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*DEVELOPING ISLAMIC FINANCE  
OPPORTUNITIES FOR TRADE FINANCING:  
ESSAYS ON ISLAMIC TRADE VIS-À-VIS THE OIC  
TEN-YEAR PROGRAMME OF ACTION*

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**DEVELOPING ISLAMIC FINANCE OPPORTUNITIES FOR TRADE**

**FINANCING:**

**ESSAYS ON ISLAMIC TRADE *VIS-À-VIS* THE OIC TEN-YEAR  
PROGRAMME OF ACTION**

**Ahmet Suayb Gundogdu**

**Thesis Submitted in Fulfilment of the Requirements for the Degree of  
Doctor of Philosophy at Durham University**

**School of Government and International Affairs  
Durham Centre for Islamic Economics and Finance  
University of Durham, United Kingdom**

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## ABSTRACT

### Developing Islamic Finance Opportunities for Trade Financing: Essays on Islamic Trade vis-a-vis OIC Ten-Year Programme of Action

Ahmet Suayb Gundogdu

International trade has been defined as the engine of growth by international development institutions as more cross-border trade associated with more economic activity, higher employment, hence, poverty alleviation. If trade is the engine of growth, trade finance can be defined as grease for the engine. Hence, availing more funds to finance the enormous amount of international trade, counting about half of global GDP, is an important agenda for the OIC as well as many multilateral development institutions. The main reason behind the efforts to avail more funds for trade finance is to direct valuable financial resources from speculation to explore opportunities to increase international trade in a way to grease and roll the wheel of real economy. With reference to the OIC Ten-Year Programme of Action to Meet the Challenges Facing the Muslim countries in the 21<sup>st</sup> century, this research aims to introduce outward-looking, cost-effective, and informal policy options for a resilient OIC trade integration to increase international trade among OIC countries.

In this regard, the first essay aims to explore the determinants of recent increase in intra-OIC trade to ascertain if it is due to policy instruments implemented by OIC organs or some other externalities. It is argued that recent increase in intra-OIC trade percentage is likely to be the product of reverse effects of oil price surge and Euro appreciation but not trade diversion effect of OIC membership. OIC membership itself alone would not increase intra-OIC trade if not accompanied with policy instrument for trade facilitation to make cross-border trade easier among member countries. However, as customs revenue constitutes the bulk of public revenue for many OIC countries, they need to be convinced about benefit of trade facilitation. Accordingly, with reference to the unwillingness of OIC countries for trade facilitation, the same essay scrutinizes the effect of tariff and WTO Customs Valuation Agreement on customs' revenue of OIC countries. The results suggest that increasing tariffs might increase customs revenue for big countries but not for small countries. Besides, the implementation of WTO Customs Valuation Agreement does not decrease customs revenue as its indirect undervaluation effect would be surpassed by its direct effect of less incentive for tax evasion.

As a crucial crop for public finances in many OIC countries and initial stage of industrialization, special emphasis is given to development of the cotton sector under the OIC Ten-Year Programme of Action. The Third Expert Group Meeting on Enhancing Production Efficiency and International Competitiveness in OIC Cotton-Producing Countries adopted the Five-Year OIC Cotton Plan of Action (2007-2011). As per the mandate of OIC, two Islamic trade finance products are proposed, one for the cotton sector through the resources mobilized with *mudarabah*, by proposing *salam* for complete supply chain financing in the second essay, and another for resource mobilization based on 2-Step *murabahah* in the context of international trade as an alternative to commodity *murabahah*, *sukuk* as well as *mudarabah* in the third essay.

In conclusion, based on further findings of the survey, the questionnaire and interviews; capacity building in trade facilitation for small countries to be complemented with OIC mutual recognition agreement for standard and conformity assessment within *halal* food standard development; integrated single window among OIC countries' customs; OIC cumulation system of rules of origin for market access; inward processing relief as an alternative to free trade zones; development of the cotton sector among OIC countries to address production constraints of LDMCs and 2-Step *murabahah* to mobilize trade finance resources to boost trade of OIC countries, particularly for LDMCs, are proposed as a part of concretely defined and well-grounded OIC trade integration framework.

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## LIST OF ABBREVIATIONS

ADB: Asian Development Bank  
AFCOT: Association Française Cotonnière  
AfDB: African Development Bank  
AfT: Aid for Trade  
AFTA: Association of Southeast Asian Nations Free Trade Agreement  
AMU: Arab Maghreb Union  
APEC: Asia Pacific Economic Cooperation  
ASEAN: Association of Southeast Asian Nations  
ASYCUDA: Automated System for Customs Data  
ATA: Admission Temporaire/Temporary Admission  
BASEIND: Basic Social and Economic Indicators  
B/L: Bill of Lading  
BDV: Brussels Definition of Value  
CEPII: Centre d'Etudes Prospectives et d'Informations Internationales  
CES: Constant Elasticity of Substitution  
CEMAC: Economic and Monetary Community of Central Africa  
CET: Common External Tariff  
CFA: Colonies françaises d'Afrique  
CFDT: Compagnie Française pour le Développement des Textiles  
CIS: Commonwealth of Independent States  
CM: Collateral Manager  
CMDT: Compagnie Malienne pour le Développement des Textiles  
CMM: Collateral & Monitoring Manager  
CMMC: Collateral Monitoring and Management Company  
COMCEC: Standing Committee for Economic and Commercial Cooperation of the Organisation of the Islamic Cooperation  
COMESA: Common Market for Eastern and Southern Africa  
COMIAC: Standing Committee for Information and Cultural Affairs  
COMSTECH: Standing Committee for Scientific and Technologic Cooperation  
CPD: Carnet de Passages en Douane  
CVA: Customs Valuation Agreement  
EBRD: European Bank for Reconstruction and Development  
D/A: Delivery Against Acceptance  
D/P: Delivery Against Payment  
EC: European Community  
ECO: Economic Cooperation Organization  
ECOWAS: Economic Community of West African Countries  
EFTA: European Free Trade Area  
EEC: European Economic Community

EGM: Expert Group Meeting  
ESCAP: Economic and Social Commission for Asia and the Pacific  
EU: European Union  
FTA: Free Trade Agreement  
GATT: General Agreement on Tariffs and Trade  
GCC: Gulf Cooperation Council  
GDP: Gross Domestic Product  
GPC: Groupement des Producteurs de Coton  
GP Margin: Gross Profit Margin  
ICAC: International Cotton Advisory Committee  
ICCI: Islamic Chamber of Commerce and Industry  
ICDT: Islamic Center for Development of Trade  
ICE: International Commodity Exchange  
ICFM: Islamic Conference of Foreign Minister  
ICR: Irrevocable Commitment to Reimburse  
ICT: information and communication technologies  
IDB: Islamic Development Bank  
IGEME: Ihracati Gelistirme Etud Merkezi (TPO of Turkey)  
IMF: International Monetary Fund  
ITFC: International Islamic Trade Finance Corporation  
IPR: Inward Processing Relief  
ITC: International Trade Centre  
ITFC: International Islamic Trade Finance Corporaion  
LAIA: Latin American Integration Association  
L/C: Letter of Credit  
LCA: Liverpool Cotton Association  
L/G: Letter of Guarantee  
LDMC: Least Developed Member country  
LIBOR: London Interbank Offered Rate  
MATRADE: Malaysian External Trade Development Corporation (TPO of Malaysia)  
MENA: Middle East and North Africa  
MERCOSUR: Mercado Común del Sur  
MFN: Most Favoured Nation  
MRA: Mutual Recognition Agreement  
NAFTA: North American Free Trade Agreement  
ODAHA: West African Economic and Monetary Union  
OECD: Organisation for Economic Co-operation and Development  
OIC: Organisation of the Islamic Cooperation  
OLS: Ordinary Least Squares  
PRETAS: Protocol on Preferential Tariff Scheme for TPS – OIC  
RTA: Regional Trade Agreement

SAARC: South Asian Association for Regional Cooperation  
SADC: Southern African Development Community  
SESRIC: Statistical, Economic and Social Research and Training Centre for Islamic Countries  
SG&A Expenses: Sales and General Administrative Expenses  
SME: Small and Medium Size Enterprises  
SOFITEX: Société Burkinabè des Fibres Textiles  
SPECA: Nations Special Programme for the Economies of Central Asia  
STF: Structured Trade Finance  
SWIFT: Society for Worldwide Interbank Financial Telecommunication  
TCPP: Trade Cooperation and Promotion Program  
TINIC: Trade Information Network of the Islamic Countries  
TNC: Trade Negotiating Committee  
TOT: Term of Trade  
TPO: Trade Promotion Organization  
TPS-OIC: Tariff Preferential Scheme for OIC  
TRAINS: Trade Analysis and Information System  
UDEAC: Economic Community of Central African States  
UEMOA: Economic and Monetary Union of West Africa  
UK: United Kingdom  
UNCTAD: United Nations Conference on Trade and Development  
UNDP: United Nations Development Programme  
UNECE: United Nations Economic Commission for Europe  
UNPCB: Union Nationale des Producteurs de Coton du Burkina  
USA: United States of America  
USD: United States Dollar  
VAT: Value Added Tax  
WDI: World Development Indicator  
WITS: World Integrated Solution Database  
WR: Warehouse Receipt  
WTO: World Trade Organisation  
WTO CVA: World Trade Organisation Customs Valuation Agreement

## **DECLARATION**

I hereby declare that no portion of the work that appears in this study has been used in support of an application of another degree in qualification to this or any other university or institution of learning.

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***“EVERY CONTAINER BECOMES TIGHTLY PACKED WITH  
WHAT IS PUT IN IT, EXCEPT FOR THE CONTAINER OF  
KNOWLEDGE, FOR SURELY IT EXPANDS”***

أبو تراب

## SYNOPSIS

With reference to the OIC Ten-Year Programme of Action, this thesis aims to introduce outward looking, cost-effective, and informal policy options for a resilient OIC trade integration based on the findings of essays employing econometric models on determinant of intra-OIC trade and OIC countries' customs revenue, the findings of two case studies on Islamic Trade Finance, a survey, a questionnaire, deliverables of COMCEC initiatives and interviews conducted with senior officials of some OIC organs.

Although there has been steady increase in intra-OIC trade (defined as intra-OIC imports as a share of total imports of OIC countries) in the last few years, recent literature on intra-OIC trade shows that OIC membership has not contributed much trade between OIC member countries. Then, what is the determinant of recent increase in intra-OIC imports from 14.4 per cent in 2002 to about 18 per cent in 2007? Given the Makkah Declaration and the OIC Ten-Year Programme of Action to increase intra OIC trade ratio, which is defined as trade among OIC countries over OIC countries' trade with the world, to 20%, the first essay scrutinizes the determinant of intra-OIC trade by gravity modelling for the period of 1995-2007. Unlike recent literature, four important international trade determinants namely, tariff, a proxy for trade facilitation & liberalization, depreciation of real exchange rate and depreciation of US dollar against Euro are included to the model so as to mitigate omitted variable bias. It is argued that recent increase in intra-OIC trade percentage is likely to be the product of opposite effects of oil price surge and Euro appreciation rather than trade diversion effect of OIC membership. It is suggested that trade liberalization and facilitation measures should be synchronized to enhance intra-OIC trade. Small OIC countries very often reveal unwillingness for further trade integration as government officials in these countries associate any forward move in trade integration with loss of valuable customs revenue, hence, burden on public finance. The same chapter scrutinizes the determinants of customs revenue in the context of WTO-member OIC countries. An econometric model of OLS, fixed effect and random effect calculations is employed with panel data of 1995-2007. The results suggest that increasing tariffs might increase customs revenue for big countries but not for small countries. Besides, the implementation of WTO Customs Valuation Agreement does not

decrease customs revenue as its indirect undervaluation effect would be surpassed by its direct effect of less incentive for tax evasion. This part of the chapter indicates implementation of information and communications technologies in the form of integrated single windows to tackle the undervaluation issue as an alternative so leakage in valuable customs revenue for small OIC countries might be appeased.

The cotton sector as a main foreign exchange revenue earner and a major source of employment is crucial for sustainable development in many OIC countries, especially in West Africa. The cotton sector was identified as a strategic sector in the “Draft road-map for achieving intra-OIC trade volumes targets” which was then adopted in 24<sup>th</sup> COMCEC Meeting in 2008 and entered to the OIC agenda. As a crucial crop for public finance in many OIC countries and initial stage for developing spinning and subsequent industries, special emphasis is given to development of the cotton sector under the OIC Ten-Year Programme of Action. The Third Expert Group Meeting on Enhancing Production Efficiency and International Competitiveness in OIC Cotton-Producing Countries, held in Antalya, Turkey, in October 2006, adopted the Five-Year OIC Cotton Plan of Action (2007-2011). The meeting adopted the following recommendation:

*(“Focus should be given to supply chain financing, start from providing input to post-harvest seed cotton purchase from farmers. To accommodate this supply chain financing existing, structural trade finance designs need to be expanded to some more OIC countries.”)*

Accordingly, the second essay presents a case study for employing Islamic finance instruments in a structured trade finance deal as an alternative to conventional financing in the context of the Five-Year OIC Cotton Action Plan. This essay goes beyond the existing case and proposes *salam* contract for complete supply chain financing starting from input financing and extend to post-harvest financing with the hope to pioneer literature in the area. Mark-up calculation is also provided for reference. After explanation of the facility structure and extended structure for supply chain financing with *salam*, a comprehensive risk analysis to identify possible risk, their causes, preventive actions and contingencies is conducted in order to show the holistic view introduced with this Islamic finance instrument. The concept of Islamic supply chain financing starting from input financing to post-harvest and pre-export finance is

explained in the context of SOFITEX, leading ginning conglomerate in Burkina Faso, West Africa. While availing the case of SOFITEX, some insight into the global cotton sector, the cotton sector in the region and financial standing of the subject cotton ginner, SOFITEX is provided so as to show how to embed structured Islamic finance tools within the context of real-life problems.

Again, the ‘Draft road-map for achieving intra-OIC trade volumes targets’ mandates developing new Islamic finance mechanisms to be of use to increase trade finance for SMEs in LDMC OIC countries. Hence, the third essay presents another case study which shows how to mobilize resources through Islamic financial instruments in order to avail more funds for trade finance accessible to SMEs in LDMC OIC countries. This essay shows how to mobilize resources through Islamic financial instruments to be utilized by importers in the context of international trade. Throughout the essay there are five entities namely, *Bank-A*, *Bank-B*, *Bank-C*, *Importer* and *Exporter* for illustration purposes. *Bank-A* and *Bank-B* are recognized financial institutions and they operate internationally while the operations of *Bank-C* are limited to the domestic market. The examples revolve around the *Bank-B*’s business processes. It is *Bank-B* which provides imported input to the importer under Direct *murabahah* Sale. Again, it is *Bank-B* which mobilizes resources from *Bank-A* through *mudarabah* and alternative Reverse 2-Step *murabahah* agreements in favour of the importer. The details of disbursement for line of financing provided by Bank-B to Local Bank-C to be utilized by the importer through 2-Step *murabahah* Agreement are also provided for Letter of Credit and Documentary Collection settlements. Also, operational details including content of L/C, ICR and legal agreement of 2-Step *murabahah* are provided within a case of a Gambian importer procuring yarn from an Egyptian exporter. This product, 2-Step *murabahah*, is proposed as a remedy for L/C confirmation problem of Least Developed countries and as an alternative resource mobilization/liquidity management to *sukuk* and commodity *murabahah* in order to direct resources for promoting OIC countries trade rather than debt trading by circumventing Islamic Law.

The results of essays, the survey, the questionnaire and interview are summarized in the conclusion chapter. Findings suggest that small countries mainly suffer from supply-side

constraints, which also include unavailability of trade finance and unavailability of any production for export, with reference to WTO Aid-for-Trade agenda and reluctance for further trade integration due to fear of customs revenue loss as it constitutes the bulk of state revenue. On the other hand, big countries suffer from market access difficulties such as customs valuation, low port efficiency, inland transportation, technical barriers, *etc.* of other OIC countries, specifically small countries. Hence, capacity-building in trade facilitation for small countries to be complemented with OIC mutual recognition agreement for standard and conformity assessment based on Halal standards, integrated single window among OIC countries' customs and OIC cumulation system of rules of origin for market access is proposed to enhance intra-OIC trade. Also, inward processing relief as an alternative to free trade zones, development of the cotton sector and 2-Step *murabahah* to mobilize trade finance resources to address supply side constraints in LDMCs and boost trade of OIC countries are proposed as parts of a concretely defined framework in the conclusion chapter. With reference to the supply side constraint of least developed OIC countries, cotton sector development is strongly proposed to bring these countries in the sphere of OIC trade integration. Otherwise, these countries lack in export capacity and suffer from non-existence of any industry. Cotton production can play a role in breaking the vicious circle of poverty and create export capacity of LDMCs as identified by the OIC Five-Year Cotton Action Plan with reference to poverty alleviation directive of the OIC Ten-Year Action Plan. It is found that supply chain financing to the cotton sector in the form of discounted formal credit would help alleviate poverty subject to:

- (i) The discounted funds with formal credit should be assured to reach farmers but not informal credit providers which may include local banks, landlords, and unscrupulous managers of agricultural cooperatives who may apply local market interest rate to poor farmers while enjoying discounted funds mobilized through formal credits.
- (ii) The funds should focus on procurement of inputs for agricultural production but not purchase of consumption items giving rise to impoverishment farmers. In this regard, availed funds should be monitored to assured that they are used for procurement of input to boost agricultural production.
- (iii) Formal discounted credit should be accompanied by several infrastructure development projects in the form of transportation, irrigation, *etc.* which targets to increase agricultural productivity to make agricultural input financing

sustainable by assuring reasonable level of yield for harvest and market access for sale of yield.

Any formal credit targeted to the cotton sector should observe these concerns.

It is also argued that in order for complete supply chain financing to be successful, it should be complemented with quality, quantity and value-increasing initiatives in order to make cotton production business profitable/sustainable:

- (i) Improving the productivity and yield levels (introducing better seeds, irrigation, mechanization of seeding);
- (ii) Decrease the contamination (use of special bags for harvesting, establishing basic warehouses in villages);
- (iii) Improving testing and classification of cotton (grant for HVI testing machines and training);
- (iv) Promoting investment opportunities in the cotton sector (Ginning machines) for processing and marketing of cotton in order to enhance international competitiveness;
- (v) Eliminating intermediaries between net cotton-exporting and net cotton-importing OIC countries (trade bridges, bringing West African cotton to warehouses in the net cotton-importing OIC countries).

# **Chapter 1**

## **INTRODUCTION AND BACKGROUND**

### **1.1 INTRODUCTION**

Globalization coupled with the establishment of the multilateral trading rules-based system has necessitated economic integration among countries. This phenomenon has manifested itself through the formation of free trade areas (FTAs), customs unions, common markets or full economic unions among countries all over the world. The establishment of the European Union (EU) as well as other forms of FTAs are successful examples of such economic integration among different sovereign states.

The dictates of the globalized economy now set the rules for the economic policies in terms of enhancing closer economic interlink among countries. In the wake of the new emerging global economic realities, the Organisation of the Islamic Cooperation (OIC) member countries, with a view to expedite their economic growth and development, need to think proactively to catch up effectively and meaningfully with the rapid pace of globalization. It has, therefore, become imperative for them to take joint actions within the framework of the OIC, based on common values and ideals, in order to strengthen their economic positions in the globe.

The OIC has fifty-seven members which came together to safeguard progress and well-being of their people and Muslims around the world. The organization was established in Rabat, Morocco on 25 September 1969 during the first meeting of heads of states. The charter of the organization was adopted in 1972 during the third session of the Islamic Conference of Foreign Ministers. As the charter highlights, the organization aims to strengthen solidarity among member states; cooperation in the political, economic, social, cultural and scientific fields; and the struggle of all Muslim people to safeguard their dignity, independence and national rights.

The OIC has three main bodies: the conference of heads of states, Islamic summit, meets every three years and formulates organization's policies as the supreme authority; the

conference of foreign ministers meets every year to follow up progress on implementation of the Islamic summit's decisions. Lastly, the general secretariat entrusted with implementation of the above-mentioned two conferences' decisions.

Throughout these summits the organization created several committees in order to coordinate cooperation in various fields. The most important of these committees are chaired by the head of states. Some of the very active ones are: The Standing Committee for Information and Cultural Affairs (COMIAC); The Standing Committee for Scientific and Technologic Cooperation (COMSTECH) and The Standing Committee for Economic and Trade Cooperation (COMCEC). At the Third Islamic Summit held in Mecca in 1981, COMCEC was established with the mandate of formulating programmes for economic cooperation within the OIC agenda. The COMCEC became operational at the Fourth Islamic Summit held in Casablanca in 1984 and the president of Turkey was elected for chairmanship. Since then COMCEC convened annual sessions regularly in Istanbul, Turkey.

The OIC Ten-Year Programme of Action adopted at the Third Extraordinary Session of the Islamic Summit in 2005 clearly recognizes the importance of economic cooperation among member countries and calls upon them to sign and ratify all existing OIC trade and economic agreements, and to implement the provisions of the relevant OIC Plan of Action to Strengthen Economic and Commercial Cooperation among OIC Member States.<sup>1</sup> After introduction, the OIC Ten-Year Programme outlines two themes and sub-items as<sup>2</sup>:

- (i) Intellectual and Political Issues
  - Political Will which urge member countries to fully implement the provisions of OIC Charter and resolutions.
  - Solidarity and Joint Islamic Action
  - Islam, the Religion of Moderation and Tolerance
  - Multiplicity of Islamic Jurisprudence
  - The Islamic *Fiqh* Academia
- (ii) Development, Socio-Economic and Scientific Issues
  - **Economic cooperation**

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<sup>1</sup> Complete list of agreements can be found on COMCEC website <http://www.comcec.org/EN/default.aspx#> last accessed on 23 November 2009.

<sup>2</sup> "The OIC Ten-Year Programme of Action to Meet the Challenges Facing the Muslim Ummah in the 21st Century" is available online at <http://www.oic-oci.org/ex-summit/english/10-years-plan.htm> last accessed on 1st May 2010.



- **Supporting the Islamic Development Bank** which highlights strengthening IDB's role to avail providing financial support in particular for Trade Finance through International Islamic Trade Finance Corporation
- Social solidarity in the face of natural disasters
- **Supporting development and poverty alleviation in Africa**
- Higher Education, Science and Technology
- Rights of Women, Youth, Children, and the Family in the Muslim World
- Cultural and Information Exchange among Member States

This research focuses on practical and economic related parts of the OIC Ten-Year Programme of Action as selected from three sub-items of the theme on 'Development, Socio-Economic and Scientific Issues', namely:

- (i) Economic cooperation by enhancing intra-OIC trade;
- (ii) Supporting development and poverty alleviation in Africa by cotton sector development particularly providing complete supply chain financing as per subsequent OIC Five-Year Cotton Action Plan;
- (iii) Supporting the Islamic Development Bank by mobilizing more resources for trade finance in favour of LDMC of OIC through International Islamic Trade Finance Corporation.

The programme under 'Development, Socio-Economic and Scientific Issues' themes sub-item on Economic Cooperation mandated that

“The COMCEC to promote measures to expand the scope of intra-OIC trade, and to consider the possibility of establishing a Free Trade Zone between the Member States in order to achieve greater economic integration to raise it to a percentage of 20% of the overall trade volume during the period covered by the plan, and call on the Member States to support its activities and to participate in those activities at the highest possible level”.<sup>3</sup>

According to the OIC Ten-Year Programme of Action, priority must be given to enhancing economic cooperation, intra-OIC trade, alleviating poverty in OIC member states with special emphasis on LDMCs, and addressing issues related to globalization, economic cooperation, environment, and science and technology. Furthermore, under the same themes entitled 'Development, Socio-Economic and Scientific Issues', the OIC Programme of Action calls upon the member states “to facilitate the freedom of movement of businessmen and investors across their borders”, “support OIC Member States in their efforts to accede to the World Trade Organization (WTO), and promote

<sup>3</sup> Report on “Follow up the Resolutions of the OIC Third Extraordinary Summit accessed on 21 September 2009 at [www.comcec.org/EN/belge/25.ICDT/AgendaN°4English2.doc](http://www.comcec.org/EN/belge/25.ICDT/AgendaN°4English2.doc)

<sup>4</sup> “The OIC Ten Year Programme of Action to Meet the Challenges Facing the Muslim Ummah in the 21st Century” is available

concerted positions between the Member States within the WTO” and “Support expanding electronic commerce among the OIC Member States”.<sup>4</sup> In this context, it might not be an overstatement to say that economic integration among OIC member countries can be considered as a pre-requisite for keeping pace with globalization.

The Programme of Action clearly mandates COMCEC to promote measures to expand the scope of intra-OIC trade, and to consider the possibility of establishing a FTA among the OIC member states for achieving greater economic integration in order to raise intra-OIC trade ratio, which is defined as trade among OIC countries over OIC countries’ trade with the world, to 20% by the end of the period covered by the plan (2005-2015). Indeed, this new direction could be deemed as a step further to the ongoing Trade Preferential System as identified in the preamble of the Framework Agreement on Trade Preferential System among member states of the Organization of the Islamic Cooperation.<sup>5</sup> In the agreement it is

“noted that due to the geographical dispersion of Member States, and the differences in their development levels which hamper the establishment of a comprehensive regional system for trade liberalization, a Trade Preferential System would be the most appropriate instrument to increase trade exchange among them.”<sup>6</sup>

The issues covered in this research, hence, are also prime subjects of COMCEC agenda as follows<sup>7</sup>:

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<sup>4</sup> “The OIC Ten Year Programme of Action to Meet the Challenges Facing the Muslim Ummah in the 21st Century” is available online at <http://www.oic-oci.org/ex-summit/english/10-years-plan.htm> last accessed on 1st May 2010.

