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Trade Finance by Islamic Banks and Exchange Rates: A Study of Pakistan's Exports between 2010-2022

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ABSTRACT

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Keywords *Letter of credit financing, Islamic banks, Exchange rate, Pakistani export, Economics, Trade finance,*

This study examines the factors that can affect the Exports of Pakistan, by paying particular attention to letter of credit financing by Islamic banks in Pakistan and exchange rate. Sample data of Islamic listed Banks is selected from last twelve years i.e. 2010 to 2022 with 975 observations. Study measures export performance using exports figures of Pakistan as the proxy for export performance while external factors namely letter of credit financing by Islamic banks and exchange rate used as an influencing factor. Applying panel data analysis, the results provide positive association Pakistan's export with Islamic banks' letter of credit financing and exchange rate, indicating that easy availability of trade financing and favorable exchange rate can help increase Pakistan's exports. The findings can aid policy managers, banking professionals, particularly those hoping to boost exports and foreign exchange through them. The study may also benefit managers seeking to broaden their knowledge of the key elements influencing export performance.



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Introduction

Muslims have been attempting in recent decades, to reorganize their lives according to Islamic precepts. They firmly believe that they have not received divine instruction in previous centuries due to the political and economic domination of the West, particularly in the socioeconomic spheres. As a result, the masses are working to restore their Islamic identity in order to structure their communal life in line with Islamic principles, following their attainment of political freedom. One of the most significant challenges faced by these Muslims was reforming their financial institutions to align with Shari'ah regulations. It was a challenging undertaking to establish the financial institutions without regard to interest in a setting where the entire financial system was predicated on interest. A specialist area of the larger financial sector, trade banking also referred to as trade finance or commercial banking focuses on enabling and assisting international trade transactions. Diverse regulatory frameworks, payment unpredictability, and currency fluctuation present a number of challenges for businesses expanding globally. Trade banking is essential in

resolving these problems since it provides a range of financial products and services meant to secure and expedite cross-border trade activities.

Islamic trade banking, as used in international trade with all products of financial services and activities with follow Shariah laws Rules & regulations and Islamic principles. Shairah prohibits regarding speculating (gharar), paying or receiving interest (riba), and engaging in activities deemed sinful or socially unacceptable (haram) for all financially transactions. Moreover, Trade banking uses worldwide transactions more seamless with shariah compliant.

The main features of Islamic banking are:

Sharia-Compliant Financing

Sharia-based financial options are what Islamic banking is all about. This generally means avoiding interest-based transactions and using Islamic financial instruments such as loans (Ijara), shareholding (Mudarabah) and interest-based financing (Murabaha).

Trade Compliance with Sharia Documentations

All exchange assentions and documentation are organized in compliance with Sharia law. Contracts must follow to ethical measures and be fair and straight forward agreeing to Islamic law.

Risk-Sharing and Profit-and-Loss Sharing

Islamic exchange managing an account places a solid accentuation on chance and benefit sharing. Since both the funder and the merchant share portion of the dangers and benefits of the venture,

Ensuring Halal Transactions

All exchanges empowered by Islamic exchange managing an account must comply with halal (passable) exercises, as per Islamic law. This implies maintaining a strategic distance from undertakings included in unlawful exercises, such as those related to betting, liquor, and other businesses.

Islamic exchange keeping money is regularly given by Islamic banks and other budgetary teach that prioritize advertising administrations in understanding with Sharia law. These organizations are essential in helping people and companies that want to conduct business internationally while upholding Islamic values. The role of Islamic trade banking is expected to expand as the world market continues to acknowledge the importance of Islamic finance. This will give participants in the international trade arena an ethical and Sharia-compliant alternative.

Foreign exchange is acquired by the countries that export commodities because they receive their profit back. In his book "International Trade," the author states that a country can gain a competitive advantage over other nations if it produces a particular kind of good, specializes in it, and trades it with those nations (Reuvid & Sherlock, 2011).

Governments are forced to include the banking sector in this picture because of the challenges, complexities, and risks involved. The banking system is currently used in almost all nations, particularly when it comes to international trade (Farzana, 2021). Today, a large number of Islamic nations are run entirely on the basis of shariah. These standards serve as a basis for Muslims to conduct business in accordance with what their faith has taught them (Azhar Rosly, 2010; Ahmad, 1994). The idea of a letter of credit (L/C), like non-Islamic banking concepts, is based on shariah principles (Lahsasna, 2007). The exchange rates that are in effect in a nation are another important aspect that affects that nation's export. Global investment decisions are mostly influenced by policies pertaining to foreign exchange rates (Genc & Artar, 2014). The value of a nation's currency

in relation to another is known as its foreign exchange rate. Thus, this component is crucial in defining the nature of trade that occurs between nations. The rationale behind this is that the buyer's cost is directly based on the foreign currency rate that is now prevailing in the market.

