, and create institutions that serve an increasingly integrated regional economy – the financial integration process should proactively take steps to build basic financial institutions that support its own work and simultaneously strengthen both conventional and Islamic financial markets.

Conventional financial institutions and instruments predominate in the region, but Islamic finance is systemically large[5] and must be included in integration plans. To some extent, the GCC regional economies are partially bifurcated into conventional and Islamic components, which can inhibit

---

[3] Page 6 of the IMF Policy Paper.

[4] For example, the IMF lists reforms to address constraints within the financial system (central collateral registries, better insolvency frameworks, building credit bureaus, and building new financial institutions to increase competition and serve rural and underserved communities), all of which can apply to both conventional and Islamic financial institutions and markets.

[5] As shown in the appendix, Islamic banking had about $837 billion (U.S. dollar equivalent) in assets at yearend 2018.

the overall financial integration process. The architects of economic integration programs are faced with a number of issues to address[6];

A. Understanding the size and structure of Islamic finance and the roles it plays in the region.
B. Developing policies to strengthen and foster growth of Islamic finance and ensuring it contributes to overall financial soundness.
C. Handling divergent responses of conventional and Islamic finance to economic events and policy actions.
D. Designing monetary policy instruments that are equally effective to the Islamic and conventional components of the finance system. This goal applies internally to each individual GCC economy to develop systems that do not materially advantage or disadvantage separate subsectors of the economy.
E. As the integration process proceeds to deal with common multi-country financial sector issues or to operationalize a common monetary or exchange rate policy within a monetary union, integrating regulatory, supervisory, and policy actions related to Islamic financial across the GCC member countries.

2. Differences between conventional and Islamic finance

Islamic finance differs in key ways from conventional finance. Islamic finance follows an ethical framework for economic and social justice which is often defined as "Shariah-compliant" (or "SC"). There are several schools of Islamic finance, but certain general principles apply:

- Prohibition on payment of interest, which is often interpreted as prohibition on financial techniques based on "time value of money".
- Encouragement of investment in real economic activities or trading in goods and services for profit.
- Islamic financial institutions should only engage in Shariah-compliant activities and transactions; if unavoidable, proceeds of noncompliant activities should be cleansed by actions such as donating gains to charity.
- Shariah-compliant activities should be segregated from non-compliant activities and funds.
- Avoid profiting from trading in financial assets or "using money to make money".
- Excessive risk taking is discouraged, which is often interpreted as prohibiting many types of financial derivatives.

[6] One question not addressed in this paper is the overall GCC policy toward Islamic finance – is it officially promoted as a favored method of finance, do Islamic and conventional finance share the stage as components of the GCC financial system, or will models of financial market development tend to reflect a larger role of conventional finance within the GCC economies? It appears relevant that the Saudi Vision 2030 plan that calls for a deep, liquid financial system by 2030 operating with best international practices and standards makes little mention of Islamic finance other than state that it would include initiatives that *enhance Shariah-compliant products within the various business spheres* – that is, "initiatives focusing on enhancing current market alternatives will define the right mechanisms to provide the necessary Shariah-compliant offerings. This will enable the correct specialization within each domain and avoid overlap/cannibalization with conventional products." This phrasing implies that the overall impetus of the financial sector development plan is aligned with conventional finance goals but with awareness that Islamic finance will contribute to the process.

- Islamic banks offer two types of deposit accounts; non-interest paying deposit accounts that closely parallel conventional accounts, and quasi-equity accounts in which returns/losses from ventures are shared between the bank and the depositor/investor.[7]
- Lending for certain activities, such as alcohol or drugs, is prohibited.
- Sharing profits for charitable purposes "zakah" is a religious duty.
- Several methods exist to smooth returns to IAH that do not have equivalents in conventional banking.
- Some Islamic financial instruments have names and financial flows that do not readily fit standard conventional financial instrument categories and flows.

Among the factors above, perhaps those potentially having the greatest impacts on Islamic finance economic integration are the prohibition on interest and restrictions to engage only in Shariah-compliant activities and transactions. Together, these conditions could constrain Islamic banks and other financial institutions in various ways.[8]