<sup>5</sup> The term “economic integration” refers to the elimination of tariff and non-tariff barriers for the flow of goods, services, and factors-of-production between a group of countries or different parts of the same countries. The degrees of economic integration can be categorized into six stages:

- Preferential Trade Agreement (PTA), which is the weakest form of economic integration. In a PTA, countries would offer tariff reductions, though perhaps not eliminations, to a set of partner countries in some product categories.
- Free Trade Area (FTA) occurs when a group of countries agree to eliminate tariffs between themselves, but maintain their own external tariff on imports from the rest of the world. The North American Free Trade Area is an example of a FTA.
- Customs Union (CU) occurs when a group of countries agree to eliminate tariffs among themselves and set a common external tariff on imports from the rest of the world. This stage of economic integration will lead to increasing economic efficiency and establishing closer political and cultural ties among member countries. The European Union represents such an arrangement.
- Common Market (CM) is a customs union with common policies on product regulation, and freedom of movement of factors of production.
- Economic and Monetary Union (EMU) establishes a common currency among a group of countries. This involves the formation of a central monetary authority which will determine monetary policy for the entire group.
- Economic Integration (EI) refers to the situation when the integrated countries have no or negligible control of economic policy, including full monetary union and complete or near-complete fiscal policy harmonization.

<sup>6</sup> Available at [www.comcec.org/EN/belge/agreements/pdf/OIC-TPC.pdf](http://www.comcec.org/EN/belge/agreements/pdf/OIC-TPC.pdf) last accessed on 22 September 2009.

<sup>7</sup> The COMCEC agenda is available online at <http://www.comcec.org/EN/default.aspx> last accessed on 21st December 2009.

- Agenda Item 3: Promotion of Intra-OIC Trade
  - TPS-OIC
  - Road Map for Enhancing Intra-OIC Trade
  - WTO Related Technical Assistance
  - Trade Finance Activities for resource mobilization to boost intra-OIC trade
- Agenda Item 5: Poverty Alleviation and Economic/Technical Assistance to OIC Countries
  - OIC Cotton Programme

Before delving into the details of the research, the following sections details the aspects and institutions of the OIC trade among the member countries.

### **1.1.1 Framework Agreement on Trade Preferential System (TPS-OIC)**

As per the Resolution establishing the Framework Agreement, the OIC General Secretariat was

“requested to contact member states to expedite the formalities of their joining the Framework Agreement and urged member states to start, in the meantime, bilaterally or through COMCEC, exchanging lists of respective offers of concessions and initiate informal consultations as a prelude to the future negotiations on the said concessions.”

Having secured the minimum number of 10 necessary ratifications, the Agreement became effective in October 2002. As a result, the Trade Negotiation Committee (TNC) was formed.<sup>8</sup>

### **1.1.2 Protocol on Preferential Tariff Scheme for TPS-OIC (PRETAS)**

The first round of trade negotiations was concluded successfully with the adoption of the final version of the Protocol on the Preferential Tariff Scheme for TPS-OIC (PRETAS). Having 10 necessary ratifications, PRETAS became effective in November 2009 as of 25th session of COMCEC. The second round of negotiations was concluded in Ankara, in September 2007, with the adoption of the TPS-OIC Rules of Origin and progress on Para-Tariff and Non-Tariff Measures.<sup>9</sup>

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<sup>8</sup> TPS-OIC was targeted to be established by 1st January 2009. As a next step cooperation for the Rules of Origin of Goods and removal of Non-tariff Barriers, is to be completed under Trade Negotiating Committee (TNC) agenda.

<sup>9</sup> The new agreement on rules of origin was introduced as the rules of origin principles introduced in the Annex-III of Framework

### **1.1.3 Road Map for Enhancing Intra-OIC Trade Volumes**

In pursuance of a resolution passed at the 23rd COMCEC Ministerial Meeting in Turkey in November 2007, an Experts Group Meeting was held in Turkey to explore further ways and means of enhancing intra-OIC trade. The event was unique in that it brought experts from OIC member countries and international organizations together to devise a work plan aimed at helping achieve the 20% intra-OIC trade target, by 2015, set under the Makkah Declaration in 2005. The meeting aimed at not only to explore ways and means of ensuring realization of the targets but also to provide a monitoring mechanism to track progress. The deliverable of this meeting ‘Draft Road Map for achieving intra-OIC Trade Volumes (Road Map)’ is provided as in the Appendix I. As indicated under development of strategic commodities prong in the Road Map, the implementation of the Five-Year OIC Cotton Action Plan is perceived as an integral part of OIC trade integration as sound cotton sector has strong potential to address supply side constraint for trade in many least developed OIC member countries, particularly in Sub-Saharan Africa. Besides, the road map recommended introduction of new financing mechanisms/tools aimed to mobilize more resources for SMEs and LDMCs. The Road Map was adopted by 24th COMCEC Ministerial Meeting in October 2008 in Istanbul, Turkey.

Following the adaptation of the Road Map for Enhancing Intra-OIC trade, the first Consultative Meeting on this plan was held on 11-12 February 2009 at the Islamic Center for Development of Trade (ICDT) Headquarter in Casablanca, Morocco to identify specific actions/activities and projects to be carried out by OIC organs. Along with the series recommendations, the consultative meeting produced the Executive Program for the Implementation of the Road Map as provided in Appendix-I.<sup>10</sup>

Going through Table 1.1, although the OIC member countries, albeit constitute a substantial portion of the world population, they merely account for about 11% of world

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Agreement on Trade Preferential System among the Member States of the Organization of the Islamic Cooperation, drafted in mid-1980s and become effective in 2002, was out of date.

<sup>10</sup> Final version of “the Executive Programme of the Road-Map for Achieving Intra-OIC Trade Volumes Targets (Executive Programme)” is available online on COMCEC website at [www.comcec.org/EN/belge/25.ICDT/AgendaN°7-iEnglish-table.rtf](http://www.comcec.org/EN/belge/25.ICDT/AgendaN°7-iEnglish-table.rtf) last accessed on 21 November 2009.

exports and about 10% of world imports. In 2008, intra-OIC exports reached US\$ 265 billion while intra-OIC imports soared to US\$ 285 billion which together constitutes about US\$ 550 billion worth of trade among OIC countries. This suggests almost 31% increase in trade among OIC countries. Similarly, OIC countries exports to the world grew by 35.52 % while OIC countries imports grew by 27.87 percent in 2008. In 2008, overall trade of OIC countries increased to US\$ 3,380 billion from US\$ 2,560 billion in 2007 which amounts to a 32% increase. Growth in trade of OIC countries with the world, 32%, surpassed the growth of OIC countries trade among themselves which is 30.99%. This is reflected by a slight decrease in intra-OIC trade ratio, which is the reference point for the Makkah declaration of 20% intra-OIC trade by 2015, from 16.64% to 16.60%.<sup>11</sup>

**Table 1.1: Evolution of the OIC Member States Foreign Trade between 2007-2009 in US\$ billion**

	2007	2008	2009	Change %
World exports	13,800.00	15,775.00	12,147	-23.00%
World imports	14,300.00	16,120.00	12,385	-23.17%
OIC world exports	1,395.31	1,890.99	1,329.35	-29.70%
OIC world imports	1,164.59	1,489.21	1,239.67	-16.76%
Intra-OIC exports	200.20	265.32	207.92	-21.63%
Intra-OIC imports	220.39	285.63	218.83	-23.39%
Intra-OIC trade	420.59	550.95	426.75	-22.54%
		Share in %		
OIC world exports/world exports	10.11%	11.99%	10.94%	-8.73%
OIC world imports/world imports	8.14%	9.24%	10.01%	8.33%
OIC world trade/world trade	9.13%	10.61%	10.47%	-1.30%
Intra-OIC exports/OIC world exports	14.35%	14.03%	15.64%	11.48%
Intra-OIC imports/OIC world imports	18.92%	19.18%	17.65%	-7.97%
Intra-OIC trade ratio	16.64%	16.60%	16.65%	0.30%

Source: Islamic Center for Development of Trade, 2010

As depicted in Table 1.1, in 2009 intra-OIC trade contracted by about 23% as it is the case for world trade. Unlike intra-OIC trade, OIC exports to world (US\$ 1.3 billion) decreased by 29.7% while OIC imports from the world (US\$1.2 billion) decreased only by 16.76%. This might suggest the effect of drop in basic commodity prices, which

<sup>11</sup> Intra-OIC trade ratio is calculated as Intra-OIC trade over OIC World trade.

accounts substantial part of OIC countries exports to world. In 2009, intra-OIC exports decreased to US\$ 208 billion while intra-OIC imports crumbled to US\$ 219 billion, which together constitutes about US\$ 124 billion of drop. This is almost a 22.5% decrease in trade among OIC countries. However, intra-OIC trade ratio defined as intra-OIC trade over OIC trade with world, which is the reference point for Makkah declaration of 20% intra-OIC trade by 2015, did not decrease as decrease in overall OIC trade with the rest of the world surpassed that of decrease in intra-OIC trade.

As pointed out by Gundogdu (2009), if interpreted literally these statistics might be misleading due to the ‘double dominance effect’. It would be wise to sort these effects before any interpretation.

### 1.1.3.1 Dominance of oil in trade among OIC member countries

If compared to intra-OIC trade with other regional integrations, to which OIC countries are members, one would discern a substantially higher intra-trade ratio.

**Table 1.2: Comparison of Intra-regional Trade, Percentage (2006)**

Imports from	AMU	ASEAN	CIS	COMESA	ECO	ECOWAS	GCC	SAARC	UDEAC	OIC	WORLD
AMU	<b>3.39</b>	0.71	0.09	0.70	4.45	0.32	3.40	0.11	0.11	14.38	<b>100</b>
ASEAN	0.12	<b>5.07</b>	0.02	0.05	0.44	0.61	4.48	0.07	0.06	10.95	<b>100</b>
CIS	0.002	0.14	<b>6.37</b>	0.02	11.32	0.16	1.42	0.06	0.00	13.08	<b>100</b>
COMESA	1.40	1.93	0.03	<b>1.19</b>	2.47	0.02	9.12	0.30	0.01	18.16	<b>100</b>
ECO	1.81	1.76	3.07	0.24	<b>7.48</b>	0.21	6.95	0.90	0.02	18.97	<b>100</b>
ECOWAS	0.90	1.23	0.01	0.11	0.84	<b>8.63</b>	1.74	0.44	0.26	13.93	<b>100</b>
GCC	0.23	2.42	0.16	0.76	3.49	0.03	<b>7.92</b>	0.98	0.00	16.52	<b>100</b>
SAARC	0.46	5.04	0.57	0.44	2.40	0.16	21.45	<b>0.50</b>	0.03	30.36	<b>100</b>
UDEAC	1.69	1.11	0.00	0.42	1.74	10.12	1.16	1.24	<b>3.43</b>	19.85	<b>100</b>
OIC	<b>1.02</b>	<b>2.60</b>	<b>0.90</b>	<b>0.63</b>	<b>4.06</b>	<b>0.76</b>	<b>6.84</b>	<b>0.57</b>	<b>0.06</b>	<b>17.58</b>	<b>100</b>

Source: IDB 2008 Key Economic Indicators, Statistical Monograph No.28, 2008

Table 1.2 compares several regional groupings, to which several OIC countries are member, intra-trade levels from imports side for 2006. A careful look at the above table would reveal the high trade complementarity of OIC countries. Intra-trade level of oil-

exporting GCC countries, 7.92%, jumps to much higher levels, 17.58%, when they merge with oil-importing OIC countries.

### 1.1.3.2 Dominance of certain countries

OIC, in terms of economic indicators, is one of the most diverse groupings as it harbours obviously despairing countries like Indonesia to Djibouti, United Arab Emirates to Cote D'Ivoire, *etc.* Regardless of geographic disparity, what matters when it comes to OIC statistics is the GDP sizes. According to SESRIC's Basic Social and Economic Indicators (BASEIND), Saudi Arabia, Malaysia, Iran, Pakistan, Indonesia, Turkey and United Arab Emirates accounts for about 60 of OIC GDP in 2010.<sup>12</sup> Similarly, these countries would sustain a dominant position in intra-OIC trade as well as over all trade of OIC countries with the rest of the world.

**Table 1.3: OIC Trade and Intra-OIC Trade in US\$ million, 2008&2009**

Country	Imports from OIC		Share		Exports OIC		Share	
	2008	2009	2008	2009	2008	2009	2008	2009
50 Countries	134,061	108,673	47%	50%	108,498	73,880	41%	36%
SAUDI ARABIA	15,573	12,154	5%	6%	35,036	27,703	13%	13%
MALAYSIA	15,794	11,868	6%	5%	20,772	17,595	8%	8%
IRAN	18,694	15,136	7%	7%	13,804	14,238	5%	7%
PAKISTAN	19,281	13,650	7%	6%	7,897	7,364	3%	4%
INDONESIA	22,698	16,613	8%	8%	16,197	11,479	6%	6%
TURKEY	29,179	17,706	10%	8%	32,595	28,634	12%	14%
U.A. EMIRATES	30,349	23,031	11%	11%	30,524	27,024	12%	13%
<b>Intra-OIC Imports/Exports</b>	<b>285,630</b>	<b>218,831</b>	<b>100%</b>	<b>100%</b>	<b>265,324</b>	<b>207,917</b>	<b>100%</b>	<b>100%</b>

*Source:* Compiled by the author from the data provided by Islamic Center for Development of Trade, 2010

As a matter of fact, the seven big countries imported about US\$ 110 billion from other OIC countries as opposed to US\$ 108 billion imports of 50 Countries from OIC countries in 2009. Share of 50 countries in intra-OIC exports goes even down to 36% in 2009. Going through Table 1.4, a careful scrutiny in the statistics would reveal the fact that these seven countries tend to trade among each other even than oil dominates trade. That

<sup>12</sup> Derived by the author from the database available at [http://www.sesrteic.org/baseind\\_1.php](http://www.sesrteic.org/baseind_1.php), last accessed on 18 November 2009.

is, there is still a very big potential for enhancing intra-OIC trade by stimulating trade of big OIC countries with the small OIC countries and trade among the small countries.

**Table 1.4: Nature of Dominant Countries' Trade in US\$ million, 2009**

COUNTRY	Imports from OIC Member States (million US\$)	Imports from World (million US\$)	Intra-OIC Imports (%)	Main Suppliers	Main intra-OIC imported products
Saudi Arabia	12,154	96,433	12.60	U.A. Emirates, Turkey, Egypt	Iron and steel, live animals; road vehicles.
Malaysia	11,868	123,575	9.60	Indonesia, Saudi Arabia, UA Emirates	Petroleum and petroleum products; paper and paperboard; road vehicles.
Iran	15,136	81,829	18.50	UA Emirates, Kazakhstan, Turkey	Iron and steel; cereals; textile yarn and fabric.
Pakistan	13,650	31,583	43.22	Saudi Arabia, UA Emirates, Kyrgyzstan	Inorganic chemicals; fertilizers; petroleum and petroleum products.
Indonesia	16,613	96,829	17.16	Malaysia, Saudi Arabia, Brunei	Petroleum and petroleum products; organic chemicals; fertilizers.
Turkey	17,706	140,929	12.56	Iran, Saudi Arabia, Algeria	Petroleum and petroleum products; natural gas; textile yarn and fabric.
United Arab Emirates	23,031	187,847	12.26	Turkey, Malaysia, Saudi Arabia	Electrical apparatus; gold; iron and steel; textile yarn and fabric.

*Source:* Compiled by the author from the data provided by Islamic Center for Development of Trade, 2010

In brief, the statistics indicate the dominance of oil in intra-OIC trade. Very few dominant countries account for the bulk of intra-OIC trade by heavy trade among themselves, even than trade among them is dominated by oil. These facts are the base for defining the 'double dominance effect' in intra-OIC trade.



### 1.1.4 OIC Cotton Programme<sup>13</sup>

Cotton plays an important role in the socio-economic development of many of the OIC member states. Twenty OIC cotton-producing countries have a share of 28% of the world total cotton production, 24% of world total cotton consumption, 36% of world cotton export and 27% of world cotton imports.<sup>14</sup>

Going through the ‘Action Plan for the OIC Cotton-Producing Countries’ Cooperation Development Strategy (2007-2011)’ report as prepared by Chairmanship of OIC Cotton Action Plan, particularly in Africa where more than 16 million people are involved in cotton production and representing 25% of the export revenues in 11 countries in Sub-Saharan Africa, spanning from Sudan to Senegal. The cotton sector in Africa plays a highly strategic role in the economy of many West African countries. Cotton has a considerable cross-sectoral impact on the economic growth, export revenues and the socio-economic development of the rural population. The region of West Africa is the second-largest exporter of cotton after the United States, comprising 15 per cent of the international market.

Cotton is a major export in a significant number of OIC member countries, including Benin, Burkina Faso, Mali, Chad and Togo. Although cotton is an important crop for other member countries such as Pakistan, Egypt, Syria and Turkey, the share of cotton in the production and exports of these countries is not as remarkable as in the case of West African Countries. Besides, these countries succeeded production efficiency and moved forward to higher value added spinning and textile industries. While in above mentioned West African countries, cotton accounts for between 5 and 10 per cent of the GDP, and exports of cotton account for over one-third of all exports and over 60 per cent of income from agricultural exports. Thus, cotton is the main cash crop and has proved to be economically viable with significant and positive impact on exports, economic growth and rural welfare. Cotton ginning, input supply, transport and marketing constitute a large share of these countries rural employment, export earnings and generate a significant

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<sup>13</sup> The information in this section is based on Islamic Center for Development of Trade.

<sup>14</sup> Based on the SESRIC report presented in the OIC Cotton Investment Forum 2007.

share of government revenue. Consequently, cotton makes up over 1/4 of the export revenue in 11 African countries, 1/2 of total revenue in Benin and 2/3 in Burkina Faso.<sup>15</sup>

A number of initiatives for the cotton sector have been launched in recent years by some international institutions since the issue became publicised in 2003 when four African cotton-producing countries, Benin, Burkina Faso, Mali and Chad, demanded that the cotton subsidy and import tariff removal be part of the WTO Doha Development Agenda. After the initiative of the Cotton-4 countries, the damaging incidence of the subsidies by the US and EU to the welfare of the cotton producing LDMCs started to get more attention in the international community.

The OIC Ten-Year Programme of Action gives special importance to the development of Least Developed OIC Countries that could be achieved through adding value to local production in particularly cotton sector by know-how, technology transfer from successful cotton producing member countries such as Pakistan, Egypt, Syria and Turkey within the concept of ‘reverse linkages’. As mentioned before, the OIC Ten-Year Programme of Action mandates alleviating poverty in OIC Member States with special emphasis on LDMCs. Again under same themes entitled ‘Development, Socio-Economic and Scientific Issues’ in Item-IV of “Supporting development and poverty alleviation in Africa”, it calls upon promoting activities aimed at achieving economic and social development in African countries, and upon participating in international efforts to support programmes aimed at alleviating poverty and capacity-building in the Least-Developed Member States of the OIC. Based on this, West African OIC cotton producers successfully embedded cotton sector development in the OIC Ten-Year Programme of Action by leading towards Five Years Cotton Plan of Action (2007-2011).

The OIC General Secretariat in cooperation with IDB and ICDT has organized a series of Expert Group Meetings on cotton as part of OIC’s Ten-Year Programme of Action. The third EGM on Enhancing Production Efficiency and International Competitiveness in OIC Cotton-Producing Countries, held in Antalya, Turkey, in October 2006, adopted the Five-Year OIC Cotton Plan of Action for 2007-2011. The 22<sup>nd</sup> Session of the COMCEC

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<sup>15</sup> Based on Action Plan for the OIC Cotton Producing Countries’s Cooperation Development Strategy (2007-2011) available online at <http://www.oic-oci.org/english/conf/comcec/Cotton%20Action%20Plan-En.pdf> last accessed on 30<sup>th</sup> March 2010/

also endorsed the action Plan. The plan aims at strengthening trade, investment and technology transfer in cotton producing member states, particularly to African Countries.

Among many of the recommendations, attention in this research is given to the following recommendation to contribute to the issue as other recommendations by the meeting on productivity, marketing, etc. can be addressed in other researches:

“Focus should be given to supply chain financing, start from providing input to post-harvest seed cotton purchase from farmers. To accommodate this supply chain financing existing, structural trade finance designs need to be expanded to some more OIC countries.”

It should be noted that there is no track of literature on how to address complete supply chain financing issue by Islamic finance instruments, which is attempted by this study.

## **1.2 AIMS AND OBJECTIVES**

This research aims to explore and respond to obstacles and remedies for OIC trade integration. In specific, this research aims to explore and analyse the present status of intra-OIC trade *vis-a-vis* hesitation of OIC countries for further trade integration due to possible customs revenue loss as burden on public finances. In doing so, this study also aims to explore and model the potentiality of Islamic financial instruments for trade finance to facilitate intra-OIC trade and strategic cotton trade for OIC countries.

The aims of this research are fulfilled through three separate yet interlinked essays; each of which has a specific aim. The aims and objectives for each essay are:

- (i) The aims of the first essay are
  - a) to explore, given the double dominance effect and recent increase in intra-OIC trade, determinants of intra-OIC trade which was defined as intra-OIC trade as a share of OIC trade with world as defined according to the Makkah Declaration. Is recent increase in intra-OIC trade a product of policies of OIC organs or other externalities?
  - b) to examine the determinants of OIC countries' customs revenue and how to address OIC countries' hesitation for further trade integration

from the aspect of possible loss of customs revenue and burden on public finance. In this regard, this part of the first essay embarks on finding an answer to the following question: Would any policies, particularly trade facilitation measures, for improving customs practices decrease customs revenue?

- (ii) The aim of the second essay is to develop a complete supply chain of Islamic financing for cotton sector as per recommendation of the ‘Third Expert Group Meeting on Enhancing Production Efficiency and International Competitiveness in OIC Cotton Producing Countries’ subsequent to the Five-Year OIC Cotton Plan of Action. The proposed Islamic finance structure is developed based on structured trade finance by which security is assumed in the form of commodity finance. A comparison of Islamic finance contract for *murabahah* and *salam* is to be evaluated in the context. This essay tries to answer: Can Islamic finance be a better alternative to conventional finance in real life example in the context of cotton sector development?
  
- (iii) The aim of the last essay is to develop an Islamic financial instrument to mobilize more funds for Islamic trade finance, particularly for SMEs and LDMC of OIC as stipulated in the Road Map. The most popular Islamic finance contract of *murabahah* is to be transformed into resource mobilization and liquidity management tool under the 2-Step *murabahah* Mechanism. Thus, the third essay aims to respond to the following research questions: Does the Islamic Finance industry lack resource mobilization and liquidity management tools? Would there be any other alternative to *sukuk* and commodity *murabahah*?

### **1.3 RESEARCH RATIONALE AND MOTIVATION**

Intra-OIC trade and cotton sector development is on the top of the OIC countries’ and specialized institutions’ (such as IDB Group, ICDT, SESRIC, ICCI) agenda as per the mandate of the Makkah Declaration in 2005. However, initiatives and activities by OIC countries and the above-mentioned specialized institutions are arguably well framed.

This research, hence, stems out of motivation to develop a resilient framework for outward looking and cost-effective OIC trade integration in order to constitute a base for future direction to avoid rigidly structured and highly institutionalized discourse.

By no means does this research put a halt on the discussion but rather aims to initiate further discussions for enrichment of OIC trade integration and the cotton sector agenda by appealing for more attraction from the OIC community within a well-defined framework. A special emphasis is given to propose feasible and concrete building blocks by evidencing from other regional integration and national best practices to discourage vague ideas for the issues as benchmarking from best practices has somehow been ignored up to now.

#### **1.4 SIGNIFICANCE OF THE RESEARCH**

Although there has been substantial efforts in both public policy discourse and academic literature on devising a certain degree of integration among OIC countries, efforts up to now seem to have not yielded remarkable results, if no result at all. Perhaps a major reason for unsuccessful attempts has been the lack of a holistic approach to embed inherent issues into a well-designed framework. In this regard, OIC's Ten-Year Plan of Action can be defined as a landmark in defining inherent issues, which have been dwelled on in many documents of OIC since its inception.

This research first of all provides insight on these inherent issues as defined in the OIC Ten-Year Plan of Action. Although determinants of intra-OIC trade have been subject of many studies, very few, if not at all, provide insight on the convoluted causes of the ratio of intra-OIC trade defined in the Makkah Declaration. Additionally, this research provides insight into hesitation of some of the OIC countries for trade liberalization/facilitation, which has been the main reason of unsuccessful OIC trade integration attempts in the past, due to fear in loss of valuable customs revenues particularly for small OIC Countries and LDMCs.

Another important inherent issue highlighted is the importance of cotton sector development in LDMCs as cotton is perceived to be the only product for these countries

to be part of intra-OIC trade. The major issues for development of the cotton sector in these countries is access to financing, as entities in those countries may not be entitled to hard currency financing due to lack of meaningful security in the form of government/bank guarantee or mortgage. In order to overcome such impediments Islamic Structured Trade Finance is proposed with reference to real-life example in this research. The lack of trade finance has been defined as a major obstacle for development of intra-OIC trade. Hence, this research proposes an Islamic Trade Finance mechanism to mobilize funds to help LDMCs in the third essay. Unlike many other studies, this research aims to be voice of LDMCs within contemplated trade integration among OIC countries and propose actions to resolve inherent impediments of LDMCs before implementation of a trade integration framework.