Research Questions

In light of the above discussion, this research attempts to find the answers to the following questions:

1. What impacts the Pakistani exports during era from 2010 till 2022?
2. What is the relationship between foreign exchange rates and the exports of Pakistan during the era of 2010 till 2022?
3. How the Letter of credit financing impacts the export of Pakistan and what is the relationship between the two?

Literature Review

Trade can be classified as either domestic or foreign depending on the size of its territory. A commerce transaction that takes place in one's own nation or another, between people who share the same citizenship, is referred to as domestic trade. Trading activity between individuals within a country and between nations have continued to rise as trade transactions have shifted from barter transactions to transactions using money intermediaries. Trade, whether domestic or foreign, is not the same. According to the Islamic nation, the state does not even need to provide clear instructions in order to interfere with domestic trade. The sole action taken by the state is to compel people to abide by sharia regulations in their commerce. Traffickers who break shariah law will face the same sanctions from the state as those who breach other mu'amalah transaction activities, like marriage, employment, and rent. The current exchange rates in the currency market, also known as the foreign exchange market, allow one country's currency to be exchanged for another country's currency. According to (Christopher J. Neely, 2015; 1) the foreign exchange market is an organizational network where banks, corporations, and people buy and sell foreign currency. The community's need for the application of sharia principles to business dealings, particularly foreign trade, coincided with the emergence of L/C facilities in the Islamic banking industry.

Letter of credit (L/C):

A L/C term used exclusively in banking industry to describe the contractual obligation. It can also be understood more simply as the non-monetary settlement of an account or as a conditional obligation that a bank must meet in order to pay the beneficiary the full amount promised, subject to predetermined criteria (Koudriachov, 2001). The beneficiary must provide the necessary paperwork to the bank in order for the transaction to be eligible for an insurance letter of credit (Harfield, 1978). Furthermore, the letter of credit contains information about the laws that apply to it as well as the kinds of documents that are required to finish the current transaction (Zhang, 2012).

The term "letter of credit" has its roots in the 19th century and is derived from a French phrase meaning "power to do something" (Koudriachov, 2001). Currently, the most widely used financial tool is the letter of credit, however its application in domestic trade is essentially nonexistent. The primary goal of the entire concept is to give the seller assurance that he will get the money he has been promised, which is a legal protection rule guarantee from the government (Harfield, 1978). The International Chamber of Commerce began publishing uniform rules in 1993, which are now known as "Unifrom Customs and Practice for Commercial Documentary Credit" (UCP's). This rules serve as the main source of regulations for all transactions involving letters of credit and do not differentiate between countries (Koudriachov, 2001). According to the study by (ICC, 2022), "UCP 600," the sixth Edition (the revised version) of the regulations that are in place in the banking industry, is the most recent version.

Islamic banks' social responsibility is based on the requirement for integrated organization at the

level of society overall, and it is a broad and well-rounded concept. The researcher emphasized the Islamic bank's commitment to taking part in certain social initiatives, programs, and ideas pertinent to its line of business, with the goal of upholding morality and advancing personal development and social awareness. The bank also has an interest in striking a balance between the interests of the various groups affiliated with the Islamic Bank throughout the nation (GlobeNewswire, 2018). According to Setyowati (2019), The Islamic Bank of the UAE performs the functions of a development bank, much like specialized development banks, so long as it directs all of its capital into investment projects. This goes beyond the role of a commercial bank that manages credit (investment) and offers banking services. The study emphasized Islamic banks' contribution to economic growth and demonstrated how crucial it is for these institutions to pool savings in order to finance development (Setyowati, 2019). According to GlobeNewswire (2018), Islamic banks in the United Arab Emirates are viewed as social banks that oversee the zakat fund and offer interest-free loans as well as investment and social services, all within strict parameters for the advancement of projects that subsequently advance the economy. According to the study, the Islamic Bank is carrying out all the fundamentals of the sophisticated banking industry in accordance with the most recent approaches and techniques to facilitate trade, encourage investment, and advance social and economic development in a manner that does not conflict with the UAE's Islamic Sharia laws. The Islamic Bank functions as an intermediary and partner that collects and reinsures funds and savings, earning a portion of the profit and absorbing a portion of the losses as they occur. It does this by receiving higher interest than that provided on deposits. (Ali, 2019)