- IFIs cannot hold a wide range of conventional instruments (loans, securities, deposits, short-term liquidity instruments, etc. that receive or pay interest). IFIs thus might be excluded from the largest and most liquid financial markets within the GCC. This isolation can deprive IFIs of financial market signals, whether market generated or the result of policy actions.
- IFI's lack access to interest-rate based liquidity support mechanisms, many of which can allow conventional banks to quickly adjust their funding to meet changes in conditions.
- IFIs cannot use interest-rate based policy instruments, except where they might be required by law.
- IFIs might not be able to use central bank liquidity support facilities, such as discount windows.
- Inability to readily access liquidity sources can force IFIs to hold more capital and in readily available forms in order to meet changes in demand for funds. The overall structure of the balance sheet could be affected, and holding of own funds in more liquid instruments might affect returns.
- A shortage of Islamic 'High quality liquid assets' (HQLA) required under Basel III rules can constrain IFI activities. IFIs might be forced to acquire HQLA from other countries, which can introduce country or exchange-rate risk.
- Available Islamic financial instruments and counterparties will be limited. Within each country, the universe of IFIs is smaller than the general market, which means that economic shocks will tend to be concentrated within the defined group of counterparties, which could increase volatility and systemic risk.

---

[7] The latter are called Profit-Sharing Investment Accounts (PSIA) or "participation accounts"; parties funding these accounts are described as "Investment Account Holders" (IAH).

[8] The lengthy list above of possible special conditions that can affect IFIs includes some phenomena that are widely understood and some that are logical deductions about how Islamic markets might operate. Regardless, there is a significant shortage of theoretical and empirical research on how the Islamic markets operate within the GCC. This is an area the GCC needs to address.

Taken in total, the above effects suggest that Islamic finance encompasses mechanisms that will tend to isolate it from GCC financial systems. This tendency runs counter to the goal expressed in the European Monetary Union that greater economic integration up to the point of creating a single market within an economic union provides important economic benefits. Within fully integrated markets, economic signals spread through the union and help direct resources to their most productive uses which can contribute to general well-being. Also, in an integrated environment, economic policy actions can spread smoothly and in a non-discriminatory manner through the entire region. If this vision of the benefits of economic integration is correct, the GCC might need to take steps to counter any effect of limited participation of Islamic finance in the general development of the economy. As a general hypothesis, greater cross-country integration of IFI will tend to reduce the relative isolation of IFI in specific economies and broaden the scope of IFI markets – which can boster the financial soundness of the system..

3. Islamic finance and GCC economic integration

As noted above, in the Common Market and Monetary Union phases of economic integration the degree of effective integration or segregation of Islamic finance will become a significant factor.

The GCC financial integration process has moved erratically and sometimes has taken actions before undertaking the necessary preparatory steps. First, integrated financial markets have not yet fully developed – individual countries are taking actions to develop and strengthen institutions and standards but more work remains – including enhancing standards and institutions related to Islamic finance and fostering its integration into national financial markets. Also, the GCC jumped partially into the monetary union phase quickly without first building the full range of requisite institutions – for example, an early step in anticipation of a union was to freeze each country's national exchange rate vis-à-vis the U.S. dollar which froze the intra-GCC exchange rates, but this was done without developing the GCC-wide institutional and policy infrastructure that would be needed for full operation of a monetary union.[9]

A monetary union involves a transition to single monetary and exchange rate policy throughout the union. Many individual steps are involved, often summarized into a "blueprint" that describes

[9] The current situation in developing the GCC monetary union pegs each of the GCC currencies (except Kuwait) to the U.S. dollar, which effectively fixes the internal GCC exchange rates. Resposibility to keep each member's exchange rate in line rests with the individual countries, a strategy which has been largely successful. This policy means that the GCC exchange and monetary policies are effectively imported from the United States, which can create a range of macroeconomic and fiscal strains within the GCC.

In some future stage, one option is to introduce a single GCC currrency pegged to the U.S. dollar, which will require replacement of individual country currency, monetary institutions, and policies by single union-wide policies. The Gulf Central Bank will need latitude to implement a single set of policies throught the union, without danger of being undercut by policies of an individual member country. Those policies, instruments, and governance mechanisms have not yet been developed. Like the current situation, GCC exchange and monetary policy will remain imported from the United States, which can potentially introduce continuing macroeconomic and fiscal strains within the GCC. Ultimately, as the union strengthens, the GCC will need to take command of its own policies and economic destiny by breaking the peg to the dollar to reflect the significant economic size of the union and its diverse global economic and financial ties. Independent policy actions must affect the monetary, fiscal, and exchange rate policies of the union which will also require effective integration of Islamic finance within the union economy.

the steps involved, the schedule, standards and policies to be introduced, and the governance and decision-making mechanisms. For example, the blueprint for the European Monetary Union included around 180 different elements, all of which had to be completed (or reasonably well completed) before the start of union. Some activities must strictly conform to a single regional standard, but others can reflect national differences and need only be reasonably "harmonized" so that they produce similar results – the greater the degree of financial integration the greater the use of single region-wide standards.