While addressing the major inherent issues, this research designed a resilient OIC integration framework with reference to experience of other regional integration initiatives, literature, the solutions developed to inherent issues herewith, the ideas of personalities from OIC on the matter, studies of other OIC organs and the results of survey conducted under this research. This should be considered as a welcome attempt in the field as a contribution to the literature but also policy making. This research, therefore, would be a reference point for policy makers and researchers who are in pursuit of exploring inherent issues of OIC trade integration, past efforts to address these impediments, and possible remedies. Resilient framework developed herein for OIC trade integration is also expected to lead to the enrichment of OIC agenda with clear direction towards OIC Trade Integration.

Lastly, considering that this research is based on and conceptualises the real cases and responds to the Islamic financing needs of a particular field, its originality should be its other strength. In particular, the proposed model with its rigour should be considered as an important contribution.

## **1.5 RESEARCH METHODOLOGY**

This research commences with some insight into scrutinizing the determinants of intra-OIC trade and OIC countries', in the context of WTO member OIC countries, customs

revenue. An econometric model of OLS, fixed effect and random effect calculations is employed with panel data of 1995-2007.

In addition case studies are introduced to develop complete supply chain of Islamic financing for the cotton sector and alternative resource mobilization tools for Islamic trade finance.

It should also be noted that discussions are based on the Road Map, the executive programme, the survey, the questionnaire and interviews conducted with OIC government officials and senior officials of some specialized institutions. “The survey on trade facilitation in OIC member countries vis-à-vis WTO trade facilitation negotiations on GATT Articles V, VIII and X and agreement on implementation of Article VII (WTO Customs Valuation Agreement) of GATT” was conducted during the Seminar on “Non-tariff Barrier Impact on Market Access” in Tunisia, 4-8 October 2009. The outline of the survey is provided in Appendix IX. In addition, the results of “Questionnaire on Enhancing Economic and Commercial Cooperation among OIC Member Countries”, conducted in 2009 by SESRIC, are incorporated.

## **1.6 STRUCTURE OF THE RESEARCH**

The thesis is organized as follows:

Chapter Two aims to shed light on the mechanism of recent increase in intra-OIC trade from the aspect of ‘double dominance effect’ by oil and dominant countries of intra-OIC trade. This chapter also goes through the OIC countries’ customs revenue issues as the possible loss of customs revenue is very often cited as lack of will for further trade integration. While doing so, literature review on OIC trade, integration, and intra-regional trade is provided.

Chapter Three presents an Islamic Structure Trade Finance case study for SOFITEX, leading cotton ginning company in West Africa. While introducing the case, some insight on cotton sector and financial standing of the company is provided to place the case within real-life content and OIC Cotton Action Plan. The chapter also evaluates the presented Islamic finance structure for improvement in complete Supply Chain Financing

as per reference to the OIC Five-Year Cotton Action Plan. The chapter demonstrates how to use Islamic finance tools to address real life example under extreme cases while putting enough risk management mitigation steps. As per agricultural finance for impact on livelihood of rural population, special attention is drawn from the chapter in pursuit of reaching people in need rather than diverting funds to a middle-man or to wasteful consumption in addition to importance complementary rural infrastructure development.

Chapter Four shows how to mobilize resources through Two-Step *murabahah* to be utilized for Islamic trade finance as a mean to boost trade of OIC countries. While doing so, special emphasis is given to drawback in *sukuk* and commodity *murabaha*. As highlighted *Shari'ah* compatibility of commodity *murabaha* is questioned. The proposed structure is explained in detail with a real-life example by which researchers or Islamic bankers can make use of it. As drawn from the chapter, the proposed Two-Step *murabaha* would be an even better liquidity management tool if embedded to organized exchanges.

Chapter Five presents the key findings of the survey, the questionnaire and interviews and discusses outward-looking, cost-effective, and informal policy options for a resilient OIC trade integration based on the findings of essays. It thus provides an integrated discussion by also articulating the policy implications of the study and the proposed model. It also brings the thesis to a conclusion.



## **Chapter 2**

# **DETERMINANTS OF INTRA-OIC TRADE: POLICY OR EXCHANGE RATE**

### **2.1 INTRODUCTION**

The effect of enhanced trade on economic growth is a well observed subject of many studies. Frankel and Romer (1999) demonstrate that a 1% increase in the trade to GDP ratio leads to increase in GDP per capita by at least 0.5%. Likewise, Islamic Development Bank (2006) indicates that among IDB countries who trade more are likely to achieve higher economic growth as well as higher human development and lower human poverty. As per GDP growth contribution, trade (net exports of merchandise goods) on average contributed 0.72 % (or about 11%) to the overall growth of IDB member countries during the last decade. In this regard, it is not surprising to see a mandate for increasing intra-OIC trade at the top of OIC agenda.

Nevertheless, it is needed to be noted that focusing on trade for growth without considering its implication on poverty may give rise to imbalances as highlighted with immiserizing growth concept of Bhagwati (1958). Growth may result in worsening of a country if it is export biased and if such bias gives rise to deterioration in the terms of trade. On the other hand, such case might not happen unless country is able to influence world prices. Besides, trade itself should not be only omen for growth and poverty since transfer of technology and the state of technology are related to poverty.

As evidenced from many studies and policy briefs, intra-OIC trade is not in the desired level. Studies of Ekholm *et al.* (1996), Al Atrash and Yousef (2000), Amin, Hamid and Saad (2005), Makdisi *et al.* (2005) and Nugent and Miniesy (2006) focusing on the MENA region show the existence of tariff and non-tariff barriers, lack of trade-related services as well as trade information and impediments to trade cooperation as the main causes of relatively small intra-regional trade.

Increasing intra-Organisation of Islamic Cooperation (OIC) trade with the dismantling of trade barriers, hence, has emerged at the forefront of the trade agenda of OIC Countries.

It was in 1997 when the OIC Summit in Tehran gave priority for increasing the intra-OIC trade. In 7-8 December 2005, the Third Extraordinary Session of the Islamic Conference produced the 'Makkah Declaration', when the Ten-Year Programme of Action setting a target of achieving 20% trade among OIC Countries by the year 2015 has been adopted.

Although all the parties agree to boost intra-OIC trade, there is a confusion regarding the definition of intra-OIC trade. World Bank and IMF definition for intra-trade includes both exports and imports (average of exports and imports) while OIC organs' (IDB and ICDDT) definition includes imports or exports alone. In this paper, calculations and facts are presented mainly with reference to imports, which indeed is the reference point of OIC organ.

As to the structure of the chapter, the chapter is organized as follows: Section two elaborate on aim, objectives and methodology while section three provides literature review. Section four presents the recent efforts for increasing intra-OIC trade. Section five introduces the model specification, variables, the methodology and expected signs for regression model on determinant of intra-OIC trade, while section six presents the results of the regressions for determinant of intra-OIC trade. Section seven presents the WTO Custom Valuation Agreement. Section eight introduces the model specification, variables, the methodology and expected signs for the regression model on determinant of OIC countries' customs revenue. The ninth section presents the results of the regressions model on determinant of OIC countries customs revenue. The final section concludes with some policy recommendations.

## **2.2 AIMS AND OBJECTIVES**

As identified in Chapter 1, this paper aims to explore and examine the determinants of intra-OIC trade. As the data indicates intra-OIC imports increased from 14.4% in 2004 to about 18% in 2007 which surged to 19.18 % in 2008 and retreated to 17.65 % in 2009. This research thus aims to locate the determining factors of such dynamism. This research also attempts to locate the sources of such growth: whether it really comes from policy efforts by OIC affiliate organs or whether it comes from some externalities. In this, specific emphasis is given to tariff, trade facilitation and liberalization, depreciation of

real exchange rate and depreciation of the US dollar against the Euro. Furthermore, this paper aims to elaborate and provide insight into the target of the Makkah Declaration and the Ten-Year Programme of Action to increase intra-OIC trade to 20% of global trade by the year 2015. Moreover, this paper also analyses the determinants of OIC countries' customs revenue as it has a pivotal role in discussion of OIC trade integration.

### **2.3 OIC TRADE, INTEGRATION AND INTRA-REGIONAL TRADE: LITERATURE REVIEW**

There are many works on trade in regional economic integration of various OIC countries, in particular on the MENA region as all parties are OIC countries. Makdisi *et al.* (2005) show the importance of trade openness on economic growth of many countries by using cross-country regressions which shows that the effect of trade openness, as in the case of MENA countries, is smaller as compared to others. In another study by Nuget and Miniesy (2006) MENA countries are found to be trading less than predicted by the way of the gravity model. The reasons are given as less trade-friendly policies and weak governance. As they suggest sharing a same borderline has less impact on trade among MENA countries because customs procedures and transport infrastructure within the MENA region are much more detrimental for intra-trade. They further recommend elimination of existing restriction on current account transaction. Mohd. Amin *et al.* (2005) investigated the extent of economic integration among five members of the League of the Arab states namely, Egypt, Jordan, Saudi Arabia, Sudan and Syria, by empirically testing the nature of intra-trade activities in the grouping. The gravity model is used in the scaled and unscaled forms for the period of 1991 to 2002 in both panel and yearly estimation. The result indicated that the failure of integration measures undertaken. The article recommended tariff reduction and the provision of better infrastructure to increase intra-trade activities among LAS members. Atrash and Yousef (2000) by employing the Tobit procedure rather than ordinary least square, suggested that intra-Arab trade and Arab trade with the rest of the world are lower than what would be predicted by the gravity equation, suggesting considerable scope for regional - as well as multilateral - integration. The results also suggested that intra-GCC and intra-Maghreb trade are relatively low while the Mashreq countries exhibit a higher level of intra-group

trade. Limam and Abdalla (1998) in their research on intra-Arab trade state that intra-Arab trade is weak regardless of several efforts to form different forms of regional integration. After examining main weak factors in intra-Arab trade by gravity model, Balassa's revealed comparative advantage and export profiles they scrutinized means to increase intra-Arab trade by prospective trade liberalization under the Arab Free Trade Area. Going through comparative advantage they established partner countries and list of commodities in order to boost intra-Arab trade. As they suggested, in order to exploit this potentials there needs to de-linking of politics from economic relationship and improving transportation links.

Islamic Development Bank (2006), *Policy Committee Paper No.3* indicates that trade contribution to growth has shown increasing trend over time due to greater trade openness of OIC member countries.<sup>16</sup> The contribution of intra-trade (net intra-exports of merchandise goods) in member countries' growth was positive in the case of oil-exporting countries, while it was negative in non-oil member countries and LDMCs. Econometric analysis suggests that a 10% increase in trade volumes of IDB member countries would improve their real per capita GDP growth by 0.2%.

The main motives behind these researches have been revealing a relationship between trade and economic growth, hence, poverty alleviation. Sirinivasan and Bhagwati (1999) argues, with reference to the experiences of OECD, NBER and IBRD projects during 60s and 70s, that trade create and even sustain higher growth. Despite the common agreement among economist for positive effect of international trade on growth, the relationship between growth and poverty alleviation is not straightforward. Dollar and Kraay (2002) examined the impact of growth for income level of the bottom 20% of the income distribution and found that there is no systematic association between economic growth and income increase for the bottom fifth. The distributional consequences of trade openness are obvious: there would be losers and winners. Hence, open trade policies should be complemented by social protection measures which would translate as *zakat* in case of Islamic economics.

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<sup>16</sup> Islamic Development Bank (2006). Policy Committee Paper No.3. Trade and development: a case of IDB member countries.

Ghani (2007) in his research 'Does OIC Membership Reduce Trade' used traditional and theoretical augmented gravity models, which state that the share of the OIC countries in world trade is small. According to his data set running from 1997 to 2002, he highlights the fact that OIC countries account for 6.2% of world export and 5.8% of world imports. He suggests that the small share of OIC countries in world trade is related to low-level economic development as the fact is evidenced from many literatures on the relationship between trade and economic growth. Given the OIC countries' interest in enhancing their trade volumes, he analyses the effect for a country to be member of OIC on its trade with OIC and non-OIC countries. As stated, he employed both traditional and theoretical gravity models and augmented these models with extra conditioning variables to accommodate the effect of difference among OIC countries in the form of culture, geography, history, membership to specific regional economic integrations, incidence of conflict and governance quality of the country. That is, he measured the effect of OIC membership as a residual after taking large differences in geography, culture, participation in regional and international organizations, history, institutional and governance quality of the country and incidence of conflict into account. His specifications for augmented traditional gravity model include bilateral trade between two countries as dependent variable, which included real terms so bilateral trade figures were deflated by the US Consumer Price Index for urban areas. In his model, he used two variables to assess trade creation and diversion effect of OIC membership. One of the variables gets the value of '1' if both trading partners are members to the OIC, the other variable gets the value of '1' if only one of the trading partners is member to OIC and other is not a member. Also, he used vector of variables that vary across the trading partners over time such as, product of GDP, GDP per capita, *etc.* In addition, he included vector of variables which do not vary over time and across the trading partners such as, distance between two trading partners as proxy for transportation cost, sharing of land border, being colonized by a same country, *etc.* He estimated the model with OLS and Rose (2004) method of being WTO membership on trade with partner country for benchmarking. He also included year-specific effect to the regression. In his traditional gravity model, Ghani (2007) used dyadic (country-pair specific) fixed and random effect estimation but not country-specific fixed and random effect. Subramanian and Wei

(2003) criticized this estimation as it does not take time-invariant country-specific variables. Besides, Ghani (2007) relied on variables from Rose (2004) for the effect of membership to an international organisation. Rose (2004) indicates that being a member of GATT/WTO is not significant for bilateral trade. In the same work, only year of entry to the GATT/WTO, but not specific agreements such as agreement on anti-dumping or WTO Custom Valuation Agreement, is taken to explain effect of trade between two countries. Before going further to the result of Ghani (2007), it would be handy to provide some literature review on the gravity model.

The gravity model for trade flows, first introduced by Tinbergen (1962) and Poyhonen (1963), has been many times applied to uncover the determinant of bilateral trade flows. As the name suggests, the model is derived from Newtonian Physics Theory explaining the attraction between two objects positively on the masses and negatively by distance. As per the gravity model of international trade, bilateral trade between two countries is positively related to economic sizes and negatively related to distance. Distance stands as proxy for the transportation cost while the GDPs stand as proxy for economic sizes in terms of market size and production capacity.

The gravity model, defined within the notion of ‘increasing returns’, assumes that countries specialize in different product categories.<sup>17</sup> Demand is assumed to be homothetic and identical across countries and firms pursuit monopolistic competition.<sup>18</sup> Anderson (1979) and Bergstrand (1985) derived the gravity equation based on CES form utility and Armington assumption of differentiated goods by location of production. With the homogenous goods, Frenstra *et al.* (1998) derived a gravity equation from a reciprocal-dumping model of trade. Based on the assumption of increasing returns technology, Keith (2003) derived the model from demand function on ‘Dixit and Stiglitz model’ of monopolistic competition between differentiated and symmetric firms. There are some other studies such as Eaton and Kortum (1997), Evenett and Keller (1998), Haveman and Hummels (2004) in which complete and incomplete specialization are taken into account. With increasing return to scale and in differentiated product

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<sup>17</sup> Feenstra, R.C. (2004). *Advanced international trade: Theory and evidence*. New Jersey: Princeton University Press, Page 144.

<sup>18</sup> Harrigan, J. (2001). *Specialization and the volume of trade: Do the data obey the laws?* NBER Working Papers 8675, pp.31.

framework, Helpman (1987) justified the gravity equation. Deardoff (1995) justified gravity equation from standard trade theories including Ricardian and Heckscher-Ohlin models. Bergstrand (1985) also examined theoretical foundations of gravity models in the previous studies related to monopolistic competition. Bergstrand (1989) stressed the effect of GDP per capita on bilateral trade. Higher GDP per capita is to be associated with easy cross-border trade and better transportation infrastructure which ultimately facilitate trade. He also argued that higher-income countries' consumers tend to demand superior-perceived foreign products. In addition, Hummels and Levinsohn (1995) argue the existence of factors other than increasing return to scale accounting for empirical success of gravity equation. To study intra-industry trade Davis (1996) used the gravity model framework. Wei (1996) defined the 'remoteness index' as GDP-weighted average of distance as a proxy for trade cost. Anderson and van Wincoop (2001) and Helpman (1987) put light on possible 'dispersion index' such as price levels, relative distances, language dummies and border dummies which, together with GDPs, make the gravity model work.

As part of this modelling, countries sharing the same border are expected to trade more compared to countries that do not share a border. However, McCallum's work on US and Canada states paved the way for a discussion on contradiction between empirical results and expected signs of the traditional gravity model. Anderson and van Wincoop (2003) argued that the traditional gravity model suffers from omitted variable puzzles and developed a theoretical gravity model for solving the McCallum (1995) border puzzle. Unlike the traditional gravity model, dependent variables with theoretical gravity model are the natural log of the average bilateral trade over the products of trade partners' GDPs. The theoretical model also uses country dummies for the multilateral resistance term. This multilateral resistance terms include country-specific price indices, as relative prices between two countries would affect trade between two countries.

In his research, Ghani (2007), by using the traditional gravity model, found that the effect of OIC membership is not positive. However, when he used the theoretical gravity model, based on the Anderson and van Wincoop (2003) insight for solving the McCallum (1995) border puzzle, he managed to produce positive or non-significant OIC effect.

It should be noted that focusing on trade volume alone might be misleading as price movements of traded goods and product composition of trade would affect gains of countries' from international trade. Such gains or losses are measured by the concept of 'terms of trade', which reflects the trend in a country's export prices relative to import prices. The early research by Singer (1950) and Prebisch (1950) draw attention to developing countries' terms of trade issue as price movement of primary/agricultural products relative to price of manufactured products might deteriorate wellbeing of primary/agricultural product exporting developing countries. The debate was substantiated by empirical research, which is known as Prebisch-Singer thesis, which is later supported by subsequent researches such as Bleaney (1993). The downward trend in primary commodities prices was argued to be product of surplus labour in developing countries. The widening gap between primary commodity prices and manufacturer prices was also attributed to income elasticity of demand for food, which is less than unity. Besides, any technical progress would decrease raw materials used for manufacturing. Although downward price trend for primary commodities has recently been questioned such with UNCTAD Trade and Development Report 2008, the issue is important for many OIC countries since their terms of trade are correlated to exports prices of their primary/agricultural product and imports prices of manufacturers. Still many OIC countries are heavily dependent on primary commodity exports. The recent favourable trend in terms of trade for primary commodity exporting OIC member countries indicates substantial benefit with membership to regional groupings.

The effect of membership to a regional grouping on enhanced intra-trade has been the interest of many studies. By any means membership to a regional economic integration is expected to have a welfare effect. Many of these studies dwelled on trade creation and diversion effects of regional economic integration. Viner (1950) introduced the notions of trade creation and trade diversion to assess welfare effect of regional trade agreements. Meade (1955) in addition to cost structures included demand elasticities which shape trade flows after customs union and hence expanded the Viner's methodology. Balassa (1965) introduced the 'gross trade creation' notion as a computable version of Viner's trade creation and diversion terminology. Bhagwati and Srinivasan (1969) analysed the non-economic objectives. They also proposed that if a small country intends to target



consumption, imports or output of specific goods, it is better to address those variables directly without intervening elsewhere. Bhagwati (1971) showed that even trade diverting PTAs may be welfare improving by arguing sufficient fixity of imports level. In another study, Bhagwati (1993) highlighted the work of Viner (1950), “The Customs Union Issue”, as static welfare question and made important contribution to the literature by focusing on political economy dimension of preferential trade agreements. He emphasized the importance of examining dynamic time path question. As he compared the regionalism versus multilateralism, he questioned whether regionalism fragments the world economy. In both static and dynamic approaches to PTAs, gross trade creation notion reflects overall trade increase among member countries derived from formation of regional trade integration. It accounts for replaced domestic production after formation as well as replaced exports from non-members. Trade diversion is explained as substitution of imports from low-cost non-member countries with imports from high-cost member countries. External trade creation is referred to as increase in trade within a regional integration and increase of trade between formed regional integration with outsiders. First Aitken (1973) employed dummy variables in gravity modelling to assess Balassa’s gross trade creation measures in the context of the European Economic Community and European Free Trade Association. Via dummy variables in a cross-sectional equation, Aitken estimated two communities’ effects on the trade of members for the period of 1951-1967 vis-à-vis gross trade creation and trade diversion effects of them. Similarly, earliest researches such as Bergstrand (1985), Thursby (1987), De Grauwe (1998), and Brada and Mendez (1988) tested trade creation effect of EFTA and EEC for several periods between 1950 and 1982 by using measures for common land-border, exchange rate volatility and relative prices. As they estimated, EFTA and EEC enhanced trade by 50% to 280%. The trade creation effect is particularly found to be strong in 1970s in the EFTA and 1960s in the EEC. Frankel and Wei (1993), with a much broader sample of sixty-three developed and developing countries, scrutinized trade creation effect in NAFTA, APEC, ASEAN and two European blocs for 1980s. They estimated trade creation effect, while controlling for common border, exchange rate volatility and the product of real GDP per capita, with the gravity model. Like previous works, they found trade creation effect for different regional trade agreements formation particularly within

APEC and EEC. In case of the EEC their estimation suggested trade increase by 25% to 80%. In case of APEC trade creation effect of regional trade agreement was found to be much stronger as trade increased by 170% to 350%.

In their later studies, Frankel and Wei (1996) tested trade creation effect for more regional trade agreements by using data set from 1965 to 1990. Frankel and Wei included dummies for the products of GDP per capita, common border and relative factor endowment to their gravity model. However, they did not include exchange rate volatility though earlier studies suggest significance of exchange rate volatility in gravity models. In their similar studies they find trade creation effect with EFTA, ASEAN, NAFTA and EEC and diversion effect with NAFTA and EEC. For example, Frankel and Wei (1995) found that NAFTA, APEC, ASEAN and EEC increased trade by 43%, 215%, 146% and 13%, respectively. Many of the studies then focused on regional trade agreements in Europe, East Asia and North America. On the other hand, although using different data sets, time periods and specifications for the gravity model, Aitken and Lowry (1973), Frankel, Stein and Wei (1985), German, Peterson and Gillard (1998) and Sologá and Winters (2001) focused on regional trade agreements in Latin America and found their trade creation effect for MERCOSUR, LAIA, Andean Pact, Central American Common Market. In later stages, Rose (2000), Frankel and Rose (2001) and Frankel and Rose (2002) embedded exchange rate volatility for currency union to gravity model. Unlike previous works, in these studies many new variables such as remoteness, land area, common colonizer, being landlocked, *etc.* were included to gravity model. For example, Rose (2000) included thirty explanatory variables in the model. Furthermore, a set of dummies for each regional trade agreement in the earlier studies were transformed into one dummy variable for any regional trade agreement. Regardless of these changes in the model, regional trade agreements were found to be trade-creating and the effect turned out to be even stronger.

Recently, further research was published with different estimation methods, subject regional trade agreements and periods to estimate these measures in the context of regional trade agreements. For example, Gosh and Yamarik (2004) found that trade creation effect of regional trade agreement discerned with gravity models in the literature

is overstated. As they suggest, there is no consensus on explanatory variables to be included in gravity model for assessing trade creation and diversion effect of regional trade agreements. Some authors specified gravity equation with trade creation alone while others did so by trade creation and trade diversion with dummy variables for each. Also, myriads of other explanatory variables are employed in previous researches. The way of inclusion or exclusion of explanatory variables raised some questions on robustness of the models. In any case, the previous studies found trade creation in most of the regional trade agreements as subjects of these studies. Hence, he questions whether “the trade creation hypothesis picking up a ‘robust’ relationship across different specifications or a ‘fragile’ relationship generated by a unique specification”?

In another study, Carrere (2004) assessed the regional trade agreements’ effect on trade, intra-regional trade and trade with the rest of the world of Sub-Saharan African countries. The Economic and Monetary Union of West Africa (UEMOA), the Economic and Monetary Community of Central Africa (CEMAC) as both preferential trade areas and monetary union, together with the Economic Community of West African States (ECOWAS), the Common Market for Easter and Southern Africa (COMESA), and the Sothern African Development Community (SADC) as preferential trade area, are included. While traditional determinants, including geography and transport cost, are controlled, Cerrere (2004) compared the effect of preferential trade agreements and currency union on trade for the period of 1962-1996 in Africa. By employing augmented gravity model relying on a transportation cost function, trade creation and diversion effects of preferential trade agreements in Sub-Saharan Africa is estimated through specific dummies variables assigned with random effect. First, the average impact of each preferential trade agreement and second, how these impacts evolved is estimated. The results suggest that African regional trade agreements significantly enhanced intra-trade through trade diversion at the initial stages. While regional trade agreements in Africa give rise to trade diversion, currency unions rather had trade-creation effects.

Elliott and Ikemoto (2004) used modified gravity model in order to assess the impact of ASEAN AFTA on intra-ASEAN trade and trade of ASEAN countries with non-ASEAN countries. In order to have comparison, they included four preferential trade agreements

namely, ASEAN, APEC, NAFTA and EU. However, while assessing the effect, they rather put emphasis on the signing year of AFTA but not implementation of common external tariff as implementation of AFTA took some time. Hence, they found that trade flows have not been significantly affected by AFTA. In the model, they did not include important determinant of international trade such as tariffs, sector-specific trade facilitation efforts. Gundogdu (2007), however, included tariff and other important explanatory variables of international trade in the context of ASEAN AFTA and found that ASEAN AFTA itself is not trade-diverting, and found that ASEAN trade facilitation efforts within AFTA measures enhanced ASEAN imports from both members and non-member countries of Japan, Korea and China.