Exchange Rates

The war of capturing the international market is going on in a dynamic way. Most of the countries try to capture it by sensing, seizing, and grabbing the best possible opportunity in the international market so as to increase exports of their country. But the issue is not just exporting the goods or services, rather there are many other factors in it. One of these factors is the exchange rate which is being followed by the exporting country. Many countries have different policies regarding exchange rates. In the past few decades of Pakistan, there have been a numerous changes occurred as a result of many reforms by government which took place over the time as well as policies and obligations implemented by IMF (International Monetary Fund). It has not only impacted the banking sector, but it has touched almost every sphere of life, more specifically the trade sectors of the country. These reforms have brought some major changes in exchange rate of market and with that the impact extends to the international trade of Pakistan and more specifically the exports side (Karim, 2014).

When the impact extends to these major sectors of the economy, it is highly likely that these will also impact any relationship in between exchange rates and the exports of Pakistan. One perspective of this relationship is the association between exporting goods and their prices in foreign currency, which is represented by the prevailing exchange rates (Bhattacharyya & Mukherjee, 2014). The relative price or the exchange rate has been subjected to many factors for example; inflation, balance of payment, monetary policy, fiscal policy, floating or fixed exchange rates etc. (Mussa, 1976). Chiorazzo et al. (2008) conduct an empirical investigation into the determinant influencing risk-adjusted returns (SHROE and SHROA) for uses of panel data from 85 bank that operated Europe (Italy) banking sector between 1993 and 2003. An inverse-U-shaped relationship has been found b/w risk-adjusted banks returns & bank size as assessed by total assets, according to the results of panel data models with fixed factors. Furthermore, a statistically significant relationship is found to exist b/w the growth rate of bank Assets and risk-adjusted returns. Dietrich and Wanzenried (2011) used panel data from 372 deposit banks in Switzerland from 1999 to 2009 to conduct an empirical analysis for the factors that determine bank profitability (ROAA, ROAE, and NIM). To examine the influence of the most recent financial crisis, the authors of study divided the samples of banks into two time periods: and pre-crisis period, which

ran from 1999 to 2006, and the crisis period, which ran from 2007 to 2009. Both before and after the crisis, the yearly deposit growth rate had a negative and significant impact on ROAA, according to the estimation results from the dynamic panel data estimators. The yearly deposit growth rate neither during the pre-crisis period nor during the crisis period appreciably influences ROAE in models where ROAE is employed as a measure of profitability. Lastly, the yearly deposit growth rate has a negative and significant impact on the net interest margin (NIM) in the crisis period in the equations where NIM is utilized as the profitability indicator; however, there is no meaningful relationship between the two variables in the pre-crisis period. İskenderoğlu et al. (2012) investigate the effects of bank scale and expansion on bank performance as assessed by ROA and ROE using quarterly data from 13 commercial banks registered in Borsa Istanbul (BIST) spanning the years 2004-2009. They depict size factors in their analysis using the logs of total assets and equity capital. In addition, growth variables are measured using the growth rates of equity capital and total assets. Results using dynamic panel data estimators demonstrate that bank size indicators have a positive and significant impact on bank performance indicators as evaluated by ROA and ROE. The authors conclude that there is a positive relationship between growth rate and performance after analyzing the data in terms of the factors that indicate the growth rate.

The value of one country's currency in another is known as the exchange rate. The sort of exchange rate system that the nation or economy uses determines how this rate changes; with a floating exchange rate system, on the other hand, changes in the rate are sensitive and fluctuate instantly (Kimberly & Erika, 2022).

Hypothesis

H1: There is a significant relationship between letter of credit financing and Pakistan’s Exports

H2: There is a significant relationship between exchange rates and Pakistan’s exports

H3: There is a significant relationship among letter of credit financing, exchange rates and Pakistan’s Exports.

Type and nature of Study

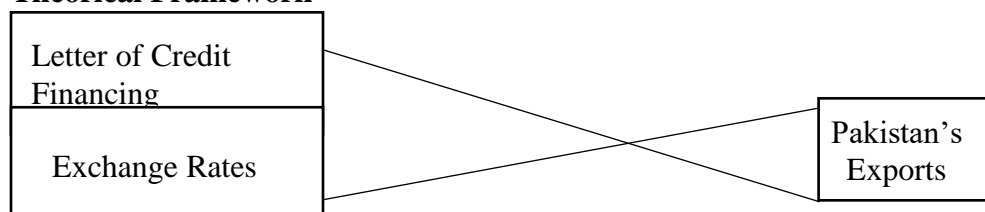
The nature of this research is quantitative, as it the reliable and suitable approach for exploring connection among dissimilar factors under the research. The goal of the study is to use statistics and theory to analyze data in order to find the real business problem's solution. The research is informal in nature because its goal is to determine how all the aspects that are taken into consideration relate to one another.