A blueprint for a monetary union may include the creation of a central institute (European Monetary Institute) or council (Gulf Monetary Council) to work out the specifics of the future union and implement the blueprint. The central body will need to work actively with member countries and support harmonization of national practices and standards.

Important contributions to the process are made at the technical level where the elements of the blueprint have to be solidified into specific programs that generate soundly-based coordinated policies that are feasible and can be implemented in the member countries and at the union level.[10]

This work might be done in separate specialized working groups or committees (monetary policy, currency design and circulation, accounting, statistics, financial supervision, internal finance, *et cetera*) working within specifics based on local legal, political, and institutional arrangements. Actions must be based on firm knowledge of local practices and resources, be feasible in each country, and be able to follow a common time schedule. The central body must monitor and steer the work of the WGs, adjudicate differences in approach, and achieve and maintain broad political backing among the member states.[11]

Within the complex process described above, the role of Islamic finance must be included. The next section lists areas where Islamic finance technical projects can be undertaken.

4. Islamic Finance within the GCC Integration Process

This section provides an annotated list of technical project related to Islamic finance that can be undertaken as part of the creation of more fully integrated financial markets within the GCC.

---

[10] Progress of each country in implementing the blueprint must be monitored so that region-wide success is not impaired by failure of a specific country to implement key action. In the movement toward a single currency, the GCC faces the problem that Oman and the UAE are presently not committed to the monetary union. There are technical areas where they could be invited as observers and could adopt the common regional standards (such as trade documentation, accounting, statistical coverage), but in key policy areas unique national practices will continue. Such diversity in practice could delay or impair the ability of Oman and the UAE to join the monetary union should they eventually decide to do so. It can be questioned whether development of harmonized standards throughout the GCC need be led by the GMCO as a monetary union institution, or whether in some areas the GCC as a whole might be a better agent for change.

[11] This process appears to have a long way to go. The 2017 Gulf Monetary Council Annual Report says, "GMCO will have to carry out in the first place a comprehensive survey of the institutional set up and the regulatory framework of member countries of member countries before embarking on the required harmonization as called for by the MUA." Significant diversity in practice is found – "Islamic banking, an important component of the financial industry is also regulated and overseen differently among the member countries." (p.46)

4.1. Common Shariah standards

It has long been noted that Islamic financial markets in general are constrained by diverse definitions of instruments and their treatment. Shariah interpretations can stem from national Shariah boards, individual respected scholars, proprietary decisions affecting products of specific firms, or by individual bank Shariah boards. Interpretations are also constrained by a shortage of qualified Shariah scholars with deep knowledge of contemporary financial markets. Important progress is being made by recommendations of the Accounting and Auditing Organization of Islamic Financial Institutions (AAOIFI) and Islamic Financial Services Board (IFSB), but much remains to be done within the GCC. The GCC can meaningfully take under its wing a project to create more common Shariah standards within the region in order to facilitate cross-border transactions and settlements and adjudication of disputes.

It is suggested that this process can be prioritized by focusing first on common standards for the major tradable instruments, with special emphasis on sovereign sukuk issues, monetary policy instruments, negotiable deposit certificates, securities that can be used as official reserves or are discountable with the monetary authorities, and assets that can be used by banks as high-quality liquid assets for bank supervisory purposes. That is, the initial approach recommended here focuses on GCC-wide treatments for a limited number of critical financial instruments – action on the broad range of instruments should perhaps be deferred.

4.2. Cross-border trading and settlement of Islamic financial instruments

A vibrant Islamic finance market will require that transactors (or their agents) can nearly seemlessly transact in Islamic financial instruments throughout the region, precisely parallel to the need to remove constraints on cross-border trading of conventional financial instruments. Active cross-border trading of Islamic financial instruments will liquify the market by expanding the customer base, channel funds to areas of greatest need, diversify risks incurred in smaller individual country markets, and spread signals from monetary policy actions affecting Islamic finance smoothly through the GCC.[12]

4.3. Monetary Policy Instruments

A GCC union will need a stable of monetary policy instruments to influence general financial market conditions by introducing or absorbing liquidity in the market. The instruments should be Shariah-compliant to be handled by IFIs, but ideally can also be used by conventional institutions, or a parallel set of conventional instruments introduced that neither advantage or disadvantage either sector. Designing such instruments could be challenging, especially to build maturity ladders

[12] Promoting active trading in Islamic financial instruments can involve; Legal standards that protect holders of assets and adjudicate disputes throughout the integrated region, Enhanced accounting standards to give public, supervisors, and tax authorities confidence that records are accurate and timely, Strengthened market infrastructure for cross-border brokerage and transactions, depository facilities, payment facilities, and credit rating agencies.