Cernat (2001), however, draws attention to the trade creation effect of regional trade agreement formation through removal of invisible trade barriers as an auxiliary trade facilitation measures to these agreements. As he suggests, by an augmented gravity model to estimate trade creation and diversion effect for the ASEAN Free Trade Agreement (AFTA), NAFTA, EU and other south-south regional trade agreements between 1994 and 1998, this kind of trade-creation effect is much stronger in the case of south-south regional trade agreements. Trade facilitation measures as compliments to these agreements boosted trade among regional partners and their trade with third parties. Hence, consistent trade-creation effect found with gravity models has a strong foundation.

The researches on intra-OIC trade were popular even in 90s. It was at the 8<sup>th</sup> Islamic summit in Tehran where OIC countries adopted a resolution on 'Preparation of the *Ummah*' for the 21<sup>st</sup> century in the Areas of Economic, Trade and Financial Cooperation among OIC Countries. One of the areas of cooperation was enhancing intra-OIC trade. Literally target set as 3% increase in intra-OIC trade in three years to hit 13% by 1421H. In pursuance of this, Bendjilali (1997) in his research examined the relationship between exports of goods and services among OIC member countries and the main macroeconomic variables so as to shed light on the determinants of, as he defines, intra-bilateral trade among OIC countries. In his research Bendjilali tried to provide some insight on target of 3% increase in three years for policy makers in OIC countries, OIC

organs, and business communities in OIC member countries. In his model, depended variable is nominal imports from one OIC country to another. In addition to regular gravity model explanatory variables, he included Islamic Development Bank trade finance availed for importing country and a dummy variable to assess the effect of membership to a regional economic cooperation namely, Gulf Cooperation Council, ASEAN, Arab Maghreb Union. The result of econometric analysis, traditional gravity modelling, showed that inter OIC trade is positively affected by the size of their economies, the extent of Islamic Development Bank trade financing, their joint participation in regional integration schemes, and negatively affected by transportation and communication costs as proxy for the distance. Based on these findings, he recommends, among some other measures, extending trade finance to further enhance intra-OIC trade. With reference to this work, in the next section some insight is given on Islamic Development Bank's role in intra-OIC trade and its trade finance facilities in specific. Given the Islamic Development Bank's trade finance facilities as a small fraction of intra-OIC trade, the effects of OIC organs policies as a factor of enhancing intra-OIC trade are scrutinized.

Based on this discussion, in the coming sections determinants of intra-OIC trade are discussed with the objective of investigating and exploring the reasons of recent increase in OIC countries' trade with the rest of the world and among themselves. Is this increase due to policy instruments by OIC organs or some other dynamics? In order to avoid above-mentioned complications several explanatory variables such as a proxy for trade facilitation to address omitted variables are included.

In the 1990s, trade facilitation started to emerge as the top trading agenda for international organizations. With the objective of smoothening international trade transactions, APEC in its Osaka Action Agenda (1995) included trade facilitation in its work plan under the title of "Trade and Investment Liberalization and Facilitation". Based on 'Trade and Investment Liberalization and Facilitation' subject APEC members announced individual action plans, as adopted in the Manila Action Plan, and

implemented them under several trade facilitation measures as per their domestic regulations.<sup>19</sup>

Trade facilitation has long been in the agenda of the WTO with several distinct stages. However, the Singapore Ministerial Conference (1996), which gave a mandate for a more comprehensive look at trade facilitation, was a milestone. Three WTO members decided to establish three specific working groups, namely ‘transparency in government procurement’, ‘trade and investment’ and ‘competition policy’. As the Ministerial Declaration instructed the WTO Goods Council to focus on possible means for simplifying trade procedures, this issue was referred as trade facilitation. In order to identify the WTO rules in the trade facilitation area, the Goods Council was directed “to undertake explanatory and analytic work, drawing on the work of other relevant organizations, on the simplification of trade procedures”. These four tasks on transparency in government procurement, trade and investment, competition policy and trade facilitation are known as ‘Singapore Issues’ since the Singapore Ministerial Conference initiated them. It was trade facilitation of the Singapore issues which broke the Cancun deadlock as the other three issues were dropped from the Doha Development Agenda after strong opposition from developing countries.<sup>20</sup>

The importance of trade facilitation in international trade has turned out to be more eminent with the inclusion of this item at the top of the agenda of international organizations. However, there is still not a standard definition of trade facilitation in the public policy discourse. Wilson *et al.* (2003), in this regard, provided the definition of trade facilitation by several international organisations as “the use of technologies and techniques which will help members to build up expertise, reduce costs and lead to better movement of goods and services” (APEC Economic Committee , 1999):

OECD, TD/TC/WP21 attributed to Reven (2001): “simplification and standardization of procedure and associated information flows required to move goods internationally from seller to buyer and to pass payments in other directions”

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<sup>19</sup> Ippei Yamazawa, APEC’s progress toward the Bogor target: A quantitative assessment of 1997 IAP/CAP, pp.11-16. (Tokyo: PEEC Japan Committee, 1998).

<sup>20</sup> WTO Secretariat website, accessed on 28 April 2010 at [http://www.wto.org/english/thewto\\_e/whatis\\_e/tif\\_e/bey3\\_e.htm](http://www.wto.org/english/thewto_e/whatis_e/tif_e/bey3_e.htm)

WTO/UNCTAD, Ecommerce and Development Report (2001: 180): “simplification and standardization of procedures, including activities, formalities and practices involved in collecting, presenting, communicating and processing data required for the movement of goods in international trade”

APEC (2002): “trade facilitation generally refers to the simplification, harmonization, use of new technologies and other measures to address procedural and administrative impediments to trade”

UNECE (2003): “comprehensive approach to reducing the complexity and cost of trade transactions process, and ensuring that all this activities can take place in an efficient, transparent and predictable manner, based on internationally accepted norms, standards and best practices”.

Heinz (2003) addressed the difficulty of setting boundaries for the definition of trade facilitation as it cuts across business efficiency, transportation, government controls and regulations, information and communication technologies as well as the financial sector.<sup>21</sup>

Usually trade facilitation refers to government regulations but literature on trade facilitation, as suggested by Heinz, goes beyond the government regulations and extends to information and communication technologies. For example, Freund and Weindhold (2000) found a significant effect of information and communication technologies, internet in specific, on trade flows among 56 countries in their gravity model. They found that the effect of internet on trade for poor countries is much higher than the effect of internet for richer countries as more internet presence decreases the traditional determinants of trade among countries such as speaking the same language or having a same colonizer in the past. They assessed the effect of web host increase in a country on its trade for 1998 and 1999. As they assessed, 10% increase in the number of web host associates with 1% increase in trade of a country. Hence, they suggest diffusion of internet as an imperative part of trade facilitation in particular for poor countries.

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<sup>21</sup> Heinz, S. (2003). Strategies to enhance trade facilitation Implementation in UNECE Member States. *UNECE Committee for Trade, Industry and Enterprise Development Seventh Session*.

Woo and Wilson (2000), on the other hand, confine the definition within efficiency improvement in the administration, procedure and logistics in the ports and customs. They expand the definition to include harmonization of standards and streamlining regulatory environment for conformance to international agreements and conventions.

Gundogdu (2007) listed international agreements and conventions with the patronage of World Customs Organization as:

- (i) International Convention on the Simplification and Harmonization of Customs Procedures, Kyoto Convention 1973 as revised Kyoto Convention in 1999 became operational in 2006. This convention set standards for every aspect of customs clearance to harmonize procedure across the globe.
- (ii) Customs Convention on Temporary Admission also known as Istanbul Convention. As the name reveals, the convention is signed in Istanbul in 1990 to facilitate temporary admission of goods. The convention introduced ATA Carnet for goods and CPD Carnet for vehicles. The main rationale behind the convention was facilitate customs duty exemption procedure for goods imported with a specific purpose such as exhibition, humanitarian mission *etc.* and expected to be re-exported within a specific time period.
- (iii) International Convention on the Harmonized Commodity Description and Coding System. Also known as HS System aimed to harmonize tariff classification of goods for customs clearance across the signatories.

Indeed, specific elements of trade facilitation were part of General Agreement on Tariffs and Trade (GATT) 1947. Most prominent of them are Article V on Freedom of Transit, Article VII on Valuation for Customs Procedures, Article VIII on Fees and Formalities connected with importation and exportation and Article X on Publication and Administration of Trade Regulations. These articles were transformed into specific WTO agreements in due course particularly in the Tokyo Round of GATT such as the Agreement on Import Licensing, Sanitary and Phyto-sanitary Measures, Technical Barriers to Trade, Pre-shipment Inspection, Rules of Origin and Customs Valuation.



There has been substantial literature on assessment of trade facilitation measures with gravity modelling.

Wilson *et al.* (2003) scrutinized the relationship between trade facilitation, GDP per capita and trade flows in the context of the Asia Pacific Region. In order to assess the effect of trade facilitation they identified four broad indicators as electronic-business usage, regulatory environment, port efficiency and customs environment. Based on country-specific data on these indicators in a gravity model, the relationship between trade flows and these indicators are estimated. In addition to these indicators and standard explanatory variables of gravity model, they also included tariffs. They found regulatory barriers deter trade while enhanced port efficiency substantially boosts trade. In addition to enhanced port efficiency, electronic business and improvement in customs has positive effects on trade flows though with a lesser impact as compared to port efficiency.

Piermartini and Nordas (2004) examined the effect of infrastructure on trade performance with a gravity model. In addition to bilateral tariffs, the model included infrastructure quality indicators including road, port, customs clearance efficiency, airport and telecommunication to assess their impact on bilateral trade in the automotive, textile and clothing sectors. After including multilateral resistances from tariffs and remoteness into the fixed effect model, the quality of infrastructure appeared as an important determinant of trade. While the effect of tariffs turned to be negative as expected, port efficiency is assessed as the most important infrastructure indicator for trade flows.

Wilson *et al.* (2005) also investigated, through a panel of disaggregated manufactured goods in the period of 2000-2001 for 75 countries, the relationship between trade facilitation and trade flows. They defined four trade facilitation categories as e-business infrastructure, port infrastructure, customs environment and regulatory environment. By employing gravity model they estimated the impact of these categories on bilateral trade flows. They found the main gains from trade facilitation come from a country's own efforts rather than that of a trade partner. Furthermore, trade facilitation items in relation to GATT articles of V, VII, VIII and X on legal and administrative reforms would significantly boost trade. As mentioned above, Article V on Freedom of Transit, Article

VII on Valuation for Customs Procedures, Article VIII on Fees and Formalities connected with importation and exportation and Article X on Publication and Administration of Trade Regulations are the main clauses of GATT on trade facilitation.

Kim and Park (2005) estimated the potential effect of trade liberalization and facilitation efforts on bilateral trade among 15 APEC countries by a gravity model. As trade facilitation indicators, they incorporated standard and conformity assessment, information and communication technologies, customs procedures and business mobility to their model. They found significant trade-creation effect for trade facilitation measures complementary to trade liberalization in the form of tariff reduction. Hence, they suggest any FTA should include arrangements for trade facilitation and should not just put emphasis on tariff reduction. Furthermore, they suggest that trade-creation effect of trade liberalization and facilitation is much stronger for highly interdependent countries such as Korea, China and Japan than the average of the APEC countries.

Soloaga *et al.* (2006) embedded poisson equation to the gravity model in order to assess the effect of several improved trade facilitation scenarios on increase in trade. They had scenarios for improvement in regulatory environment, port efficiency, service sector infrastructure and customs environment. As they found, port efficiency of both importer and exporter is important but unlike Wilson *et al.* (2003), they did find stronger effects on bilateral trade from port efficiency of the importing country than the exporting country.

Gundogdu (2007) assessed the effect of trade facilitation efforts of ASEAN countries on bilateral trade in East Asia namely ASEAN plus China, Japan and South Korea for the time period of 1997-2004 the research being the first one to assess the significance of mutual recognition agreements as a trade facilitation tool on trade flows. In doing so, he introduced a methodology within a gravity model for this purpose. His resulting analysis indicates enhanced trade both among ASEAN countries and between ASEAN countries and non-member East Asian countries as a result of ASEAN trade facilitation measures. Hence, he concluded that the ASEAN Free Trade Agreement is not trade diverting itself though recent efforts in the area of Mutual Recognition, integrated Single Window may give rise to some trade diversion as they exclude non-members. He proposed enhancing

the coverage of mutual recognition agreements as the result of the model suggested that cooperation in the area of standard and conformity assessment can boost intra-regional trade. He also highlighted the importance of decreasing delivery time for time-sensitive goods i.e. perishable goods as a priority subject of trade facilitation efforts. Trade facilitation projects require substantial financial resources. He also draws the attention to the fact that once these high-cost projects are implemented, all trading partners of the country benefit. In this regard, he opened an avenue for further discussion on the source of funds for trade facilitation projects, as many trading partners would get a free ride out of implementation of trade facilitation projects.

In 2009, Islamic Center for Development of Trade (ICDT) in collaboration with the UNCTAD estimated the impact of the TPS-OIC, under total derogation of customs duties (removal of all obstacles to trade). The results suggest a static US\$19 billion rise of intra-OIC trade (1997 data). With the dynamic effects stimulated by more foreign direct investment, horizontal integration, removal of non-tariff barriers, cumulating rules of origin, *etc.* this gain argued to be even higher.

Again Gundogdu (2007), as cited from United Nation ESCAP Trade and Investment Divisions survey including some OIC countries such as Bangladesh to identify most problematic trade facilitation areas, indicated the rank of these areas as depicted in Table 2.1.

**Table 2.1: Some of the Most Problematic Factors in International Trade Identified by the Private Sector:**

<b>Most problematic areas in trade facilitation</b>	<b>Rank</b>
Customs valuation	1
Inspection and release of the goods	2
Tariff classification	3
Submission of documents for clearance	4
Obtaining an import licencing	5
Payment of fees and penalties	6
Technical and sanitary requirements	7
Identification of origin of the goods	8

*Source:* Gundogdu (2007) as cited from UNESCAP Trade and Investment Division, Asia Pacific Research and Training Network on Trade

Customs valuation with a direct monetary implication on both public authorities and importers ranks on the top of the list. Gurler (2002) discusses the implications of the WTO Customs Valuation Agreement and emphasises on difficulties in implementation of the WTO Agreement on Customs Valuation in the case of African OIC member countries. The issue of customs valuation turns to be more important in the case of developing countries, including many OIC countries, as the bulk of the public income are generated from customs. As Gurler (2002) cites from WTO, in case of African countries 50 to 60% of government income comes from customs. As Gurler (2002) states “the main implementation difficulties are related to the fear that the Agreement would limit their customs administrations to deal with the cases where goods were deliberately undervalued, which in turn would result in a loss of revenue from customs duties”. The government income implication of the issue is perceived to be one of the main reasons for many OIC countries being hesitant for further trade integration.

It should also be stated that there has been substantial literature on customs valuation as an integral part of trade facilitation.

According to ICDT Annual Report 2009, tariff incomes accounts for more than half of the government revenues in some developing countries, particularly in Africa. Hence, the public authorities of these countries are unwilling to have any change in as-is let alone implementing a comprehensive preferential trade agreement with drastic tariff cuts. It is suggested that successful implementation of any preferential trade agreement depends on compensation of potential revenue loss for government due to tariff cuts. For those countries, if not levying value added tax on imports, introduction of value added tax for imports is suggested as a remedy to potential loss of government revenue.

Walsh (2003) defines Customs Valuation as an integral part of trade facilitation together with issues related to charges levied on imports, quota, licensing arrangement and the application of preference systems. He also explained provisions, together with their implementation procedures, of the WTO Customs Valuation Agreement. In addition, Finger and Schuler (2000) presents customs valuation within the wider sphere of reforms, which are based on transparency, accountability, objectivity and balance. After

presenting historical background of customs valuation issues, Rege (2002) accounts the resentment of developing countries for application of transaction values as it would supposedly decrease the customs revenue due to undervaluation.

Indeed, tax evasion in customs through misclassification and undervaluation of imports is a momentous issue especially in developing countries. King (2003) indicated common under-invoicing and lack of effective valuation processes in developing countries, which highlighted the importance of capacity-building for implementation of any customs valuation system. On the other hand, Filmer (2003) presents the concerns of importers, as there exist some threat of assuming higher value as well as delaying clearance in customs so as to direct importers for illegal settlements. In the same fashion, Ghimire (2005) identified the discretionary power of customs authorities as a major issue with the customs valuation process. Finger and Schuler (2000) observe the lack of remedy and diagnose with WTO Custom Valuation Agreement for least-developed countries for their problem with customs administrations. They suggest capacity-building in the form of computer systems and databases for sound implementation of the agreement as a proper administrative environment does not exist in many developing countries.

There are many studies on tariffs and customs revenue. According to Pritchett and Sethi (1994) importers tend to evade tariffs as it gets higher. Hence, increase in tariff revenue would be less than expected after increased tariff rate due to tax evasion. Accordingly, a decrease in tariffs would not necessarily mean decrease in revenue as lower tariffs decrease the marginal benefit to avoid taxation. Hence, customs revenue may increase as a result of increase in tax base. Both Ebrill *et al.* (1999) and Khattry and Rao (2002) worked on revenue-maximizing optimum tariffs rate. In regional focus, Abgeyegbe *et al.* (2004) examine the effect of trade liberalization on customs tax for not only aggregate but also subcategories for Sub-Saharan Africa.

On the other hand, not much has been done for the quantitative effect of the WTO Customs Valuation Agreement, tariffs and imports on OIC countries customs revenue. As a result special section in this chapter on determinant of OIC countries customs revenue

in connection to implementation of WTO Customs Valuation Agreement is introduced as an extension model to identify determinant of intra-OIC trade.

In addition to these works employing econometric models on OIC countries trade, there are some other descriptive researches on OIC integration. For example, SESRIC' study "Integration into the World Economy: Experience of the OIC Countries" (2005), which was prepared by and presented to the OIC Economic Conference held during the 20<sup>th</sup> Session of the COMCEC, highlights the role of regional integration efforts under efficient and effective institutional framework as a preliminary step for a larger scale integration.

In extending the debate, Dabour (2004) examines the implications of establishment of an Islamic Common Market. While examining these implications and various constraints he emphasises the importance of gradual economic integration. SESRIC (2003) propose alliance for OIC countries' stock exchanges and clearing house. Ilkin (2003) analyses the use of information and communication technologies (ICT) and e-commerce in OIC countries. He recommends capacity-building in the ICT sector and establishment of inter-banking payment systems in electronic form to promote intra-OIC trade.

From another approach, Gurler (2002) discusses the implications of WTO agreements of Customs Valuation, Pre-shipment Inspection, Rules of Origin and Import Licensing on OIC countries. He specially emphasises the difficulties in implementation of these agreements especially in the case of African OIC member countries. As he states (2002: Page 64) "many of the difficulties encountered by developing country members in implementing these agreements are compounded in African countries". He counts vast border and land between these countries, lack of trade finance, high duties, red tape and lack of resource as the main causes. In the case of customs valuation agreement, he proposes capacity-building through customs reform to address possible leakage of customs revenue after implementation of the WTO Customs Valuation Agreement. He accounts for Pre-shipment Inspection activities for verification of the quality, the quantity, the price including currency exchange rate and cost of financing, and customs classification. Though pre-shipment inspection is seen as an important tool for assurance

of proper customs valuation for many OIC countries, Gurler (2002) did not observe the crucial relationship between pre-shipment inspection and customs valuation. In case of the Agreement of Rule of Origin and Import Licensing, he confined himself merely to explaining the agreements and status of implementation of these agreements in African OIC member countries. However, he rightly addressed the issue of cost implication with implementation of these agreements for OIC countries as the implementation of these agreements necessitates capacity-building in trade facilitation in the form of computerization of customs procedures, training for customs officers, customs reform *etc.* He did not connect the issue of capacity-building in trade facilitation with OIC trade integration though in his research of Gurler (2000) he examines the role and function of trade arrangements in the formation of an Islamic Common Market or any other prospective economic integration. Then, after providing conceptual background of regional integration he evaluated regional economic groupings among OIC member countries and their possible role for an Islamic Common Market. He classified regional economic grouping in six categories based on the level of the integration as:

- (i) Preferential trade area
- (ii) Free trade area
- (iii) Customs union
- (iv) Common market
- (v) Monetary union
- (vi) Economic union

In this research he also provides comprehensive background information on OIC trade integration initiatives since its inception. Similarly, Hzaine (1998) conducted a survey on major economic groupings within the OIC and, based on this, offered some policy options for an Islamic Common Market. He proposed abolishment of overlapping groupings and policy harmonization (rule of origin, ECT compensation system) for an Islamic Common Market. However, the Framework Agreement on Trade Preferential System among Member States of the Organization of the Islamic Conference noted that ``due to the geographical dispersion of Member States, and the differences in their development levels which hamper the establishment of a comprehensive regional system

for trade liberalization, a Trade Preferential System would be the most appropriate instrument to increase trade exchange among them.”<sup>22</sup>

As a result, Ariff (1998) discusses the notions of regionalism and globalism and proposes outward looking, cost-effective, low-profile, informal policy options for OIC integration. As he highlights, “some regional schemes had failed largely because they were too ambitious at the outset”. He warns that targets should be kept within reach so success can breed success, and also rightly points out the difficulties in reaching a consensus in large economic groupings, as is the case with the OIC. Besides, he argues that the cost of rigidly structured, highly institutionalized OIC integration might exceed the expected benefit of out of this formation. Although Ariff (1998) touched upon very important issues of OIC trade integration, he did not propose specific OIC integration framework based on concrete pillars.

## **2.4 POLICIES TOWARDS INCREASING INTRA-OIC TRADE**

The role of international organizations in promoting international trade has been the subject of many studies. Rose (2004) concluded that being a WTO member has no significant role to promote international trade.<sup>23</sup> However, in his recent study, Ghani (2007) argues, from the evidence of gravity model estimation, being an OIC member country has positive or non-significant effect on bilateral trade. Indeed, being a member of an organization alone may not explain more trade if there is no initiative from the side of this organization to enhance intra trade. Since the OIC has developed such strategies, it is worth mentioning OIC initiatives to enhance intra-OIC trade at this stage as the subject in question requires.

After the United Nations (UN), the OIC is the second largest inter-governmental organization with a membership of 57 states spread over four continents. It was in 1970 when the Islamic Conference of Foreign Ministers (ICFM) decided to establish a permanent secretariat, headed by a secretary general, in Jeddah in their meeting in Saudi

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<sup>22</sup> Available at [www.comceec.org/EN/belge/agreements/pdf/OIC-TPC.pdf](http://www.comceec.org/EN/belge/agreements/pdf/OIC-TPC.pdf) last accessed on 22 September 2009.

<sup>23</sup> Kim (2006) re-estimated, by excluding oil, agriculture and textile sectors, the model used by Rose and shows that WTO does, actually, promote international trade. Subramaniam and Wie (2003) modified the same sample, specification of the gravity model and the definition of WTO membership. They showed that WTO membership increases a country's international trade.



Arabia.<sup>24</sup> Since then there have been many initiatives among member countries in economic and trade cooperation under the OIC umbrella. The resolution of the Makkah Summit in 2005, however, is a milestone in accelerating trade cooperation efforts with a mandate to increase intra-OIC trade 20% by 2015. Accordingly, along with the Ten-Year Programme of Action specific duties have been assigned to the several OIC affiliates:<sup>25</sup>

- (i) Islamic Development Bank – IDB (Jeddah);
- (ii) Statistical, Economic and Social Research and Training Center for Islamic Countries (SESRIC) (Ankara);
- (iii) Islamic Center for the Development of Trade ICDT (Casablanca);
- (iv) Islamic Chamber of Commerce and Industry ICCI (Karachi).

These institutions have been carrying out several projects under the pivotal role of the Committee for Economic and Commercial Cooperation of the OIC (COMCEC) agenda related to economic and trade cooperation among OIC member countries. For instance, the Islamic Development Bank (IDB) has prepared feasibility works for Medium Term Trade Financing and implemented it. In addition, IDB has also established the International Islamic Trade Finance Corporation (ITFC), which is expected to be the arm of the IDB with a mandate to enhance intra-OIC trade. Furthermore, IDB has been cooperating with the COMCEC in the development of the Tariff Preferential Scheme for OIC (TPS-OIC) through the Trade Negotiating Committee (TNC) on the Tariff Preferential Scheme and its outcome in the form of a Protocol on Preferential Tariff Scheme for TPS – OIC (PRETAS). As part of this, PRETAS, an agreement with tariff reduction rates, has been developed. As a next step cooperation for the ‘Rules of Origin of Goods and removal of Non-tariff Barriers’ is to be completed under the TNC agenda. The Islamic Center for the Development of Trade (ICDT) in Casablanca is in full charge of the Trade Information Network of the Islamic Countries (TINIC). Moreover, SESRIC undertook the renewal of the most important strategic document of the COMCEC Plan of

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<sup>24</sup> OIC webpage accessed on 27 June 2008 at [http://www.oic-oci.org/oicnew/page\\_detail.asp?p\\_id=52](http://www.oic-oci.org/oicnew/page_detail.asp?p_id=52)

<sup>25</sup> Third Session of the Extraordinary Islamic Summit Conference December 7-8, 2005

Action. It is again SESRIC which prepared the inventory of the decisions taken regarding the economic and trade cooperation within the framework of the OIC.

With the focus on trade creation rather than trade diversion and in cooperation with COMCEC, a number of policy measures have been identified to implement these measures which includes trade development, promotion of non-reciprocal market access to the LDMCs to enhance their trade as well as setting-up of sub-targets for trade for the individual member countries in various regions based on their trade potential.