Data Size and Procedure of Data Collection

When it comes to obtaining accurate and concise data from primary sources, the method of fact-finding proves to be quite beneficial, especially when it involves asking closed-ended questions. However present study data is collected using financials of Islamic Banks operating in Pakistan and SBP data base. Similarly the populations of present study are the Islamic Banks operating in Pakistan and sample of data collection use quarterly data of last Twelve year to get as much data.

Research Design and Methodology

Theoretical Framework



influence of L/C financing and exchange rates on Pakistan’s exports, a general estimation model is

developed based respectively. Since the data for this study is a combination of time series and cross-sectional observations, panel regression analysis is done. The generated study model, together with the study's hypotheses, are expressed in the equations below. The model, which links currency rates, letter of credit finance, and Pakistan's exports, is a panel regression function (Jaizah Othman, 2018).

The Each Country empirical model is described as follows.

$$PE_i = \alpha + \beta_1 LC + \beta_2 ER + \epsilon_i$$

Where countries PE is the symbol for log of Pakistan's Exports in last Twelve years, α is the constant (unchanged factor). Letter of credit financing and exchange rates respectively, lastly ϵ is term of error. Regression analysis has been used to evaluate the produced research model by the relationship between the variables. This study will need to use correlation analysis to determine the relationship between the variables before moving on to regression analysis. Many independent variables are employed in the panel regression analysis to predict the value of the dependent variable. It also clarified how changes in independent variables may result in changes in the dependent variable. The coefficient of determination (R²) indicates how well the regression equation can predict. The co-efficient of determination could be any value between ± 0.01 and ± 1.00 , according to Saunders (2009). furthermore to determine whether there is a significant link between the independent and dependent variables. The null hypothesis is rejected when the p-value is less than the significance level (Hyen, 2017).

Result and Findings

Descriptive Statistics

The mean, standard deviation, minimum and maximum values of all observations are shown in Table 1. The data in this table shows that there been significant fluctuations in the exchange rate between 2010 and 2022. The exchange rate's minimum and maximum values were 85.71 and 224.76, respectively, while its mean was 127.28 with a standard deviation of 39.65. Letter of credit finance has a mean of 5.05 but standard, minimum, and maximum values of 0.70, 1.41, and 6.21, respectively. This implies that businesses in Pakistan rely a great deal on letter of credit financing. Furthermore, the export sample mean is 4.39, the standard deviation is 0.05, and the lowest and maximum values fall between 4.30 and 4.50. In addition, we may conclude from examining the export's mean, standard deviation, minimum, and maximum values that it remained mostly unchanged over the course of the study period.

Table 1: Statistical significance of key variables

<u>Variables</u>	<u>Mean</u>	<u>Std</u>	<u>Min</u>	<u>Max</u>
<u>Export</u>	<u>4.39</u>	<u>0.05</u>	<u>4.30</u>	<u>4.50</u>
<u>Exchange</u>	<u>127.28</u>	<u>39.65</u>	<u>85.71</u>	<u>224.76</u>
<u>Letter of Credit Finance</u>	<u>5.05</u>	<u>0.70</u>	<u>1.41</u>	<u>6.21</u>

Correlation Analysis

Table 2 presents the correlation matrix among the variables. It is shown that the correlations among the variables are uniformly very low and moderate plus significant at level $p < 0.05$. All variables are correlated positively with each other, such as exchange rate positively influence Pakistan exports as higher exchange rate mean higher income and higher investment in assets that may also yield higher return, the strength of correlation is moderate as correlation values is 0.55. Whereas letter of credit financing positively influences Pakistan export, based on the above table, the correlation coefficient of 0.11, which means the level of relationship between L/C financing of Islamic Banks to Pakistan exports is very low. The strength of the relationship between the

variables can be seen from the coefficient values given in the table. The correlation coefficient may support this research.