into the instruments. An initial step is to study the existing national policy instruments to judge their effectiveness and more general applicability.[13]

4.4. Government Fiscal Policy and Islamic finance

Government funding and financing strategies can have large impacts on Islamic financial markets in the GCC. Most importantly, governments can finance fiscal deficits by issuing long-term sukuks, which can be used by IFIs to meet their supervisory HQLA requirements or be held against long-term obligations, such as in insurance and pensions – actions that can contribute to the long-term structural development and soundness of the Islamic finance sector. Regular scheduled issuance of sovereign sukuks could be undertaken to help support the deepening and liquidity of Islamic financial markets. Similar sukuk issuance might be taken by mandated public savings and pension schemes, such as social security, other public pensions, and investment funds. The funding of such projects through sukuk also can help boost the household savings rate, which could be an important development policy goal to help support increased capital investment for long-term development of the GCC economies.[14]

Because cross-border demand to hold longer-term SC obligations could be strong for smaller GCC countries and also numerous non-GCC countries, steps should be taken to facilitate their international usage.

The currency denomination of the sukuks could be in U.S. dollars or a GCC currency.[15] Using a GCC currency anticipates a future GCC monetary union in which the new union currency might break the link to the U.S. dollar[16] – to the extent that the sukuks are taken up in non-GCC countries this could support greater international acceptance of the new GCC currency.

4.5. Accounting

Common financial accounting standards for IFIs will ultimately be required throughout the GCC for supervisory and monetary policy purposes and to facilitate cross-border investment flows. Standards based on International Financial Reporting Standards (IFRS) are international best practice and should be applied to both conventional and Islamic institutions. However, Islamic banking includes various financial transactions and instruments that are not easily encompassed or are distorted within IFRS. The Accounting and Auditing Organization for Islamic Financial Institutions (AAOIFI) has devised a separate set of accounting standards applicable for IFIs. The AAOIFI and International Accounting Standards Board have a project underway to reconcile the AAOIFI standards with IFRS; the GCC should monitor this accounting work and mandate

---

[13] The development of GCC Shariah-compliant monetary policy instruments in a range of maturities effectively parallels initiatives to create maturity ladders for general market trading on Islamic instruments.

[14] "The current low savings ratio hinders the development of the financial services sector overall." (KSA Financial Sector Development Program Charter. 2017.)

[15] Currently a nominal step because the GCC currencies – other than the Kuwaiti dinar – are pegged to the U.S. dollar.

[16] See R. Krueger, B. Kamar, and J-E. Carlotti. "Establishing Conversion Values for New Currency Unions: Method and Application to the planned Gulf Cooperation Council Currency", IMF Working Paper WP/09/184, August 2009.

appropriate accounting standards for the region that best reflect the region's needs for information on IFIs.

4.6. Statistics

In addition to financial accounting statements for individual IFIs, the IMF and Islamic Financial Soundness Board (IFSB) have each recently designed aggregate financial statements for Islamic banks for use in financial soundness analysis. The IFSB framework is currently the only active aggregated statistical presentation of the Islamic banking sector – it is recommended that the GCC require all countries compile these data sets, and also prepare statistics on total Islamic financial activity within the GCC.[17] Also, whenever relevant, the GCC Statistical Office should explicitly separately identify Islamic financial activities within their full set of statistics.

A GCC centralized securities database should be set up (along the lines of an ECB database of global securities issues) that separately enumerates both conventional and Shariah-compliant securities. The ECB database is massive and probably includes almost all SC instruments globally, but unfortunately does not separately identify the SC instruments – a situation that should be corrected.

Information on the operation of the market might be derived from the IFSB's macrofinancial statistical database of Islamic banking and other markets, from commercial data bases covering individual banks, and from the experiences of national regulators and supervisors. One GCC priority should be to build a detailed research and supervisory data base on banking institutions in the region, covering both conventional and Islamic institutions. Research will be needed on the structure and operations of the Islamic sector, differences in structure and behavior between the Islamic and conventional sectors (which would benefit from complilation of separate statistical peer groups for Islamic and conventional financial subsectors), and the interactions between the Islamic and conventional institutions.

Many of the actions suggested within the spheres enumerated above, are effectively independent of being in a union – steps to actively upgrade systems (dialogs on Shariah standards, payments and settlement systems for Islamic financial instruments, accounting, statistics, sovereign sukuk issuance, financial supervision of IFIs, AML/CFT[18], etc.) are valid initiatives that can strengthen financial markets to support their growth and soundness regardless of whether a monetary union is ultimately set up. If the union never results, the GCC Islamic financial markets will be more efficient and robust to everyone's benefit. Conversely, a first focus on building strong, dynamic,

[17] See the new IMF *Financial Soundness Indicators Compilation Guide (2019)* Annex 7.4 "Islamic Deposit Takers and Financial Soundness Indicators" and R. Krueger "Perspectives on Islamic Finance in the National Accounts (forthcoming).