#### **2.4.1 The Role of Islamic Development Bank<sup>26</sup>**

One should note the pivotal role and contribution of IDB for promoting intra-OIC trade. IDB embarked on operations within the framework of the Ten-Year Action Programme and established, accordingly, ITFC. 47 OIC member countries as well as six finance corporations have signed the agreement. ITFC is expected to be the essential institution of IDB with a mandate to enhance intra-OIC trade with a five-prongs strategy including trade finance, trade facilitation, trade promotion, capacity building and strategic product development. Indeed, trade finance business is not something new to IDB. With the inception of ITFC all trade windows of IDB would be combined under one entity so as to create synergy for embarking many initiatives for enhancing intra-OIC trade under the Ten-Year Action Programme.

The ITFC with authorized capital of US\$3 billion and subscribed capital of US\$613 million became operational in January 2008 and took over all the trade finance business and trade cooperation programmes of the IDB Group under a single umbrella. The principal objective of the ITFC is to promote and enhance trade of member countries and to supplement the efforts of IDB in this regard by providing trade finance and engaging in activities that facilitate intra-OIC trade and international trade of MCs. ITFC delivers these objectives through two parallel lines of approach, namely Trade Finance Operations and the Trade Cooperation and Promotion Programme.

In short, the ITFC fulfils its objective by undertaking the following functions:

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<sup>26</sup> Based on the work experience of the author with Islamic Development Bank Group.

- (i) Finance trade, alone or in cooperation with other financial institutions;
- (ii) Assist OIC MCs and institutions to access private and public funds from international markets for short-term trade financing;
- (iii) Provide assistance for the development of investment opportunities in MCs to enable them to enhance their international trade capabilities;
- (iv) Develop and diversify financial instruments and products for trade financing;
- (v) Provide technical assistance and training to Trade Promotion Organizations (TPOs) and financial institutions in MCs;
- (vi) Promote and facilitate intra-OIC trade and international trade of MCs;
- (vii) Support trade promotion activities of TPOs.

The ITFC trade finance arm emphasizes on enhancing intra-OIC trade through providing short-term trade finance facilities and establishing trade links between the entities in different OIC member countries. Accordingly, the share of intra-OIC trade in overall ITFC trade finance approvals for 2008 reached to 83%. By availing trade finance facilities in the era of global financial and economic crisis, ITFC support OIC member countries to sustain their economic and social development.

As explained above, the ITFC is charged with the responsibility of providing trade financing for economic operators in OIC Member countries with particular emphasis on enhancing intra-OIC trade. A summary of IDB group trade finance approvals, from inception to date 1977-2010, is presented in below:

**Table 2.2: Islamic Development Bank Trade Finance**

Import Trade Financing Operations (ITFO)	US\$ 23.710 billion
Export Financing Scheme (EFS)	US\$ 1.670 billion
Islamic Banks Portfolio (IBP)	US\$ 3.040 billion
Unit Investment Fund (UIF)	US\$ 0.906 billion
ITFC Trade Finance Operations (2008)	US\$ 2.505 billion
ITFC Trade Finance Operations, (2009)	US\$ 2.166 billion
ITFC Trade Finance Operations, (2010)	US\$ 2.554 billion

*Source:* International Islamic Trade Finance Corporation

By the end of 2010, the cumulative IDB Group trade financing stands at US\$36.551 billion with intra-OIC trade financing representing 75% of this total trade financing. ITFC commenced business activities at the beginning of 2008 and during this first year of

operations, 70 trade finance operations in 24 OIC member countries were approved for a total of US\$ 2.505 billion. The total share of intra-OIC trade finance approval in 2008 was 83%, representing a modest increase from 77% achieved the previous year. The level was almost sustained from 2008 to 2010

Financing for small and medium-size enterprises (SMEs) and LDMCs in member countries is one of the highest priorities for ITFC. In this regard, 44% of total private sector approvals in 2008 were in favour of entities in the SMEs category and 43 % went to LDMCs and assisting them to mainly import raw and semi-finished industrial products to be used for the manufacture of goods meant mainly for export markets. ITFC approval in favour of LDMCs amounted to 45% of all approvals, for 2010.

Another area of focus for ITFC is the development of strategic commodities particularly in LDMCs in order to assist these countries to alleviate poverty and sustain the jobs available in agro-industry sectors. Especially, providing funds for input financing turns to be an urgency to put the economies of LDMCs into track as the production cycle has been damaged in the recent fertilizer price surge, food crisis and global financial crisis. Given the huge volume of OIC countries imports and its relatively low capital, ITFC focused on high-impact operations and improving its ratios of LDMCs, SMEs, Strategic Commodities as explained earlier. Also, special emphasis is given to increase private sector financing. However, the public sector still constitutes more than half of the annual approvals.

The SMEs are the main driving forces of the economies of many OIC countries, particularly for LDMCs and it is for this reason that ITFC is keen to promote new financing tools to boost financing for LDMCs and SMEs in order to enhance intra-OIC trade. Furthermore, ITFC identified several initiatives and counter-measures to maintain the same level of support to member countries and their public and private institutions to minimize the effects of the global financial crisis.

The ITFC's trade promotion and development arm, the Trade Cooperation and Promotion Programme (TCPP), focuses on strengthening Trade Promotion Organizations (TPOs) through intensive capacity-building activities and promoting and

enhancing intra-trade through facilitating trade promotion activities in OIC countries. In view of the need to fulfil the above-stated objective, TCPP has been developed as the trade promotion and facilitation arm of ITFC, with a mission of planning and delivering effective and tailor-made trade-related technical assistance projects to the concerned trade institutions and SMEs in OIC member countries. TCPP, as a facilitator and catalyst to promote intra trade and enhance export capacities of MCs and in coordination and cooperation with partners, carried this role through providing sustainable trade development solutions to OIC countries' trade promotion institutions and government agencies. The final objective is aimed at supporting, enhancing and developing the private sector exports in OIC member countries. In 2009, ITFC through TCPP organized and/or supported 36 activities/projects under the four business lines of the programme, which are trade promotion, trade facilitation, capacity building, and development of strategic products. A total of 36 member countries participated in these activities and/or received financial support from ITFC. The activities undertaken are classified as follows:

- (i) Meetings that cover trade information facilitation, capacity building, Aid-for-trade, intra-trade promotion, *Halal* food, development of strategic products, food crisis;
- (ii) Training courses on export strategies and international marketing were conducted for the benefit of some exporting companies/establishments (SMEs) in some member countries;
- (iii) On-the-job trainings for the benefit of selected Trade Promotion Organizations (TPOs) and selected Chambers of Commerce;
- (iv) Organizing and sponsoring participations of TPOs and SMEs from OIC member countries in the international trade exhibitions and business matching events.

The following is the examples of the activities/projects implemented under four business lines of the programme in 1430H.

### **1st Business Line: Trade Promotion**

The objective of the 1<sup>st</sup> Business Line as being trade promotion is to act as a catalyst and facilitator for intra-OIC trade, TCPP sponsors the participation of national TPOs and SMEs in buyers-sellers meetings, trade-bridge programmes and international trade exhibitions, business forums; enabling them to reach out to new markets, identify new

business opportunities, establishing partnerships and acquiring information on sectors and business culture of their targeted markets.

The following examples can be given as part of such activities: Collective Participations of TPOs from selected MCs in ITFC Pavilion at INTRADE 09 Malaysia 10-12 November 2009.

The ITFC/TCPP organized and sponsored collective participations of Trade Promotion Organizations from 8 MCs (Oman, Kuwait, Saudi Arabia, Turkey, Iran, Indonesia, UAE, and Pakistan) in the ITFC Pavilion at INTRADE 09 where given the opportunity to present their countries' economic development and to reach out to new markets, and to identify new business opportunities. This was one of the trade promotion activities implemented by ITFC, having direct and immediate impact on trade, aims at increasing the volume of intra trade, enhancing trade cooperation among MCs. ITFC is committed to support participations of TPOs, mainly from CIS and African countries in international trade exhibitions to enable them to access new markets and promote their export products in their target markets.

## **2nd Business Line: Trade Facilitation**

Trade facilitation as the second business line of TCPP aims at enhancing economic integration among OIC MCs and supporting their integration into the world economy. To this end, TCPP provides financial support for the activities such as meetings, conferences, seminars and workshops related to harmonization of international trade rules and regulations, transport and logistical services, e-trade, *Halal* food regulations with a view of strengthening administrative capacities of OIC member countries to enable them to develop and implement their national policies in these areas.

Among the activities of trade facilitation 'Aid for Trade Initiatives for SPECA and ESCWA Regions' can be mentioned.

ITFC/TCPP launched the regional initiative on Aid for-Trade (Aft) Road Map for the United Nations Special Programme for the Economies of Central Asia (SPECA) countries (Afghanistan, Azerbaijan, Kazakhstan, Kyrgyzstan, Tajikistan, Turkmenistan

and Uzbekistan) in collaboration with the Governments of Kyrgyzstan, Azerbaijan, Finland and many international and regional organisations as WTO, United Nations Development Programme (UNDP), International Trade Center (ITC), United Nations Economic Commission for Europe (UNECE), European Bank for Reconstruction and Development (EBRD), Asian Development Bank (ADB) to discuss the means and modalities for the organization of the Experts Group Meeting and Ministerial Meeting held in 2010 in Kyrgyz and Azerbaijan. The ITFC expressed its readiness and willingness to sponsor the Experts Group and Ministerial meetings organized in 2010. This initiative is expected to identify trade development needs of the relevant countries and prepare the Road Map for the implementation of trade development programmes, which will strengthen competitiveness of the beneficiary countries in global markets.

### **3rd Business Line: Capacity Building**

The main objective of the Capacity Building-oriented business line is to enhance trade support capacities of institutions in MCs as an indigenous source that support and strengthen private sector competitiveness in international markets. Capacity development is the key to sustainable trade development. Without having qualified human resources and efficient organizations, it would be difficult to plan and implement national trade development policies. It is for this reason, ITFC/TCPP gives special importance to capacity-building activities and allocates considerable amount of its annual budget to organize on-the-job training programmes and training seminars for trade support organizations and SMEs on various subjects ranging from international marketing and export strategies to trade finance and export credit insurance *etc.* In 2009, the total number of activities/project implemented under capacity building was fourteen, in which over 35 OIC MCs, mostly from French-speaking and CIS countries participated.

Capacity Development Technical Assistance Projects should be mentioned among the projects undertaken by the Capacity Building business line. ITFC/TCPP has extended its effort in the field of capacity building by initiating and sponsoring three technical assistance projects to strengthen training departments of some TPOs (IGEME, MATRADE, High School of Trade of Tunisia) in order to serve other TPOs and

enterprises of OIC MCs through offering specialized training programmes to improve their international trade competitiveness. The validation symposium of the first phase of the projects was held in Istanbul, Turkey during 4-5 November 2009. ITFC plans to provide funds to implement similar projects for some other TPOs from French-speaking and CIS countries in the near future.

#### **4th Business Line: Development of Strategic Product**

The objective of the Development of Strategic Product business line is to Assist MCs to develop their trade capacities and competitiveness in the sectors and products where they have comparative advantages. Among its projects revitalization of the groundnut sector in selected Sub-Saharan countries should be mentioned.

ITFC/TCPP launched the implementation of a project ‘Revitalisation of the Groundnut Sector’ in Senegal, Gambia and Guinea Bissau. Groundnut is the principal source of export earnings of Gambia, Guinea-Bissau and Senegal and accounts for almost 70% of the rural labour force in these countries. Due to the high importance of groundnuts for the economies of these countries, the ITFC has initiated and funded a preliminary study, which aims at assessing the current situation of the sectors in each of the three countries and providing solutions to overcome the constraints, with a view to support the increase of improved, higher value-added groundnut production and of exports to both international markets and OIC states.

In addition, the IDB Group is very keen on cooperating with the COMCEC in the development of Tariff Preferential Scheme for OIC (TPS-OIC) through the Trade Negotiating Committee (TNC) on the Tariff Preferential Scheme and its outcome in the form of a Protocol on Preferential Tariff Scheme for TPS – OIC (PRETAS). PRETAS, an agreement with tariff reduction rates, has been developed. TPS-OIC is targeted to be established by 1st January 2009. As a next step cooperation for the Rules of Origin of Goods and removal of Non-tariff Barriers, shall be completed under Trade Negotiating Committee (TNC) agenda. In order to enhance intra-OIC trade the IDB has signed the Memoranda of Understanding (MOU) with Malaysia and Turkey. These MOU are expected to boost close cooperation and co-financing. Similar MOU are expected to be



signed with other member countries and institutions as well. Reference to Economic Cooperation of the OIC Ten-Year Programme Resolution I.3, the IDB has organized activities to provide support to its member countries in the process of acceding to the WTO or contemplation thereof. Basically, the IDB activities on WTO-related matters target the acceding members in order to facilitate and expedite their accession process by providing awareness among these members related to the WTO Agreements and related issues. In addition to technical assistance, IDB has conducted Workshops on WTO issues, Trade Policy Courses, Seminars, sectoral studies (on Agriculture, Investment, Services, Trade-related Aspects of Intellectual Property Rights, and E-Commerce), and consultative meetings in conjunction with the last six WTO Ministerial Conferences especially for those member countries acceding to the WTO.

The presented information so far suggests substantial increase in efforts by OIC affiliates to boost intra-OIC trade. However, a close look at the details might reveal possible ineffectiveness of these activities. For example, trade finance provided by IDB Group although accounting for billions of dollars is still meagre compared to intra-OIC trade volume. Per annum, IDB Group trade finance availed would make less than one percent of intra-OIC imports alone. As a result, unlike Bendjilali (1997) trade finance is not perceived as an independent variable of intra-OIC trade in the model to be introduced in this chapter. In addition, existing trade cooperation and promotion activities seem to be *ad hoc* but not well organized within a framework. Given the double dominance mentioned previously, it is plausible to seek the cause of recent increases in intra-OIC trade in other dynamisms but not necessarily with the efforts of OIC affiliates.

## **2.5 MODEL SPECIFICATION FOR DETERMINANTS OF INTRA-OIC**

### **TRADE: EMPIRICAL INVESTIGATION**

As mentioned previously, this part is constructed around the gravity model in identifying the determinants of intra-OIC trade. This section aims to detail the model specification.

#### **2.5.1 Methodology**

The determinants of intra-OIC trade is examined through an econometric model namely, the traditional gravity model where bilateral trade between two countries is positively

related to economic sizes and negatively related to geographic distance. It should be noted that the data set is designed in balanced panel structure.

Since its introduction, dating back to works of Tinbergen (1962) and Poyhonen (1963), the Gravity model for trade flows has been employed to scrutinize determinants of bilateral trade flows. The model itself is derived from Newtonian Physics Theory. The attraction between two objects positively related to the masses and negatively to the distance between them. Similarly, in case of international trade, the model indicates positive correlation between economic sizes and trade flows and negative one with geographic distance. That is,

$$F_{ij} = A * \frac{Y_i * Y_j}{D_{ij}} \quad (2.1.)$$

where:

$F_{ij}$  stands for trade flow from country  $i$  to country  $j$ ;

$Y_i$  and  $Y_j$  are the economic sizes of the two countries;

$D_{ij}$  is the geographic distance between country  $i$  and county  $j$ ;

$A$  stands for gravity constant

By taking natural logs, a linear form of relationship between log trade flows and the logged economy size and distance would be obtained as:

$$\ln F_{ij} = \alpha \ln Y_i + \beta \ln Y_j - \theta \ln D_{ij} + \zeta \ln A + \varepsilon_{ij} \quad (2.2.)$$

Since the introduction of the model, theoretical basis of the model and variables have been subject to many studies as explained in the literature review part of this chapter. However, Anderson and van Wincoop (2003) argued that the estimation of the traditional gravity model suffers from omitted variable bias as equations do not have a theoretical foundation. Recent research on intra-OIC trade excluded the effect of bilateral applied tariff rates as an independent variable for intra-OIC trade. This, together with the effect of real exchange rates as well as improvement in trade facilitation and liberalization level of countries, might give rise to omitted variable bias in the gravity model estimation. This

paper, hence, unlike other intra-OIC trade research, aims to show the effect of price levels between importing and exporting countries through the inclusion of relative depreciation of real exchange rates as well as including the depreciation of the US dollar against the Euro into the econometric model as determinant of intra-OIC trade. It should be noted that the independent variable envisioned being the real imports of OIC countries from the rest of the world, that is both member and non-member countries. Based on the result of the econometric model, another econometric model is introduced to provide some insight on OIC countries' customs revenues.

### 2.5.2 The Model Specification

The rudimentary gravity equation is augmented by including specific variables to fulfil the objectives of this chapter. The functional form employed for this research is as depicted in the following equation:

$$IMP^{ijt} = F_i(GDP^{it}, GDP^{jt}, DIST^{ij}, TARIFF^{ijt}, DEXR^{jt}) \quad (2.3.)$$

where: *IMP* stands for real imports of OIC member countries from the rest of the world, *GDP* stands for real gross domestic product, *DIST* stands for weighted distance, *TARIFF* stands for weighted tariff and *DEXR* stands for real exchange rate. Together with real exchange rate, applied tariff is taken into account as an explanatory variable. Dummy variable for imports of OIC member countries from non-OIC countries and border effect have also been included. Natural logarithms of the variables are taken. Hence, real imports of OIC countries from non-OIC and OIC countries are expressed in a log-linear form in equation 2.4. below:

$$\begin{aligned} LnIMP^{ijt} = & \beta_0 + \beta_1 LnGDP^{it} + \beta_2 LnGDP^{jt} + \beta_3 LnDIST^{ij} + \beta_4 Ln(100 + TARIFF^{ijt}) + \beta_5 LnTO^{it} \\ & + \beta_6 ApEXR^{jt} + \beta_7 BORD^{ij} + \beta_8 COMCOL^{ij} + \beta_9 SMCTRY^{ij} + \beta_{10} LnFXUSDEUR^{ij} \\ & + \beta_{11} EXTRA\_OIC^{ij} + e^{ijt} \end{aligned} \quad (2.4.)$$

where superscripts *i* and *j* stand for the importer (an OIC member country) and exporter, respectively and *t* donates years.

In this model, dependent variable is real imports of OIC member countries from the rest of the world for the period of 1995-2007. Dependent variable,  $IMP^{ijt}$ , is the real imports of country  $i$  from  $j$  at time  $t$ .  $GDP^{it}$  and  $GDP^{jt}$  are real Gross Domestic Product at time  $t$  for country  $i$  and  $j$ .  $DIST^{ij}$  stands for the weighted distance between two countries.<sup>27</sup>  $ApEXR^{ijt}$  is appreciation of country  $i$ 's real exchange, includes both relative nominal exchange rates and price levels, in year  $t$ .  $TARIFF^{ijht}$  is weighted tariff rate of country  $i$  imposed on product imported from country  $j$  in year  $t$ .<sup>28</sup>

It should be mentioned that it is difficult to get a quantitative measure for trade facilitation and liberalization. Recently, the World Economic Forum released very relevant data with the Global Enabling Trade (ETI) Report in June 2008 in that regard.<sup>29</sup> However, data is not provided for all OIC member countries for the time period of 1995-2007. Hence, trade openness index is used as a proxy for a country's level of trade liberalization and facilitation.  $TO^{it}$ , Trade openness index is measured as percentage of trade to GDP.<sup>30</sup> Herein, membership to other regional organizations such as ECOWAS or the effect of Generalized System of Preferences is not included since the tariff variable captures their main effects on imports.

<sup>27</sup> The distance data used herein is the weighted distance of country  $i$ 's and country  $j$ 's big cities. The basic idea is to calculate distance based on big cities of two countries. Hence inter-city distances are weighted by the share of the city in the overall country's population. The general formula developed by Head and Mayer (2002) used for calculating distances between countries  $i$  and  $j$  is:

$$d_{ij} = \left( \sum_{k \in i} \left( \frac{pop_k}{pop_i} \right) \sum_{l \in j} \left( \frac{pop_l}{pop_j} \right) d_{kl}^\theta \right)^{1/\theta}$$

where  $pop_k$  designates the population of agglomeration  $k$  belonging to country  $i$ . The parameter  $\theta$  measures the sensitivity of trade flows to bilateral distance  $d_{kl}$ . The distance used in this paper calculation sets  $\theta$  equal to -1, which corresponds to the usual coefficient estimated from gravity models of bilateral trade flows. The main motivation to use weighted distance is to capture the effect of big cities rather than pure distance between two capital cities (CEPII manual).

<sup>28</sup> This variable denotes weighted average tariff rate in the percent ad valorem term which is specific to the trading partners, product categories and year and includes the lowest applicable rates as well as all available preferential rates. Bilateral trade values are used as weight. To avoid log zero in case tariff level is zero, 100 is added.

$$\ln TARIFF^{ijht} = \ln(100 + TARIFF^{ijht})$$

<sup>29</sup> The ETI focuses on four trade-enabling issues: (1) market access, (2) border administration, (3) transport and communications infrastructure and (4) business environment. The market access index measures the extent to which the policy and cultural framework of a country welcomes foreign goods into the country. The border administration index assesses the extent to which administration at the border facilitates entry to a country. Once inside, transport and communications infrastructure index measures whether the country has the requisite infrastructure to facilitate the movement of goods from border to destination. Finally, the business environment index considers the overarching regulatory and security environment impacting the transport business in the country.

<sup>30</sup> Note that using this indicator as a representation of openness may be misleading. Even when this indicator has a relatively small value, it does not necessarily imply high trade barriers. It may, in fact, be caused by a large proportion of GDP being created by non-traded activities and other factors.

$BORD^{ij}$  is a dummy variable: if country  $i$  and  $j$  share a common border the dummy variable gets the value of 1, zero otherwise. Likewise,  $COMCOL^{ij}$  is a dummy variable. If country  $i$  and  $j$  had a common colonizer the dummy variable gets the value of 1, zero otherwise. If country  $i$  and  $j$  are used to be part of same country, the dummy variable of  $SMCTRY^{ij}$  gets the value of 1, zero otherwise.  $LnFXUSDEUR^t$  stands for value of one US dollar against the Euro. The main objective of including this variable is to show the effect of depreciation of the US dollar. The Euro alone, not SDR, is preferred since the Euro area has traditionally been one of the main partners of OIC member countries. Besides, valuation of the SDR includes the US dollar itself and the portion of the US dollar in the SDR has changed for the time period, 1995 to 2007, of this chapter.<sup>31</sup> Note that, synthetic Euro exchange rate values before its introduction has been calculated by geometrically weighting the bilateral exchange rates of the twelve Euro area countries.<sup>32</sup>

One further variable as proxy for trade creation and diversion effect of the OIC is introduced.  $EXTRA\_OIC^{ijt}$  is dummy variable taking the value of 1 for the observations if country  $j$  (country of origin) is not a member of OIC in year  $t$ .<sup>33</sup> This dummy variable captures the change in exports of third countries to the OIC members. Hence, if there is decrease in exports of third countries it should be interpreted as trade diversion and *vice*

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<sup>31</sup> SDR is International reserve assets created by the International Monetary Fund and allocated to its members to supplement existing reserve assets. They represent each holder's assured and unconditional right to obtain other reserve assets, especially foreign exchange. IMF cannot allocate SDRs to itself but receives them from members through various financial transactions and operations. Entities authorized to conduct transactions in SDRs are the Fund itself, participants in the Fund's Operations Division for SDRs and Administered Accounts, and prescribed "other holders". The SDR can be used for a wide range of transactions and operations, including the acquisition of other members' currencies, the settlement of financial obligations, the making of donations, and the extension of loans. SDRs may also be used in swap arrangements and as security for the performance of financial obligations. Forward as well as spot transactions may be conducted in SDRs. The SDR is the unit of account for the Fund. The value of the SDR is determined daily by IMF on the basis of a basket of currencies with each currency assigned a weight in the determination of that value. In the derivation of the SDR value, the currencies of the basket are valued at their market exchange rates for the US dollar, and the US dollar equivalents of each of the currencies are summed to yield the rate of the SDR in terms of the US dollar. On January 1, 1996, the SDR valuation basket weights were 39 per cent for the US dollar, 21 per cent for the deutsche mark, 18 per cent for the Japanese yen, and 11 per cent each for the French franc and pound sterling. On January 1, 1999, the currency amount of deutsche mark and French francs were replaced with equivalent amounts of euros, based on the fixed conversion rates between those currencies and the euro, announced on December 31, 1998 by the European Council. The weights in the SDR basket were changed to US dollar, 39 %; euro, 32 % (in replacement of the 21 % for the deutsche mark and 11 % for the French franc); Japanese yen, 18 %; and pound sterling, 11 %. As of January 1, 2001, the SDR valuation basket weights are the sum of the values of the amount of each currency in the following amounts: US dollar, 45 per cent; euro, 29 per cent; Japanese yen, 15 per cent, and pound sterling, 11 % (UNSTAT DEFINITION). [http://unstats.un.org/unsd/cdb/cdb\\_dict\\_xrxx.asp?def\\_code=130](http://unstats.un.org/unsd/cdb/cdb_dict_xrxx.asp?def_code=130)

<sup>32</sup> Bank of England calculation. Since 11 May 1999, the Bank of England has published a daily effective trade-weighted exchange rate index for the euro area. It is also compiled on the basis developed and used by the IMF. The weights reflect the pattern of trade between the euro-area as a whole and countries outside the euro area. (Trade between countries within the euro-area is excluded, so the weights are based solely on extra euro-area trade). Sterling has the biggest weight, with the US dollar the next largest.

The index is calculated by weighting together the individual exchange rates for the 12 euro-area currencies against non-euro area currencies. So it represents an effective index for the 12 euro area currencies as a group. This permits the index to be calculated prior to 31 December 1998, using "synthetic" euro exchange rates. These are calculated by geometrically averaging the bilateral exchange rates of the original 11 euro-area currencies using "internal weights" based on the country shares of extra euro-area trade.