Table 2: Correlation coefficient of explanatory variables

<u>Variables</u>	<u>Exchange Rate</u>	<u>Letter of Credit Finance</u>	<u>Export</u>
<u>Exchange Rate</u>	<u>1</u>		
<u>Letter of Credit Finance</u>	<u>0.33</u>	<u>1</u>	
<u>Export</u>	<u>0.55</u>	<u>0.11</u>	<u>1</u>

Hausman test

Hausman created an experiment to easily choose the appropriate method among two competing methods (fixed effects and random effects). This test indicates whether or not there is a significant difference between the estimators for the fixed effect and the random effect. The Hausman test was used in this study to determine the best approach. The cross section's chi-square value is 37.48, with a p-value of 0.0017, according to the results. Therefore, the fixed effects model is advised to be used by the Hausman test in order to get reliable and effective estimates.

Econometric model analysis

The findings of regressions on Pakistani exports derived from panel data for the years 2011 through 2022 are presented in Table 3. according to the Hausman test result, which indicated that FEM is better suitable. The currency rate and letter of credit financing are the primary elements that are used to interpret Pakistan's exports, according to the FEM regression result. It gives the exchange rate and letter of credit financing as the empirical result of FEM with estimator. Specifically, there is a statistically significant positive correlation between the exchange rate and Pakistani exports. This finding indicates that, if all other independent variables remain constant, a 1% increase in the exchange rate may result in a 0.66% increase in Pakistani exports. Stated differently, this suggests that the exchange rate has a significant role in determining Pakistan's exports and has the potential to increase them. Furthermore, at the 1 percent significance level, there is unquestionably a positive statistically significant correlation between Pakistan's exports and letter of credit funding. According to the projected coefficient of 0.255, a 1% increase in letter of credit financing will result in a 0.255% rise in exports from Pakistan. As a result, businesses that use financial facilities operate more effectively and boost Pakistani exports.

Table 3: Regression analysis of equations

Variables	Coefficient	t-statistics	P Value
(Constant)	0.488	1.864	0.000
Exchange Rate	0.661	2.77	0.003
Letter of credit financing	0.252	5.351	0.002
R Square	66.48%		
F	260.962		
Sig.(F-stat)	0.000		

Discussion

This investigation proposes that a 1% increment within the trade rate may interpret into a 0.661% increment in Pakistani trades, expecting all other autonomous factors remain consistent. Stated differently, this suggests that exchange rates have a significant role in determining Pakistan's export growth and can support the development of foreign exchange. Results of Aivazian (2005), Azzoni and Kalatzis (2006), Adelegan and Ariyo (2008), Jangili and Kumar (2010), Nair (2011), Ruiz-Porrás and Lopez-Mateo (2011), and Jangili and Kumar (2010) are likewise consistent with this outcome. According to the letter of credit financing coefficient of 0.255, if the other independent variables remain same, a 1% increase in the letter of credit financing of Islamic banks will result in

a 0.255% increase in Pakistan's exports. The following studies: Saquido (2003), Aivazian et al. (2005), Baum et al. (2008), Carpenter and Guariglia (2008), Bokpin and Onumah (2009), Li et al. (2010), both support this conclusion and have the same predictive signature. This data means that the larger the loan form, the greater the export growth of Pakistan will be. It is also consistent with previous studies by Adelegan and Ariyo (2008), Li et al. (2010), Ruiz-Porras and Lopez-Mateo (2011) have the same sign as expected.

Conclusion

We should draw the following conclusions from the findings of our investigation. To begin with the exchange rate is statistically significant across regressions and roughly positive. This finding suggests that the primary factor influencing Pakistan's export growth is the exchange rate, or the depreciation of the PKR. It also indicates that companies use to export more when exchange rate increases as they get more in return due to PKR devaluation. Secondly, letter of credit financing is positive and statistically significant associated with exports of Pakistan across all estimators. It indicates that letter of credit financing by Islamic Banks helps exports of Pakistan to be increase. The results also support the idea that a letter of credit has a significant role in boosting Pakistan's exports. Based on the results of the study, it can be concluded that letters of credit have a greater impact on export growth than exchange rates.

Policy Recommendation

This research provides valuable insights into the effects of exchange rate volatility and letter of credit (LC) financing on Pakistan's exports, making it valuable reading for Pakistani economists, bankers, and banking industry professionals. According to a research implementation point of view, this study will aid finance managers, particularly policy makers, in formulating policies by choosing to comprehend important variables and their impact on exports from Pakistan by careful analysis after taking into account all the variables. Since Pakistan needs to increase the performance of its exports, the study will aid in controlling and promoting the significance of the exchange rate and letter of credit finance relationship with exports of Pakistan. Policy managers stand to gain greatly from the study, particularly those who hope to use it to boost exports and foreign exchange. Therefore, it is beneficial for managers to be aware of these consequences.

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