[18] In late December 2019, the Arab Monetary Fund and IFSB published a paper on AML/CFT policy regarding Islamic finance. It found no significant difference in ML/FT risks between conventional and Islamic banking. Thus, it saw no need for specific measures addressing ML/FT risks in Islamic banking and that countries should continue their own regulatory regimes in line with the Financial Action Task Force standards.

and sound Islamic financial markets would facilitate creating a union whenever the political forces align to agree to launch the union.

5. Conclusions

This paper recognizes that the current political climate within the GCC is not conducive to the establishment of a monetary union and that it is therefore at this juncture not opportune to go full speed ahead with preparatory work for Gulf Monetary Union.

The present political climate suggests that the GCC should focus its integration efforts on the completion of its Common Market and possibly a Single Market, rather than move aggressively toward establishing a monetary union. As the experience of the European Union shows, this itself is a major operation likely to take a considerable number of years. This holds particularly true for financial market integration and Islamic finance as a part thereof. It is in this context important to ensure that arrangements for treating Islamic finance created in support of the Common Market will not form an obstacle for further monetary integration when the time is felt ripe for such integration.

Because of its highly specific nature and with possible effects on multiple aspects of the GCC integration program, it is recommended that separate "Working Group on Islamic Finance" with a macroeconomic and policy orientation be set up covering treatment of Islamic finance within the GCC regional setting and to strengthen Islamic finance growth, soundness, and public benefit.

It is important that the working group be subsidiary to the GCC or GMCO as the regional central organizing authority. The WG must internalize that its dual roles are to faithfully represent the interests of Islamic finance within the overall integration process but simultaneously strengthen the Islamic financial sector to help it adjust to the priorities and schedule of the integration process and the technical requirements being addressed by other technical groups dealing with regional integration. Differences in recommendations between the Islamic finance WG and other technical groups should ultimately be taken to the GCC level for resolution – a process that might not be pretty as it must consider resources and scheduling issues, political influences and voting power, institutional and historical realities, public concerns, international standards and practices, and more, but within this process the needs of Islamic finance can always be a part of the conversation.

References

Arab Monetary Fund and IFSB. "Joint Working Paper on Money Laundering and Financing of Terrorism (ML/FT) Risks in Islamic Banking" (WP-12) December 2019.

Gulf Monetary Council. Annual Report 2017.

International Monetary Fund. "Gulf Cooperation Council: How Developed and Inclusive are Financial Systems in the GCC?" Policy Paper. 2018.

International Monetary Fund. *Financial Soundness Indicators Compilation Guide* – Annex 7.4 "Islamic Deposit Takers and Financial Soundness Indicators". 2019.

Kingdom of Saudi Arabia. "Financial Sector Development Program Charter". 2017.

R. Krueger, B. Kamar, and J-E. Carlotti. "Establishing Conversion Values for New Currency Unions: Method and Application to the planned Gulf Cooperation Council Currency", IMF Working Paper WP/09/184, August 2009.

R. Krueger "Perspectives on Islamic Finance in the National Accounts" (forthcoming).

Appendix: GCC Islamic banks

The table below presents IFSB data on the number of Islamic banks and their assets in each GCC country.

Islamic banking in the GCC – Yearend 2018

All data in millions

Country	Number	Total Assets: national currency	Total Assets: U.S. dollar
Bahrain	21	n.a.	58,899
Kuwait	6	30,724	101,389
Oman banks	2	1,544	4,014
Oman windows	6	2,754	7,159
Qatar	4	350,045	94,512
United Arab Emirates	8	582,576	157,295
Saudi Arabia banks	4	632,975	170,903
Saudi Arabia windows	8	901,539	243,415
GCC Total	59	-----	837,586

Source: Islamic Financial Services Board. Prudential and Structural Indicators Database. https:\\psifi.ifsb.org. U.S. dollar equivalents translated from national currency data using Morningstar data for December 31, 2018.

Data cover stand-alone Islamic banks and Islamic windows of conventional banks. Islamic windows are separate sections, offices, divisions, etc. of conventional banks that handle Shariah-compliant transactions. Although market practices might vary, in principle, Shariah-compliant transactions of windows should be strictly segregated from the conventional transactions of the parent bank because the conventional transactions might not be Shariah-compliant.