<sup>33</sup> All countries of destination, importers, in this model are OIC members.

*versa*. Usage of similar variables has been substantiated with several publications mentioned in the literature review part of this chapter. First, Aitken (1973) for example used such variables to assess trade creation and diversion effect.

### 2.5.3 Data

Annual real imports of 57 OIC member countries from 1995 to 2007 are collected from WITS (World Integrated Solution Database). Weighted distances, border dummy, common colonizer and same country dummy were collected from CEPII database. Real exchange rates index of importing country, Gross Domestic Product, together with consumer price indexes and exchange rates, are obtained from World Development Indicators Database. Depreciation of real exchange rates of the importing country is calculated by the author. Weighted average of applied tariff rates, in which import values are used as weight, were derived from the Trade Analysis and Information System (TRAINS).<sup>34</sup> Depreciation rates of the US dollar against the Euro are derived from the Bank of England.<sup>35</sup>

### 2.5.4 Expected Signs of Coefficients

Gravity models explain bilateral trade by trading countries' economic sizes and distance. Accordingly, as the GDP of trading countries increase, trade among them is expected to increase while increase in distance between trading partners are associated with decrease in trade. Hence, coefficients of GDP of both importing and exporting countries are expected to be positive while coefficient of distance should be negative. As tariff imposed by the importing country is expected to decrease exports, tariff coefficient should be negative. Basically, it is assumed that the more open a country is to trade, the higher will be the level of trade facilitation. Hence, trade openness, proxy for trade facilitation and liberalization, would be positive. Meanwhile, a real appreciation of an

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<sup>34</sup> Please refer to WITS for the formula. <http://wits.worldbank.org>

<sup>35</sup> On 31 December 1998, in accordance with Article 1091 (4) of the Treaty establishing the European Community, the irrevocable conversion rates for the euro were adopted by the EU Council. This was upon a proposal from the Commission of the European Communities and after consultation with the European Central Bank. The euro conversion rates took effect at 00:00 (local time) on 1 January 1999 (1 January 2001 for Greek Drachma).

In compliance with the legal framework for use of the euro, the irrevocable conversion rate for the euro for each participating currency is the only rate to be used for conversion either way between the euro and the national currency unit, and for conversions between national currency units.

Prior to 1999, a synthetic euro exchange rate has been calculated by geometrically weighting the bilateral exchange rates of the (then) eleven euro area countries using "internal weights" based on the country shares of extra euro-area trade.

importing country's currency would positively affect the flow of commodities to the importing country. Hence, coefficient of appreciation of real exchange rate is expected to be positive. The dummy variable for the border effect is expected to be positive as countries sharing a border are expected to trade more. The coefficient of common colonizer variable is also expected to be positive since the presence of people speaking same languages, sharing similar culture and even measurement scales would make positive contribution to trade. As expected the coefficient for value of the US dollar against the Euro is to be positive if appreciation of the dollar against the Euro increases the imports of OIC member countries.

*EXRTA\_OIC* approximates the change in exports from third countries to OIC members as a result of OIC efforts in enhancing international trade including trade facilitation and liberalization efforts. Hence, if there is a decrease in exports from third countries to OIC members, this dummy should be negative. On the other hand, if the exports from third countries increased this variable should be positive.

## **2.6 DETERMINANTS OF INTRA-OIC TRADE: FINDINGS**

### **2.6.1 Test Results for the Traditional Gravity Model**

Before including the additional variables, the regression for the traditional gravity model was conducted. In this model it is considered that imports of OIC countries depend on the economic sizes of their GDP, GDP of partner countries, distance and dummy variables aforementioned.

The results of cross-sectional pooled OLS estimation as depicted in Table 2.3 clearly support the gravity model. Coefficient of both exporter's and importer's GDPs are positive and significant while the effect of distance is negative. Unexpectedly, the results of Model-1 shows that sharing a common land border is insignificant. Barry *et al.* (2004) employed the gravity model for analyzing the impact of China's growth on 13 Asian countries' exports and, they, similar to result of Model-1, found that sharing a common border is not significantly different from zero. The reason is argued to be relatively small trade of bordering countries in the region compared to their total trade with the rest of the

world. Besides, mutual dispute, impeded trade flow due to geographic barriers, nonexistence of trade complementarity, *etc.*, might account for such result.

**Table 2.3: Regression Result for the Traditional Gravity Model**

	Model-1	Model-2
Log Real GDP of Importer	0.232* (0.013)	0.332* (0.025)
Log Real GDP of Exporter	0.365* (0.012)	0.472* (0.024)
Log Weighted Distance	-0.681* (0.036)	-0.470* (0.061)
Log Weighted Tariff		-0.186* (0.040)
Appreciation of Importer's Real FX		1.276* (0.179)
Increase in Importers Trade Openness		0.244* (0.078)
Non-OIC Exporter	0.209* (0.059)	0.246* (0.087)
Border	0.187 (0.198)	0.990* (0.320)
Common Colonizer	0.177* (0.065)	0.551* (0.093)
Number of Observations	7267	2989
R2	0.783	0.790

Notes: (a) Regressand: Log real import (OIC countries)

(b) Intercept is suppressed

(c) Standard errors in the parenthesis

(d) '\*' Values are significant at 5% level

Anderson and van Wincoop (2003) argued that traditional gravity equations suffer from omitted variable bias. As a matter of fact, appreciation of an importer's real exchange rate, incorporating relative exchange rate and price level, tariff, improvement in trade facilitation are very significant determinants of international trade. Exclusion of them is likely to lead omitted variable bias in the model. Hence, in Model-2, results with inclusion of these variables are also provided. Border effect turns to be positive and significant as expected. Though inclusion of these variables as the determinants of trade is crucial, it is not easy to find data especially on tariff. Consequently, this decreases the number of observations. After a concise focus on the importance of above-mentioned possibly omitted variables, the regression model for the determinant of OIC countries' imports is run with inclusion of those variables. One would, from Table 2.4, realize that



the result of OLS and random effect support each other while they somehow contradict with the result of fixed effect in the model. The coefficient for real GDP of importer, contrary to expectations, turned to be negative and insignificant with fixed-effect estimation.

**Table 2.4: Regression Result for the Determinant of OIC Countries' Imports**

	OLS	Fixed Effect	Random Effect
Log Real GDP of Importer	0.380* (0.027)	-0.163 (0.563)	0.424* (0.038)
Log Real GDP of Exporter	0.495* (0.025)	0.860* (0.394)	0.523* (0.034)
Log Weighted Distances	-0.413* (0.060)		-0.433* (0.087)
Log Weighted Tariff	-0.169* (0.040)	-0.197* (0.048)	-0.186* (0.039)
Increase in Importer's Trade Openness	0.255* (0.077)	0.903* (0.587)	0.233* (0.106)
Appreciation of Importer's Real FX	0.735** (0.433)	1.930* (0.521)	1.556* (0.386)
Border Effect	1.266* (0.327)		1.237* (0.504)
Common Colonizer	0.554* (0.092)		0.643* (0.140)
Same Country	-1.866* (0.557)		-1.871* (0.878)
Value of USD against Euro	0.841* (0.287)	0.785* (0.260)	0.775* (0.235)
Non-OIC Exporter	0.266* (0.087)		0.952 (0.128)
Number of Observations	2989	2989	2989
R2	0.147	0.043	0.145

- Notes: (a) Regressand: Log Real Imports of OIC Countries  
 (b) Intercept not reported;  
 (c) Standard errors in the parenthesis  
 (d) '\*' Values are significant at 5% level  
 (e) '\*\*' Values are significant at 10% level  
 (f) Hausman Test: Prob>Chi2=0.754

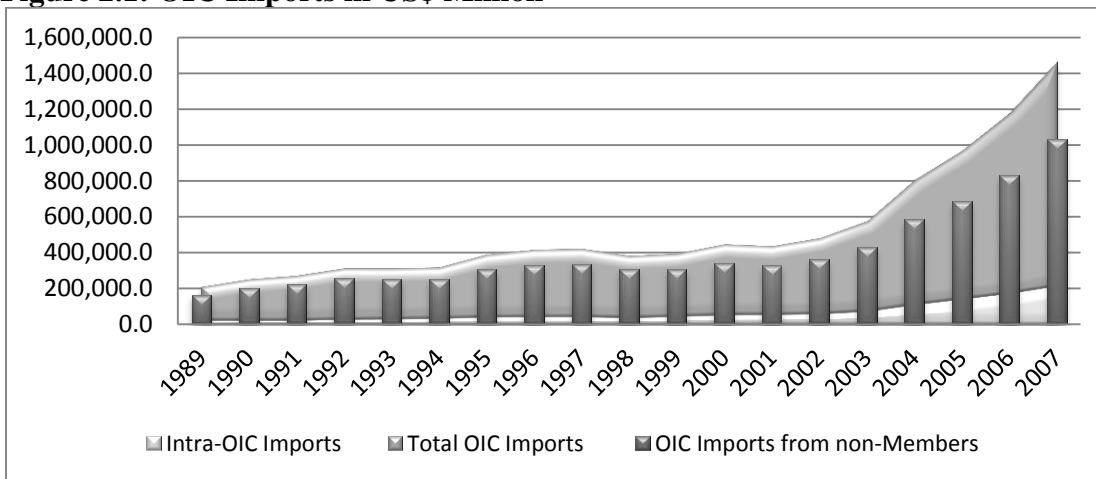
However, it should be noted that Hausman test supports the random effect calculation.<sup>36</sup> The results show that the coefficient of determination or  $R^2$  is relatively low, but similar

<sup>36</sup> Hausman Test Result:  
 b = consistent under HO and HA; obtained from xtreg  
 B = inconsistent under HA, efficient under Ho; obtained from xtreg

to the results of other studies such as Rose (2004), where the intercept is not suppressed and data includes bilateral trade of numerous countries as both exporters and importers. After the inclusion of additional variables to Fixed Effect Model, however,  $R^2$  increases.

As can be seen in the result depicted in Table 2.4., the coefficients of the other variables turn out to be as expected. However, having once been part of a same country appears to have negative impact on exporting to OIC countries. This might be attributed to hostile feelings aroused in the process of getting independence or separation of the previously shared country. Given the positive and significant coefficient of common colonizer variable, one may argue that OIC countries that used to be part of the same country tend to trade less given the other determinants of their imports.

**Figure 2.1: OIC Imports in US\$ Million**



*Source:* Based on Data provided by Islamic Development Bank Economic Policy and Statistic Division

As Table 2.4. demonstrates, the coefficient for non-OIC exporter, albeit positive, turns to be insignificant with random effect calculation contrary to OLS estimation by which the same coefficient turns to be significant and positive. Given these estimations, at least it is possible to argue that being a non-OIC country, given the applied tariff, distance, *etc.*, exporting to OIC is not unfavourable. As a matter of fact, Figure 2.1 shows not only the strong growth in intra-OIC imports but also strong growth in OIC imports from non-OIC

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Test: HO difference in coefficients not systematic  
 $\text{Chi2}(6) = (b-B)'((v_b - V_B)^{-1})(b-B)$   
 $\text{Prob} > \text{Chi2} = 0.754$

countries in recent years. In his recent study, Ghani (2007) found, with the theoretical gravity model, positive or non-significant OIC membership effect for trade of OIC countries. That is, there exists evidence to argue that OIC is not trade diverting itself in the present context according to this calculation. Exports to OIC countries increased for both OIC and non-OIC countries in the time period.

Gundogdu (2007) had similar conclusions in assessing the effect of ASEAN trade facilitation measures on intra-regional trade in East Asia. He ascertained that for the time period from 1997 to 2004, imports of ASEAN member countries increased from both ASEAN member countries and non-ASEAN East Asian countries due to the improvement in trade facilitation measures and removal of non-tariff trade barriers under AFTA regional integration. In the same fashion, Cernat (2001) explained net trade creation effect of trade facilitation in the context of African RTAs. Very often regional free trade agreements come with not only tariff reduction/quota derogation but also trade facilitation measures including implementation of Single Windows, cooperation in standard and conformity assessment leading to Mutual Recognition Agreements (MRA), harmonization of tariff nomenclature, custom valuation and procedures.<sup>37</sup> Once these measures are implemented all parties exporting to the region get benefits (Gundogdu 2007). However, note that due to their nature some trade facilitation measures are more intra-trade friendly. For example, MRA and Rule of Origin Cumulation System as compared to Single Windows and harmonization of tariff nomenclature, though all enhance trade of a country, are more intra-trade promotion-oriented since they favour only the participating countries while others favour all trading partners.<sup>38</sup> Figure 2.2 shows that OIC member countries have experienced higher trade openness levels used as proxy for trade facilitation and liberalization herein, than industrialized countries since 1990. These can be attributed the dominance of the oil trade of OIC countries as the index is a measure of trade over GDP. However, recent widening of the trade openness level between OIC countries and industrial countries can possibly be attributed to the

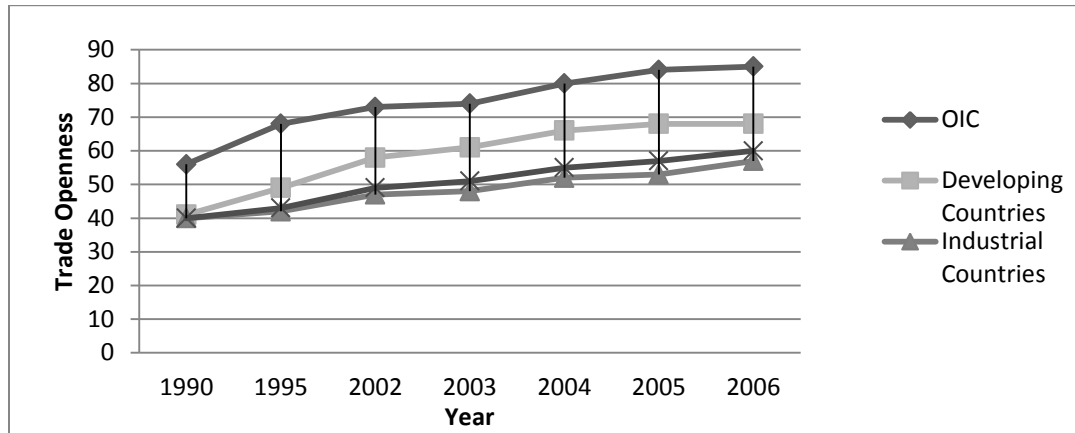
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<sup>37</sup> The Single Window System as a trade facilitation idea enables international traders to submit regulatory documents such as custom declarations, import-export permit, certificate origin, etc. at a single location and/or single entity with electronic processing. A mutual recognition agreement (MRA) is an international agreement between two or more countries to recognize one another's conformity assessments test for goods including quality control. Recently the term is applied to agreements on the recognition of professional qualifications in ASEAN. Refer to Gundogdu (2007) for more details.

<sup>38</sup> Cumulation rule allows products originating in the other member countries of a regional integration agreement not to be regarded as non-originating when used in a processing in one of the other member countries.

trade facilitation and liberalization efforts. These improvements came as a part of requirement of participation into regional economic integration or unilateral efforts.

**Figure 2.2: Trade Openness as a Proxy for Trade Facilitation**



*Source:* Calculated by the author based on IDB 2008 Key Economic Indicators, Statistical Monograph No.28

As indicated in Table 2.5, there has been substantial increase in OIC grouping's trade openness since 1990.

**Table 2.5: Openness of OIC Economies in Categories**

	1990	1995	2002	2003	2004	2005	2006
SSA	51	63	65	69	72	74	78
MENA	56	62	68	70	77	82	85
Asia	61	79	86	81	86	89	85
CIT	37	77	88	91	95	95	93
LDMC	45	57	62	62	64	63	61
Non-LDMC	57	70	75	76	82	86	87
OIC	56	68	73	74	80	84	85
Developing Countries	41	49	58	61	66	68	68
Industrial Countries	40	42	47	48	52	53	57
World	40	43	49	51	55	57	60

*Source:* Calculated by the author based on IDB 2008 Key Economic Indicators, Statistical Monograph No.28

As compared to industrial countries, performance of OIC grouping is remarkable. For example, Turkey implemented massive trade facilitation and liberalization efforts in late 1990s due to EU Customs Union Requirement. Tunisia also unilaterally benchmarked Singaporean Single Window of TradeNet to improve its custom efficiency.<sup>39</sup> As an example from Africa, Guinea's, one of OIC's Sub-Saharan member countries, MFN applied simple (11.9 %) and weighted (12.5 %) tariff averages were above the regional average. As a member of the Economic Community of West African Countries (ECOWAS), Guinea has adopted the group's Common External Tariff (CET), and as a result Guinea's tariffs decreased from their earlier levels.<sup>40</sup>

In providing empirical support, Cernat (2001) argued that Regional Trade Agreement (RTA) formation might have increased trade with both regional and third countries in the case of South-South RTAs after puzzling with net trade creation effect of African RTAs. He emphasized the effect of trade facilitation measures which came along with tariff reduction for explaining net trade creation effect of African RTAs. The question remains then how can one explain the recent increase in intra-OIC trade as a share of total imports given that OIC itself is, according to result analysis, not trade-diverting and improvement in OIC member countries trade facilitation and liberalization efforts as well as Terms of Trade (TOT) improvement probably boosted not only OIC exports but also non-OIC exports to OIC countries?

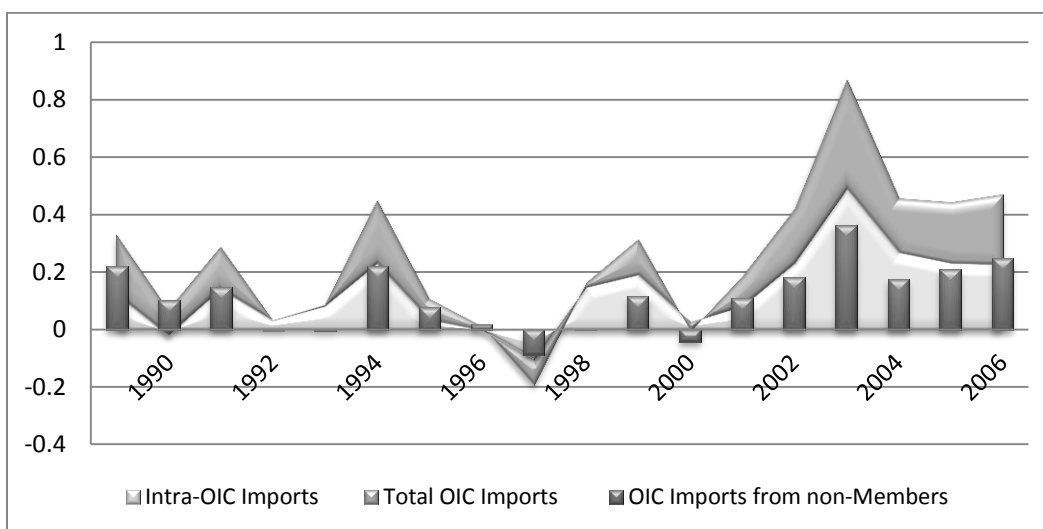
Figure 2.3 shows the recent growth in both intra-OIC imports and imports from non-OIC countries. One would see that recent increase in intra-OIC trade as a share of total OIC imports, from 2002 to 2006, comes from surpassing growth rate of intra-OIC imports over imports from non-OIC countries. Both rates are positive but magnitude of the former is higher than the latter.

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<sup>39</sup> Jayanta, R., Shweta, B. (2005). Key issues in trade facilitation, summary of World Bank/EU workshops in Dhaka and Shanghai in 2004. World Bank Policy Research Paper 3703.

<sup>40</sup> Islamic Development Bank Economic Policy Brief No: 69

**Figure 2.3: Growth of OIC Imports**



Source: Calculated by the author based on data provided by Islamic Development Bank Economic Policy and Statistic Division

According to the result of OLS Fixed Effect and Random Effect estimation from Table 2.4, OIC countries tend to import more in *real terms* with appreciation of US Dollar against Euro. Then, recent Euro appreciation against the US Dollar obviously has negative effect on real OIC imports. On the other hand, this negative effect on real terms has not materialized in nominal terms because of the fact that the recent increase in oil prices against the US dollar has, at least, no negative effect on import capacity of oil exporting OIC member countries such as Saudi Arabia and UAE. Besides, member countries like Turkey mainly use the US dollar for their imports transaction and their foreign exchange earnings are, mainly, in Euro.<sup>41</sup> This phenomenon is also tractable from the recent Terms of Trade (TOT) improvement. Over all OIC terms of trade index has improved from 93 in 2001 to 112 in 2005.<sup>42</sup>

Going through Table 2.6, these kinds of details are important because Indonesia, Malaysia, Saudi Arabia, Turkey and United Arab Emirates represent a significant – more than 50% - of the overall intra-OIC exports of the 57 OIC member economies.

<sup>41</sup> Refers to the author's experience with Turkish Exporters Union in supervising Inward Processing Licenses.

<sup>42</sup> Source: IDB 2008 Key Economic Indicators, Statistical Monograph No.28

**Table 2.6: The Share of Big OIC Economies in Intra-OIC Trade and TOT\***

	<b>Intra Exports</b>	<b>Total Exports</b>	<b>Intra Exports</b>	<b>Total</b>	<b>TOT in 2001</b>	<b>TOT in 2005</b>
UAE	19,535	139,353	11.8%	11%	93	143
Turkey	14,984	85,142	9%	6.7%	98	101
Saudi Arabia	31,032	208,867	18.7%	16.5%	106	182
Malaysia	11,839	160,556	7.1%	12.7%	100	102
Indonesia	10,707	103,964	6.5%	8.2%	94	60*
<b>% Contribution</b>	<b>53.1%</b>	<b>55.2%</b>	<b>53.1%</b>	<b>55.2%</b>		

\* In 2006, total intra-OIC merchandise exports is 165,820; total OIC merchandise exports is 1,263,283 in US \$ million ; in 2000 TOT index is 100; in 2004 Indonesian TOT is 105.

Source: Based on IDB 2008 Key Economic Indicators, Statistical Monograph No.28,

On the other hand, the Sub-Saharan member countries constitute the meagre part of the total OIC GDP and trade. It should be noted that in the present context of the model it could only be argued that appreciation of the US dollar against the Euro affects imports of OIC countries from both OIC and non-OIC countries.

However, intra-OIC trade is defined as a ratio of imports of OIC countries among themselves over their total imports from the rest of the world. The question then is how we can search for evidence from the same dataset for the significant effect of appreciation of the US dollar against the Euro on this ratio?

One method would be looking at the effect of appreciation of the US dollar against the Euro on imports of OIC countries from non-OIC countries. If it is insignificant, then it would be argued that appreciation of the US dollar against the Euro affects OIC imports from OIC countries. For this purpose, a proxy variable is created by multiplying the dummy variable of non-OIC exporter and variable of value of the US Dollar against the Euro. As Table 2.7 shows the proxy variable turns to insignificant for both Random Effect and OLS estimations.<sup>43</sup>

<sup>43</sup> Fixed Effect estimation is not possible as data set is based on country pairs.

**Table 2.7: The Effect of Euro/USD Exchange Rate on Non-OIC Exports to OIC**

	OLS	Random Effect
Log Real GDP of Importer	0.386* (0.027)	0.427* (0.037)
Log Real GDP of Exporter	0.499* (0.024)	0.525* (0.034)
Log Weighted Distances	-0.455* (0.061)	-0.463* (0.089)
Log Weighted Tariff	-0.170* (0.040)	-0.183* (0.039)
Increase in Importer's Trade Openness	0.263* (0.077)	0.238* (0.103)
Appreciation of Importer's Real FX	0.733** (0.432)	1.556* (0.385)
Border Effect	1.296* (0.326)	1.237* (0.504)
Common Colonizer	0.595* (0.092)	0.668* (0.141)
Same Country	-1.961* (0.556)	-1.921* (0.878)
Value of USD against Euro	0.369 (0.542)	0.548 (0.446)
Non-OIC Exporter	0.297* (0.092)	0.189 (0.130)
The Proxy	0.639 (0.631)	0.312 (0.521)
Number of Observations	2989	2989
R2	0.149	0.147

Regressand: Log Real Imports of OIC Countries

Intercept not reported

Standard errors in the parenthesis

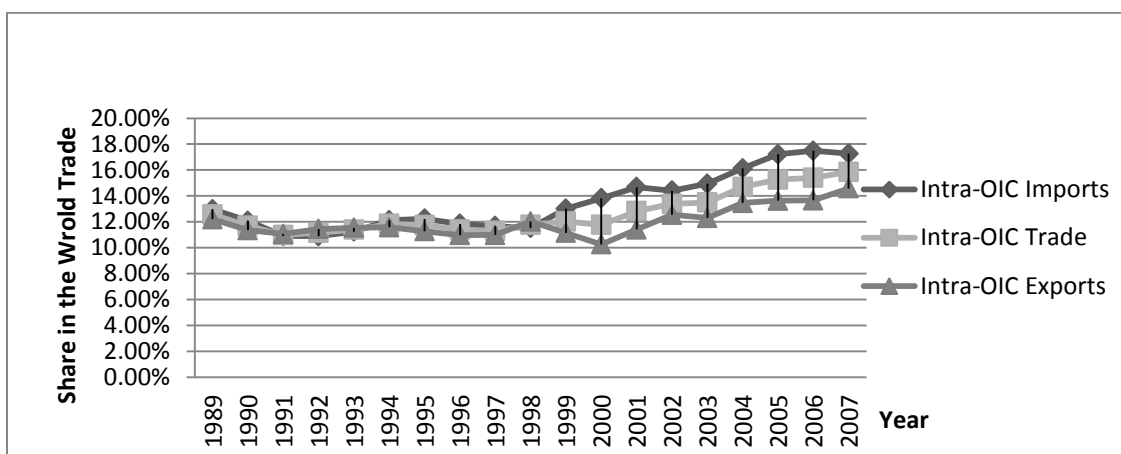
\* Values are significant at 5% level

\*\* Values are significant at 10% level

Figure 2.4 show that intra-OIC imports and exports used to exhibit similar patterns and very close percentages before 1998. The difference between intra-OIC imports and exports widened after 1998. Since 1998, then the Council of European Union set the conversion rates for its members' currencies based on market rate on 31 December 1998, one would discern a pattern change in intra-OIC trade as well.



**Figure 2.4: Trends in Intra-OIC Trade Indicators (1990-2007)**



*Source:* Calculated by the author based on data provided by Islamic Development Bank Economic Policy and Statistic Division

These evidences seem to be more than coincidence for the role of the USD/Euro exchange rate on intra-OIC trade. Following from Figure 2.4, intra-OIC exports experienced decrease in 1999 and 2000 while intra-OIC imports improved for the same period. However, both ratios have been improving alongside the recent Euro appreciation. This contradicts with positive and significant variable of the value of the US Dollar against the Euro on OIC imports in real terms. Then there must be another dynamic, which surpasses the negative effect of recent Euro appreciation, for increase in intra-OIC imports as a share of OIC imports from the world.

This other dynamic perhaps is the effect of oil, which requires further attention. Table 2.8 presents data on the intra-OIC oil exports/imports by SITC's (Rev.3) 1-digit commodity level for 2005. The impact of oil to intra-OIC trade statistic is obvious from the table.

**Table 2.8: Intra-OIC Oil Trade, 2005 \***

	From Intra-OIC (US\$ million)	From the World (US\$ million)	% in intra- OIC trade	Share of intra-OIC oil trade in world oil trade (4)
	(1)	(2)	(3)	
<b>Imports</b>	38,923.7	79,047.2	36.7	49.2
<b>Exports</b>	31,763.9	452,888.9	27.8	7.0

\* *Fuels, Lubricants, and related materials; SITC's (Rev.3) 1-digit commodity level*

*Source:* Comtrade database

As can be seen in Table 2.8, Column (3) shows the intra-OIC oil imports (exports) over intra-OIC total imports (exports), while Column (4) shows the OIC oil imports from (exports to) OIC countries over OIC oil imports from (exports to) the rest of the world. One would easily discern the discrepancy between intra-OIC imports and intra-OIC exports as a share of world trade due to OIC countries' dominance in the oil export business. Figure 2.4 has already shown this obvious discrepancy after 1998.

Accordingly, one would argue that the main reason behind recent the increase in intra-OIC imports as a share of world import is oil price increase. However, this argument cannot explain the whole phenomenon without Terms of Trade (TOT) improvement of OIC countries and the effect of exchange rates. In very simple form, recently both intra-OIC imports and OIC imports from the world have increased but magnitude of intra-OIC imports growth is higher than that of imports from the world.

Assume a world where only OIC countries are oil exporters and amount of oil exported is constant over the time. Also assume that OIC countries imports, together with oil from other OIC countries, only cars from the rest of the world in Euro and number of cars imported is constant over the time. These assumptions are made based on the result analysis of the econometric model. Recall from the econometric model that appreciation/depreciation of the Euro has no effect on real OIC imports from non-OIC countries so a constant number of imported cars becomes a slightly reasonable assumption. Under such assumptions, the result of econometric analysis is discussed as per a hypothetical world for which relevant data is specified in Table 2.9.

Table 2.9 shows that intra-OIC imports has increased from 14.4% to 24.3% as the oil price increase from US\$60 to US\$114 while Euro/USD exchange rate is intact. 24.3% intra-OIC retreated to 17.6% as the Euro appreciates to a new level of US\$1.5. Recalling that this chapter began with an inquiry of recent increase in intra-OIC imports from 14.4% in 2004 to about 18% in 2007, it is important to contextualise this within the oil dynamics as well.

**Table 2.9: Intra-OIC Imports Scenario**

Oil Price in USD (A)	Euro/USD Exchange Rate (B)	Car price in Euro (C)	84,400 unit OIC Imports from OIC Countries (A)*84,400=(D)	1000 cars OIC imports from the rest of the world (C)*1000=(E)	Intra-OIC Imports in % (D/D+E)
60	1	30,000	5,064,000	30,000,000	14.4%
Oil Price 114\$; 1 Euro is 1\$					
114	1	30,000	9,633,000	30,000,000	24.3%
Oil Price 114\$; 1 Euro is 1.5\$					
114	1.5	30,000	9,633,000	45,000,000	17.6%

*Source:* Compiled by the author

Under the circumstances of the oil price of US\$60 and Euro/USD exchange rate of 1, the intra-OIC imports are 14.4%. And, in the case of the second scenario, where the oil price hits US\$114 and Euro/USD exchange rate remains at 1, the ratio would increase to 24.3%. However, depreciation of the USD against the Euro would decrease this ratio to 17.6% as indicated in the third scenario.

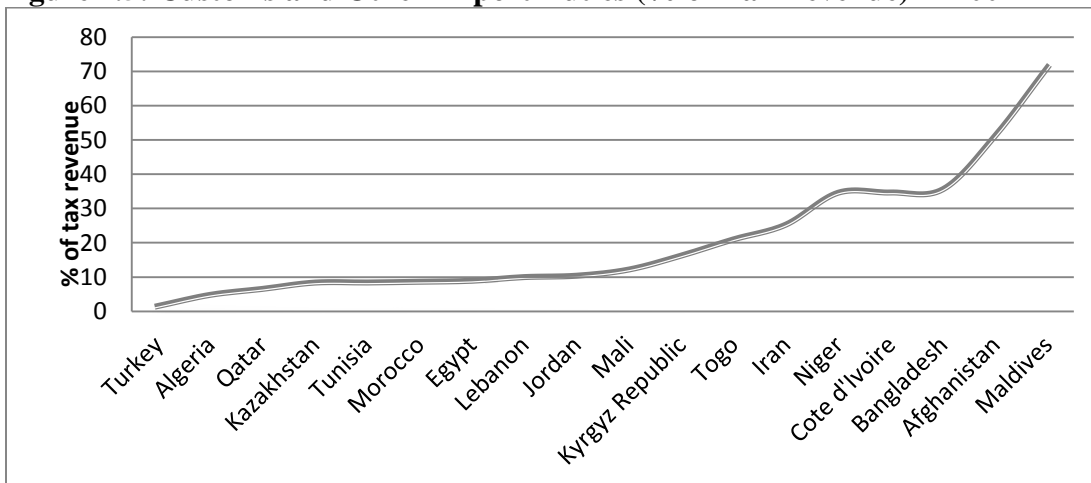
This part, hence, sheds light on the determinant of intra-OIC trade in a way to contribute the realization of the Makkah Declaration and the Ten-Year Programme of Action to increase intra-OIC trade to 20% of global trade by the year 2015. The findings of the estimations, the time period of 1995-2007, indicate that OIC member countries have started to trade more and more with each other and the rest of the world. This can partly be attributed to their unilateral efforts as well as requirement of membership to regional free trade areas such as COMESA, ECOWAS, *etc.* in dismantling the inherent trade barriers and tariff reductions.

In this regard, there are still substantial trade facilitation improvement opportunities that exist in eliminating trade barriers among OIC member countries, reducing red tape, improving infrastructure and reducing financial constraints. However, according to the estimations herein, these kinds of efforts should certainly be encouraged to generate more income growth, as it would not only boost intra-OIC trade but also enhance OIC countries trade with non-members as they will make trading easier for all parties once implemented; that is, they are not expected to divert trade. Accordingly, in order to

achieve the 2015 target, there should be more endeavours on intra-trade-oriented trade facilitation measures such as the Mutual Recognition Agreement, cooperation in unified rule of origin by developing an OIC cumulation system. Developing a full implementation of the Protocols on Preferential Tariff Scheme and Framework on OIC Trade Preferential System (OIC-TPS) is also very crucial to pave the way for achieving intra-OIC trade targets. However, stressing too much on the 20% target might result in shutting our eyes to the truth. As a matter of fact, this target can be achieved by improvement in trade between a couple of the big OIC economies given their dominance in intra-OIC trade statistics as well as in the trend in the USD/Euro exchange rate and oil price surge. Given the dominance of oil in OIC trade statistics targets also should be set for non-oil trade. From a developmental aspect more attention should be given to enhancing trade of small OIC economies especially in Sub-Saharan Africa. The target of 20% should be subdivided for country grouping such as Least Developed Member Countries and Sub-Saharan African Member Countries so enhancing intra-OIC trade would be more meaningful in developmental aspects. This should be melted in a strategy for transformation in customs.

However, OIC countries, especially small OIC countries, are sometimes hesitant to transform their customs as public authorities tend to associate any transformation in the form of trade liberalization or facilitation with decreased customs revenue.

**Figure 2.5: Customs and Other Import Duties (% of Tax Revenue) in 2007**



Source: World Development Indicators

This worry is especially intense with Least Developed Countries as the customs revenue constitutes the bulk of the tax revenue. As indicated in Figure 2.5, among OIC countries, the share of customs revenue in tax is as meagre at 2 per cent in the case of Turkey to 71 per cent in the case of the Maldives. As WTO members, both are obliged to implement the WTO Customs Valuation Agreement. WTO defines customs valuation as a customs procedure applied to determine the customs value of imported goods as per the WTO Customs Valuation Agreement which intends to provide fair, neutral and uniform valuation in order to protect importers from the risk of arbitrary valuation by customs authorities. However, introduction of this agreement may give rise to some concern especially for those OIC countries having high customs revenue to tax revenue ratio as it may lead revenue loss due to under-invoicing by traders.<sup>44</sup>

The sensitivity of customs valuation is observed through real-life experience between domestic spinners and fibre importers to influence government for public discourse in their favour. Customs duties can be in the form of specific duty such as US\$ 1 per kilo, *ad valorem* duty which depends on the value of the goods or a mix of these two methods. For customs transactions under *ad valorem* duty, determination of value of the goods is very sensitive as the customs duty is calculated by multiplying customs valuation with *ad valorem* rate of the duty (*e.g.* 10 per cent of the customs valuation). Hence, the issue of customs valuation has implication far ahead of tax collection or transfer pricing as it can distort the prices in favour of some parties while depriving others. For example, domestic spinners would pressure the government to sustain minimum price for customs value of fibre imported by arguing otherwise they cannot survive. In the same fashion fibre importers, mainly textile and apparel producers, would ask government to accept actual price paid for customs value of the imported fibre so they can stay competitive in the global market and retain their share in export markets. Given the sensitivity of the issue, customs valuation has been in the agenda of international trade negotiations for quite some time.

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<sup>44</sup> According to Country Policy Review of WTO, Turkey implemented, albeit with some reservation, WTO Customs Valuation Agreement as of 07/01/2003 while not surprisingly Maldives did not.

Formal discussions on customs valuation goes back to the establishment of the League of Nations but it was the general conference of the United Nations for Trade and Employment in 1947 when the discussions on the customs valuation issue had a common base to be incorporated in Article VII of the General Agreement on Tariffs and Trade (GATT). The article defines the general principles of customs valuation based on the 'actual value' of the imported merchandise on which duty is assessed, or of like merchandise while discouraging valuation based on the value of merchandise of national origin or on arbitrary or fictitious values. However, GATT-contracting parties end up with different valuation systems as the article allows countries substantial flexibility in defining the 'actual value' of imports. The first international standards on customs valuation according to Article VII was developed in 1950. 13 European governments then developed the Brussels Definition of Value (BDV), based on the concept of 'normal price', in an effort to achieve greater harmonization of customs valuation practices. Many other countries adopted the same for their customs valuation practices.<sup>45</sup> Indeed, the BDV suggest invoice price to be used for customs valuation purposes but flexibility is given to customs authorities in case invoice price cannot be used.<sup>46</sup> Then, customs authorities can use another method based on the normal price which can be determined by customs on the basis of the available information to them in the context of conditions and other circumstances for the specific valuation transaction.<sup>47</sup> The application of BDV caused widespread dissatisfaction among traders as downward variation of declared value from normal price was taken into account up to 10 % and upward variation was fully taken into account. The level of traders' dissatisfaction grew even more when price changes were not reflected to the reference list by customs authorities on time and transactions contained new or rare products not captured in the list. Obviously, a more flexible and uniform valuation method was needed as per the Tokyo Round objective for achieving the expansion and ever greater liberalization of world trade through the progressive dismantling of obstacles to trade. In 1979, The Tokyo Round Valuation Code, or the

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<sup>45</sup> Against the normal price concept of BDV, on the other hand, big countries viz Australia, New Zealand, Canada and United States used a "positive" concept of valuation laying down the standards based on the price actually agreed on in sale.

<sup>46</sup> For example, suspiciously under invoicing, transaction between related importer and export, goods on consignment, etc.

<sup>47</sup> A normal market price is defined as "the price that a good would fetch in an open market between a buyer and seller independent of each other". Goorman, A and Wulf, L 2005, 'Customs Valuation in Developing Countries and the World Trade Organization Valuation Rules', in L Wulf and J Sokol (eds), *Customs Modernization Handbook*, World Bank, Washington D.C., pp.155-181.

Agreement on Implementation of Article VII of GATT, concluded. The system introduced was based on the price actually paid or payable, namely ‘transaction value’, for the imported goods in order to provide a fair, uniform and neutral system for the valuation of goods for customs purposes while accommodating commercial realities. Many developing countries were reluctant to join the new valuation agreement due to the fear of substantial loss of customs revenue triggered by undervaluation of imported goods by traders.<sup>48</sup> This aversion came to an end with the establishment of the WTO after the Marrakesh Agreement which also replaced the Tokyo Round Code by the WTO Agreement on Implementation of Article VII of GATT (also known as WTO Custom Valuation Agreement) as the agreement became binding for all WTO members.<sup>49</sup> The WTO Customs Valuation Agreement (WTO CVA) is not intended to be used for combating dumping nor does it bring provisions for purpose of determining export duties, quota administration, internal taxation and foreign exchange controls. In essence, it is the same as the Tokyo Round Valuation Code which applied solely for levying *ad valorem* duties on imported goods.

Based on the empirical results and the discussion in the preceding section, the following section aims to shed light on the effect of tariffs reduction, imports and implementation of WTO Customs Valuation Agreement on customs revenue of OIC countries. In addition, the relationship among tariff reductions, imports and the agreement is to be scrutinized in the context of WTO member OIC countries. The determinant of OIC countries’ customs revenue is examined with an econometric model where the level of customs revenue is explained by imports, tariffs and implementation of the WTO Customs Valuation Agreement.

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<sup>48</sup> The agreement officially came into force on January 1, 1981 and was adopted by various signatories from the mid 1980s onward. The Tokyo Round Valuation Code was signed by more than 40 contracting parties.

<sup>49</sup> Came at the end of Uruguay Round, Marrakesh Agreement offered least developed countries an extra flexibility in implementing WTO agreements. Agreement on Implementation of Article-VII of GATT 1994, also known as WTO Customs Valuation Agreement, provides contracting developing countries with certain flexibility for implementation. For example, it is stated in Article-20 of the said agreement that developing countries not party to the Tokyo Round Valuation Code may delay application of the provisions of WTO Customs Valuation Agreement (CVA) for period up to five years. Besides, they may delay application of paragraph 2(b).iii of Article-1 and Article-6 (provisions related to computed value method) for additional three years.

## 2.7 WTO CUSTOMS VALUATION FRAMEWORK

In the beginning, instead of delving into the details of the whole WTO agreement, concise explanation on the customs valuation system introduced by the new agreement (WTO CVA from the Annex 1A of the Marrakesh Agreement) is provided below.<sup>50</sup> The methods provided by the provisions in the Part I of the agreement are organized as follows:

### (a) Transaction value method governed by Article 1

The primary method of custom valuation is proposed to be transaction value. As stated in Article 1, the value is to be determined on the basis of the price actually paid or payable for the goods when sold for export to country of importation after adjusted in accordance with Article 8.<sup>51</sup> Price actually paid refers to total payment made or to be made in future by seller. Payment does not need to be in the form of money transfer. That is, payment can be direct or indirect. It can be in the form of Letter of Credit or bill of exchange for Documentary Collection.

Transaction Value method would not be implemented in case:

- There are restrictions for the disposition or use of the goods;
- The sale price is subject to some condition or consideration for which a value cannot be determined with respect to the goods being valued;
- The part of any subsequent resale, disposal or use of the goods by the buyer is to be accrued by seller and appropriate adjustments cannot be made in accordance with the provisions of Article 8 of the agreement;
- The buyer and seller are related.

Article 15 defines the relatedness. Accordingly, persons are deemed to be related if they are officers or directors of one another's businesses; legally recognized partners in business or employer and employee. Also, in cases where

- any person directly or indirectly owns, controls or holds 5 per cent or more of the outstanding voting stock or shares of both of them;
- one of them directly or indirectly controls the other;

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<sup>50</sup> World Trade Organization (WTO) 1994, *Agreement on Implementation of Article VII of the General Agreement on Tariffs and Trade*, viewed 28 July 2009, [http://www.wto.org/english/res\\_e/booksp\\_e/analytic\\_index\\_e/cusval\\_02\\_e.htm](http://www.wto.org/english/res_e/booksp_e/analytic_index_e/cusval_02_e.htm).

<sup>51</sup> Article-8 elaborates on portion to be added or subtracted to the price actually paid to be paid under the provision of Article-1. Among many of them are commissions, brokerage, cost of handling charges associated with the transport of the goods to the place of importation, the cost of packing, royalties and fees which are not included in the price actually paid or payable.



- both of them are directly or indirectly controlled by a third person;
- together they directly or indirectly control a third person; or
- they are members of the same family

they are deemed to be related. However, relatedness itself would not necessarily make transaction values unacceptable if the importer can demonstrate that the relationship did not influence the price.

**(b) Transaction value of benchmark from identical or similar goods method by Article 2&3**

In case the customs value of the imported goods could not be determined from the provisions of Article 1, importer may demonstrate the price of sales to any unrelated buyer in the same country for identical or similar goods at about the same time as the goods being valued. Transaction value of identical or similar goods needs to be at the same commercial level and in substantially the same quantity. If benchmark in the same commercial level and/or quantity is not possible, adjustment needs to be done accordingly. For example, exporter may apply certain discount for each quantity level. Upward or downward adjustment to the value can be done according to this information while benchmarking. This process is to be carried out by consultation between importer and custom authorities.

**(c) Deductive value method by Article 5**

In case the custom value of the imported goods could not be determined from the provisions of Article 1, Article 2 and Article 3, importer may ask for benchmark from the value of the identical or similar imported goods in the country. Benchmark is to be based on unit price of benchmarked imported goods in the “greatest aggregate quantity”. For example, in case benchmarked imported goods sold in two sales (first in 600 units with a price of 95 currency unit and second in 300 unit 100 currency unit), as the greatest number of unit sold is 600 the unit price in the greatest aggregate quantity of 95 currency unit would be base for customs valuation. Then this would be subject to further deduction, as the additions usually made for profit and general expenses such as transport, insurance, taxes, *etc.* within the country in connection with domestic sale. Note that in any case, benchmark should be at or about the same time and between unrelated persons.

#### **(d) Computed value method by Article 6**

Again, in case the customs value of the imported goods could not be determined from the provisions of Article 1, Article 2, Article 3 and Article 5 importer may request for application of Article 6 for computed value method. However, as accorded in Article 4, importer may request to reverse the order of application of Article 5 and Article 6.

Computed value consists of the cost/value of input used in production process, profit and general expenses of producer/exporter located out of the jurisdiction of importation country.<sup>52</sup> Accordingly, use of computed value method is likely to be confined for those cases where the importer and exporter are related. Hence, exporter is ready to supply the necessary costings and provide facilities for any subsequent verification for the customs authorities of importation country.<sup>53</sup>

In case customs value could not be determined from the provisions of Article 1 through Article 6, customs value is to be determined by reasonable means consistent with the provisions of Article 1 through Article 6 on the basis of data available in the importation country. That is, customs value is to be determined, to the greatest extent possible, based on previously determined customs values. This is defined as the Fall-back method by the WTO. However, with reference to Article 7, customs authorities need to refrain from customs valuation based on:

- (i) Selling price of domestically produced products in domestic market;
- (ii) Selling price of the goods in the market of exportation country;
- (iii) Selling price of the goods in the third market;
- (iv) The cost of production other than provisions of Article 6;
- (v) Arbitrary or fictitious values;
- (vi) Minimum values.

Developing countries are allowed to suspend the application of minimum value restriction by making reservation. The provisions of the agreement consistently state that

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<sup>52</sup> Where figures provided by the exporter on its own profit and general expenses are not consistent with those reflected in sales of the same class or kind of goods produced by the exporter for the importation country, customs authorities of importation country may base upon relevant information other than supplied from the exporter. On the other hand, whether certain goods are “of the same class of kind” as other goods is to be determined arbitrarily on a case-by-case basis.

<sup>53</sup> Developing countries not party to the Tokyo Round Valuation Code are given option to delay the application of provisions related to computed value method for additional three years after five years of grace period of implementation of other provisions as stated in the Article-20 of the WTO CVA.

customs authorities are to select the lower value of two alternatives. Accordingly, Article 7 restricts customs authorities to apply a system which provides for the higher of two alternatives.

Part II of the agreement elaborates on administration, consultations and dispute settlement issues. A legal framework of WTO Committee on Customs Valuation and WCO Technical Committee of Custom Valuation is also provided in this part. Accordingly, WTO Committee on Customs Valuation shall annually review and inform the Council for Trade in Goods on implementation issues. In addition, flexibility with deadlines for implementation of the agreement for developing countries is defined.

Obviously, the WTO valuation system is very favourable for importers as it restrains customs authorities from challenging the declared value without documentary evidence and increasing value without opportunity to claim against. And, implementation date of the WTO Customs valuation agreement would constitute a sound explanatory variable to scrutinize effect of trade facilitation measures on customs revenue.

## **2.8 MODEL SPECIFICATION FOR DETERMINANTS OF OIC CUSTOMS REVENUE**

### **2.8.1 The Model Specification**

The functional form for determinant of customs revenue employed in this study is as follows:

$$CR^{it} = F_i(IMP^{it}, TRF^{it}, CVA^{it}, VAT^{it}, OCD^{it}) \quad (2.5.)$$

where CR stands for customs revenue of OIC member countries, which is expected to depend on imports (*IMP*), tariffs (*TRF*), implementation of WTO Custom Valuation Agreement (*CVA*), value-added tax (*VAT*) and other customs duties (*OCD*). According to Baunsgaard and Keen (2005), often more than half or more of the VAT is collected at the border in many developing countries. Although it is an important component of customs revenue for some countries, both other customs duties and value-added tax is dropped due to the difficulty in obtaining data. Then basic equation is augmented by

including indirect effect of tariffs and implementation of WTO CVA through imports in order to fulfil the objectives of this study.

Natural logarithms of the variables are taken. Hence, customs revenue of OIC countries is expressed in a log-linear form:

$$\ln CR^{it} = \beta_0 + \beta_1 \ln IMP^{it} + \beta_2 \ln(100 + TRF^{it}) + \beta_3 IndTRF^{it} + \beta_4 CVA^{it} + \beta_5 IndCVA^{it} + e^{it} \quad (2.6.)$$

where superscripts  $i$  stands for the importer (an OIC member country)  $t$  donates years.

Dependent variable is customs revenue of country  $i$ , an OIC member country, for the period of 1995-2007.  $IMP^{it}$  is imports of country  $i$  at year  $t$ .  $TRF^{it}$  is weighted tariffs rate of country  $i$  imposed on products imported in year  $t$ .<sup>54</sup>The coefficient for tariffs is expected to be positive as revenue is calculated in ad valorem.

One variable as proxy for the effect of implementation of WTO Customs Valuation Agreement is introduced.  $CVA^{it}$  is dummy variable taking the value of 1 for the observations if country  $i$  implemented WTO CVA in year  $t$ .<sup>55</sup>This dummy variable captures the change in customs revenue as a result of the implementation of the agreement. Hence, if there is decrease in customs revenue it should be interpreted as negative direct effect of the implementation of WTO CVA and vice versa.

Both tariffs and implementation of WTO CVA is expected to have indirect effect on customs revenue through imports. An increase in tariffs or the implementation of WTO CVA may decrease imports, hence, decrease customs revenue. In order to estimate the indirect effects, two variables are created through multiplying existing tariffs and CVA variables by existing imports variable.  $IndTRF^{it}$  captures the indirect effect of tariffs thorough imports on customs revenue while  $IndCVA^{it}$  captures the indirect effect of the

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<sup>54</sup> This variable denotes weighted average tariff rate in the percent ad valorem term which is specific to the trading partners, product categories and year and includes the lowest applicable rates as well as all available preferential rates. Bilateral trade values are used as weight. To avoid log zero in case tariff level is zero, 100 is added.

<sup>55</sup> All countries of destination, importers, in this model are OIC members.

implementation of WTO CVA through imports on customs revenue.<sup>56</sup> For both, coefficient would be negative if higher tariffs and the implementation of WTO CVA lead to less import.

## **2.8.2 Data**

Annual imports and weighted average of applied tariffs rates is obtained from the World Integrated Trade Solutions (WITS) for 40 WTO member OIC countries for the period of 1995-2007.<sup>57</sup> Annual customs revenues are derived from World Development Indicator (WDI). The most challenging part of data collection turns to be the identification of WTO CVA implementation year for 40 OIC countries which are also member of WTO. The Agreement allows developing member countries to delay the implementation for a transition period of five years from their entry to WTO. Furthermore, developing countries are opted to request a further extension from Committee on Customs Valuation for additional extension. Many OIC countries got this additional extension.<sup>58</sup> Hence, the implementation year is identified by digging into the WTO Trade Policy Reviews for each WTO member OIC country accessed through WTO website.<sup>59</sup>

## **2.9 LOCATING THE DETERMINANTS OF OIC CUSTOMS REVENUE: EMPIRICAL ANALYSIS**

The correlation between imports and customs revenue is straightforward: more trade is associated with more customs revenue. However, this is not the case for the relationship between tariffs and customs revenue as tariffs would have both direct effect and indirect effect through imports on customs revenue. Increasing tariffs would enhance customs revenue if decrease in imports as a result of higher tariffs does not surpass the said direct effect. The relationships can be observed from Figure 2.6, scatter plot for the sample of this study.

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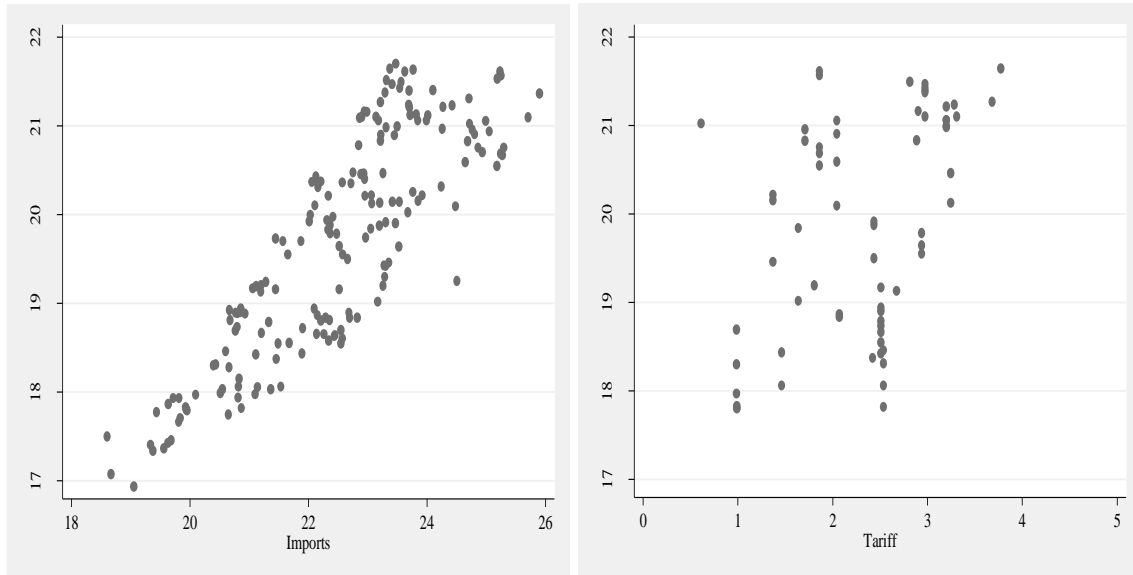
<sup>56</sup> See Greene (2007) for the standard explanation.

<sup>57</sup> Please refer to WITS for the formula of weighted applied tariff rate. <http://wits.worldbank.org>

<sup>58</sup> Indeed, as Rege (2000) identified the lack of ownership as the main reason for delays in implementation.

<sup>59</sup> World Trade Organization (WTO) 2009, "Trade Policy Reviews" viewed 15 July 2009, [http://www.wto.org/english/tratop\\_e/tp\\_r\\_e/tp\\_rep\\_e.htm#chronologically](http://www.wto.org/english/tratop_e/tp_r_e/tp_rep_e.htm#chronologically).

**Figure 2.6: Correlation of Imports and Tariffs with Customs Revenue<sup>60</sup>**



*Source:* Calculated by the author

The effect of tariffs increase on customs revenue diminishes as the tariffs level soars. This can be seen more obviously from the result of regression analysis illustrated in Table 2.10. As the results of fixed and random effect calculation suggests, both direct effect and indirect effect of tariffs are statistically significant and positive direct effect of tariffs on customs revenue is stronger than negative indirect effect of tariffs through decreased imports. Hence, overall effect of increased tariffs on customs revenue seems to be positive although this effect is curbed by decreased imports as result of higher tariffs.

Although Huasman test fails to indicate model selection between fixed effect and random effect, the nature of explanatory variables would give rise to serious concern with ‘fixed effect calculation’. The important explanatory variables of VAT and other duties were excluded from data set as finding such data was not feasible. This might lead to a correlation between error term and the some explanatory variables, hence, distort the calculation. For instance, the expected positive correlation between imports and customs revenue does not hold with ‘fixed effect’ calculation, but does so with ‘random effect’. Hence, the result of ‘random effect’ calculation might suggest better interpretation of the relationship between independent variables and the dependent variable.

<sup>60</sup> Both X and Y Axes are in logarithmic form.

**Table 2.10: Regression Result for the Determinant of OIC Countries' Customs Revenue**

	OLS	Fixed Effect	Random Effect
Log of Imports	1.205* (0.179)	-0.090 (0.250)	0.427* (0.209)
Direct Effect of Tariffs	-3.685* (1.375)	12.673* (0.170)	3.735* (1.800)
Indirect Effect of Tariffs	0.188* (0.060)	-0.526* (0.170)	-0.150* (0.077)
Direct Effect of WTO CVA	3.162 (1.910)	5.822* (0.980)	5.565* (1.183)
Indirect Effect of WTO CVA	-0.142** (0.084)	-0.266* (0.043)	-0.250* (0.052)
Constant	-6.166 (4.105)	23.685* (5.922)	11.092* (4.881)
Number of Observations	64	64	64
R <sup>2</sup>	0.87	0.70	0.75

Notes: (i) Regressand: Log customs revenue of OIC Countries

(ii) '\*'; Values are significant at 5% level; '\*\*' Values are significant at 10% level

(iii) Hausman test fails as model fitted on these data fails to meet the asymptotic assumptions of the Hausman Test.

(iv) Standard Deviations are in the brackets

Again going through Table 2.10, negative and significant indirect effect of WTO CVA may suggest that introduction of WTO CVA gives rise to undervalued declaration of imports which translate into lower imports level in statistics, hence, decrease customs revenue which is calculated as multiplication of *ad valorem* tax and imports. On the other hand, direct effect of implementation of WTO CVA agreement turns to be positive with fixed and random effect calculation. This might be interpreted as revenue increase from increased transparency in customs and less incentive for tax evasion. Importers might prefer to declare transaction value and pay customs tax accordingly rather than going through the hassle of avoiding taxation. Accordingly, one may not argue that the implementation of the agreement increase the customs revenue as the coefficient of direct positive effect of WTO CVA is bigger than that of indirect negative effect with this calculation.

Nevertheless, the relationship between imports and customs revenue from Figure 2.6 give rise to a question of validity of those relationship explained with the model for all

countries. As one may observe, variance increases as the imports increase suggesting that the effect of explanatory variables might be in different degrees for small and big countries. Then it is worth to run the model for small and big countries separately. For this purpose, sample average is taken and an observation defined to be for big country if the GDP is greater than US\$ 40 billion, small otherwise. Table 2.11 summarizes the result of the regression analysis for OLS, fixed effect and random effect calculations for small and big countries.

**Table 2.11: Regression Result for the Determinant of OIC Countries' Customs Revenue by Economic Size of the Subject Country<sup>61</sup>**

	OLS		Fixed Effect		Random Effect	
	Small Country	Big Country	Small Country	Big Country	Small Country	Big Country
Log of Imports	1.343* (0.232)	-0.636 (0.426)	-0.247 (1.062)	-0.906 (0.233)	1.129* (0.410)	-0.232 (0.230)
Direct Effect of Tariffs	-5.455* (1.660)	11.437* (4.509)	13.153 (9.650)	13.941* (3.040)	-3.217 (3.123)	12.787* (3.849)
Indirect Effect of Tariffs	0.270* (0.076)	-0.457* (0.188)	-0.570 (0.428)	-0.576* (0.124)	0.162 (0.142)	-0.524* (0.158)
Direct Effect of WTO CVA	6.644* (2.830)	9.445* (4.294)	9.071* (2.942)	9.226* (1.999)	5.562* (2.461)	8.808* (2.660)
Indirect Effect of WTO CVA	-0.303* (0.130)	-0.396* (0.177)	-0.419* (0.136)	-0.404* (0.082)	-0.252* (0.114)	-0.385* (0.109)
Constant	-9.245** (5.090)	37.041* (10.093)	26.471 (23.692)	23.331* (5.622)	-4.804 (9.019)	27.061* (7.231)
Number of Observations	34	30	34	30	34	34
R <sup>2</sup>	0.851	0.559	0.63	0.90	0.53	0.87

Notes: (i) Regressand: Log customs revenue of OIC Countries

(ii) '\*' Values are significant at 10% level; '\*\*' Values are significant at 5% level;

(iii) Hausman test fails as model fitted on these data fails to meet the asymptotic assumptions of the Hausman Test.

(iv) Standard Deviations are in the brackets

The results of fixed-effect and random-effect calculations in Table 2.11 suggest that unlike big countries, both direct and indirect effect of tariffs on customs revenue is not significant for small countries. However, we were expecting that increase in tariffs would have positive direct effect on customs revenue. We were also expecting realization of

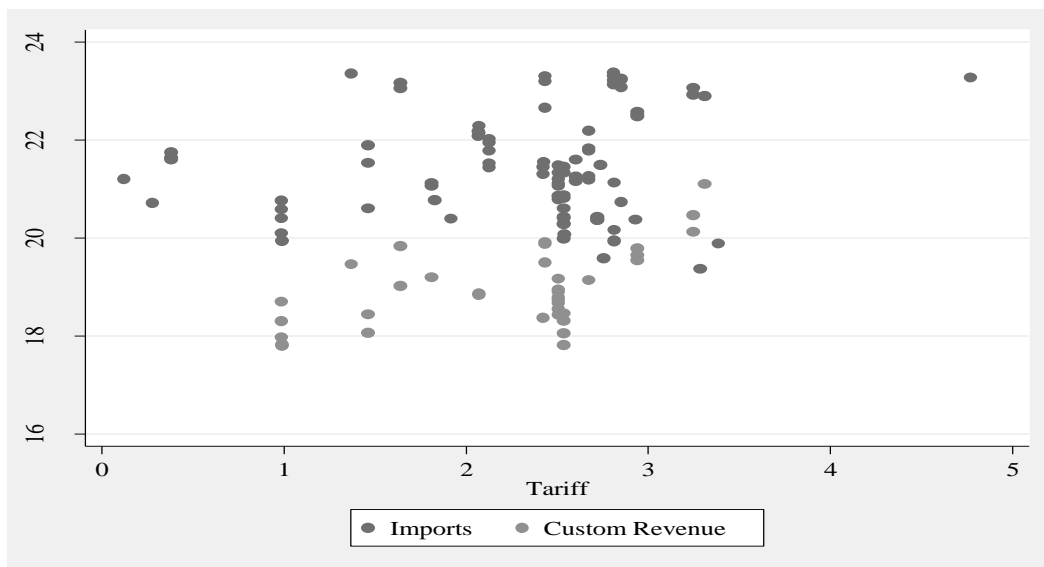
<sup>61</sup> Unexpectedly, coefficient of imports is turned to be, albeit insignificant, negative for some estimations. This might come from omitted variable, i.e. VAT and other customs duties, bias inter alia decreased number of observations due to split of the data set for separate calculation for small and big countries.



negative indirect effect of tariffs on customs revenue as any increase in tariffs would decrease imports and favour domestic substitute products.

Going through Figure 2.7, one may not observe a statistically significant correlation between imports and tariffs for small countries. On the other hand, one may discern a slight uplift in customs revenue suggesting positive direct effect, albeit statistically insignificant according to regression calculations, of tariffs on customs revenue.

**Figure 2.7: Effect of Tariffs for Small Countries**<sup>62</sup>



*Source:* Calculated by the author

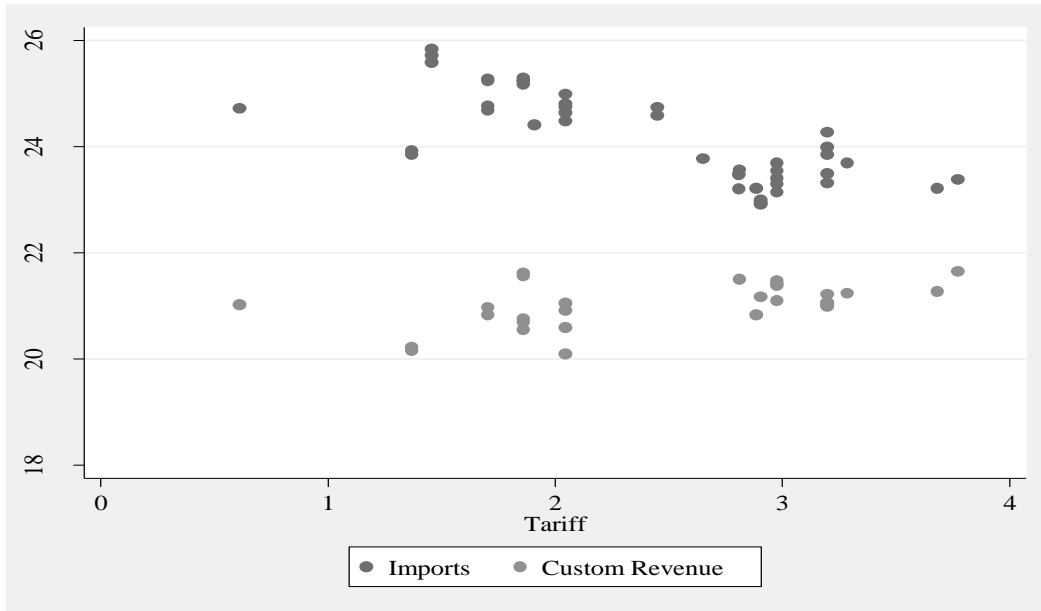
As production capacity of small countries would very often be limited, traders may not have the option of domestic substitutes for their imports, hence, increasing tariff rates would not discourage them from imports. However, insignificant increase in customs revenue suggests the lack of capacity or ability of customs authorities to leverage this situation in favour of government in the case of small countries. This suggestion might be further consolidated as both direct and indirect effects of implementation of WTO Customs Valuation Agreement are the same for both small and big countries.

Going through Figure 2.8, one would see the effect of tariffs on customs revenue and imports as expected in the case of big countries. Tariff has negative correlation with

<sup>62</sup> Both X and Y Axes are in logarithmic form.

imports and positive correlation with customs revenue. That is, direct effect of tariffs on customs revenue surpassed its indirect effect through decreased imports as a result of increase in tariffs.

**Figure 2.8: Effect of Tariffs for Big Countries**<sup>63</sup>



capacity building in the customs of developing countries to ensure fair revenue for governments emerges as an important issue to make multilateral trade systems attractive for them. In this regard, more attention is needed to develop a system to impede undervaluation, sustain certain level of revenue for the governments of developing countries and hence make multilateral trade systems attractive for developing nations.

As experience shows, many countries implement verification systems in compliance with WTO 'Agreement on Pre-shipment Inspection' by which authorized inspection companies inspect the goods in the country of exportation for verification of customs classification, quality, quantity, and price including exchange rate and financial terms. This might be a useful tool to prevent undervaluation and fraud in the classification of the goods. However, the process itself creates additional burden on importers especially in developing countries, increase import cost and the integrity of inspection companies might also be of a question.

Increasing the capacity of customs authorities in developing countries and developing a system for integration or at least efficient cooperation between customs across the globe might serve better to prevent undervaluation. This approach is also in compliance with the Doha Ministerial Conference decision to direct Committee on Customs Valuation to identify and assess practical means for the exchange of information among customs authorities for export values. In this regard, capacity-building activities to enhance ability of customs authorities to efficiently process transactions and collect duties by information and communications technology solutions are crucial. The establishment of single windows at national level, possibly to be integrated to other countries' single windows as planned by ASEAN countries, for one-time submission and collection of trade documents, hence, computerization of trade procedures in the form of online customs declaration, imports licensing transactions, electronic payments, or any other cross-border transaction might more effectively address the undervaluation issue. This direction would also be in compliance with WCO SAFE Framework.

## 2.10 CONCLUSION

The results on determinants of intra-OIC trade models in this chapter suggest inefficiency of OIC level policy efforts. It is argued that recent increase in intra-OIC trade percentage is likely to be product of opposite effects of oil price surge and Euro appreciation rather than trade diversion effect of OIC membership. The reference intra-OIC trade ratio would soar during high oil prices and a strong US dollar. Hence, the issue of increasing intra-OIC trade should be addressed with effective policies rather than relying on externalities of other variables such as oil price. However, policies developed, particularly pertaining to market access such as custom valuation, should address the concerns of countries vulnerable to loss of valuable customs revenue. As the findings for determinants of OIC countries customs revenue models indicate, trade facilitation policies for customs does not necessarily give rise to decrease in customs tax collection. The results suggest that increasing tariffs might increase customs revenue for big countries but not for small countries. Besides, the implementation of WTO Customs Valuation Agreement does not decrease customs revenue as its indirect undervaluation effect would be surpassed by its direct effect of less incentive for tax evasion. In this regard, streamlining small countries in intra-OIC trade should be carried out in a way to protect their delicate balance to enhance their capacity for tax collection at customs, hence, would require tailor-made policies directed to trade facilitation, particularly, custom valuation issues. Nevertheless, other trade facilitation measures should be part of a holistic approach to address many aspect of market access.

## **Chapter 3**

# **ISLAMIC STRUCTURED TRADE FINANCE: A CASE FOR COTTON PRODUCTION IN WEST AFRICA**

### **3.1 INTRODUCTION**

The cotton sector as a main foreign exchange revenue earner and a major source of employment is crucial for sustainable development in West Africa. The sale of seed cotton is the main or only source of cash revenue for farmers in the rural areas. Hence, it is critical to support seed cotton production in the fight against poverty in the region. The basic component of assuring seed cotton production is to support post-harvest seed cotton processing activities till export so the cycle of production may prevail.

Traditionally, banks involved in international trade finance rely on balance sheet analysis and look for government guarantees in the forms of letter of guarantee or comfort for assessing the creditworthiness of potential clients in developing countries. Security appears to be tangible assets. Very often real estates are asked as collateral. Traders in developing countries have large credit requirements compared to their equity.

UN ESCAP's, in cooperation with International Trade Centre (ITC), surveys show that in economies in transition banks require collateral physical assets at 150 per cent of the value of the trade finance facility.<sup>64</sup> In many cases, potential traders are not eligible for clean financing due to their short track records, insufficient capital base and unsatisfactory access to government guarantees due to government obligation to IMF. As a common practice traders need to show three years uninterrupted profit in their balance sheet with bank guarantee, albeit local bank guarantees are not perceived to be solid enough, to be eligible for clean financing. As a result, only large creditworthy traders are actively involved in trade in developing countries. The main reason for credit providers to be hesitant to extend trade finance facility on an unsecured basis to traders in developing countries is their high default rate.

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<sup>64</sup> *Trade Finance Infrastructure Development Handbook for Economies in Transition* (2005), United Nations Publication

Globalization and privatization are other factors giving rise to need for more structured trade finance. With privatization, many trading activities have moved out of the hands of State-owned and government-controlled bodies and into the hands of private companies. Naturally sales to government entities are backed by State while sales to the private sector trade are backed by commercial bank guarantee which does not mean much to credit providers especially in Sub-Saharan Africa.

Given the unpredictable political and economic risks in Sub-Saharan Africa as well as financial security requirements, it turns to be very difficult to penetrate these markets with traditional devices and stimulate economic development. Structured Trade Finance (STF) models have been promising to tackle these difficulties. The main objective with STF is meeting the needs of the borrower in terms of maturity, repayment schedule as well as of the credit provider in terms of currency repatriation, default risk.

Accordingly, there are no standardized structured trade finance deals due to its objectives to meet tailor-made dress requirements for parties. Hence, the evolution of a range of innovative, structured trade financing techniques to mitigate the risk of losses and assess the potential losses associated with financing commercial transactions turns to be an important aspect of development agenda. There are some efforts by multilateral development agencies including the World Bank, Islamic Development Bank, *etc.* for initiating more structured trade finance deals. For example, the World Bank Institute and the African Region's Financial and Private Sector have initiated and launched the Trade Finance Clinics in Dar-es-Salaam with an objective of replicating similar entities in other COMESA countries.<sup>65</sup> International Islamic Trade Finance Corporation of Islamic Development Bank Group established structured trade finance unit for Sub-Saharan African countries.

It should be noted that there are some works on conventional structured trade finance for supply chain financing but little has done on an Islamic version. Considering that Islamic finance is developing in trade finance areas in Sub-Saharan Africa it is essential that this should be considered and modelled.

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<sup>65</sup> Operations implemented within the framework of the Africa Trade Facilitation Project (ATFP) targeting Africa Trade Insurance (ATI), Exporters and Importers in COMESA region.

In this chapter, after introducing aims, objectives and methodology, section four elaborates on literature. Section five briefly elaborates on some definitions for structured trade finance. While section six provides some highlights on global and West African cotton trade in the context of the Five-Year OIC Cotton Plan of Action, section seven introduces the cotton sector in Burkina Faso and SOFITEX. The eighth section explains the existing Islamic structured trade finance for SOFITEX. Section nine evaluates the existing structure, introduces *salam* for upgrading the structure for complete supply chain financing. Section ten analyses the risks factors with the proposed new structure. Final section concludes.

### **3.2 AIMS AND OBJECTIVES**

The main aim of this chapter, as identified in Chapter 1, is to explore and structure Islamic finance instruments in a structured trade finance deal as an alternative to conventional financing.

As part of the structuring, the Islamic finance product developed in this chapter aim at addressing this specific non-payment risk by structuring the transaction in such a way that a payment is made upfront at the ginning level to the producers contributing, while involved in a commercial transaction, to alleviate poverty in OIC member countries.

It should also be mentioned that in the structuring, the study aims to employ two main Islamic financial contracts and in the end identify the most effective one.

Before delving into the technicalities after defining the aims and objectives of the study, it should be noted that prior to the development of Islamic instruments through *mudarabah/murabahah*, conventional financing had no alternative in the region, and the financing used to start only after arrival of cotton fibre in warehouse of export ports. With the assumption of ownership of the products, Islamic finance enabled the beneficiary to obtain financing at the very beginning of the post-harvest phase. However, this chapter goes beyond the existing structure and proposes *salam* contract for complete supply chain financing starting from input financing with the hope to pioneer literature in the area. As highlighted in Chapter 1, the Third Expert Group Meeting on Enhancing Production

Efficiency and International Competitiveness in OIC Cotton-Producing Countries, held in Antalya, Turkey, in October 2006, adopted the Five-Year OIC Cotton Plan of Action (2007-2011). The meeting adopted the following recommendation as stated in Chapter 1:

Focus should be given to supply chain financing, start from providing input to post-harvest seed cotton purchase from farmers. To accommodate this supply chain financing existing, structural trade finance designs need to be expanded to some more OIC countries.

Thus, an attempt is given in this chapter to explore and model Islamic structured trade finance in the case of cotton in Sub-Saharan Africa.

### **3.3 METHODOLOGY**

This chapter shows a creative case study to fulfil financing needs of entities involved in post-harvest seed cotton processing activities while mitigating inherent risks by Islamic Structured Trade Finance design from the case of SOFITEX (a state-controlled agro-industrial and commercial entity in Burkina Faso) for an amount of Euro 60 million to facilitate production, ginning, transportation and warehousing at seaports, and shipping processes with the hope to pioneer literature in the area.

In the real-life case presented herein, there are two contracts: First contract is the *mudarabah* contract between *mudarab* and *rabb al mal* to delegate authority for undertakings of this financing operation. Second contract is a *murabahah* contract between *mudarab* and the Beneficiary/SOFITEX by which the *mudarab* purchase cotton fibre from cotton producers and sell it to the Beneficiary by a predetermined mark-up. Unlike many *murabahah* transactions, selling to the Beneficiary does not happen immediately but it happens at the time of exports.

The existing Islamic Structured Finance design for SOFITEX was analyzed, akin to the credit control process of financial institutions, in detail so as to provide clear understanding of the subject matter. This structure was evaluated and a new design to incorporate pre-harvest financing is proposed to better accommodate financing needs of the cotton sector in the form of supply chain financing. Before introduction of the Islamic



finance structure, however, some insight on the cotton sector and its place in the development agenda is also provided to justify worth of the subject matter in order to introduce main issues with the sector.

It should be noted that most of the material, empirically or otherwise, discussed in this chapter, is drawn from researcher's own experience in directly involving with such cases. Since for such material there is no literature available, individually created knowledge in handling such cases has been the main source in conducting the research for this chapter. This also helps to theorise the social reality in the form of trade financing by directly engaging with every aspect whereby the advantages of ethnomethodology can be observed.

### **3.4 ISLAMIC FINANCE AND AGRICULTURAL FINANCE: AN INTRODUCTION**

Chapra (2008) states that the ultimate goal of Islam is a blessing for mankind through promotion of *falah* or real well-being of humanity, which can be attained by ensuring the enrichment of the following ingredients, as defined by Ghazali, a major Islamic scholar of the 11<sup>th</sup> century:

- (i) *Nafs* (The human self)
- (ii) *Din* (Faith)
- (iii) *Aql* (Intellect)
- (iv) *Nasl* (Posterity)
- (v) *Mal* (Wealth)

As indicated, wealth and faith are perceived as extremely complementary in Islam which would not promote unscrupulousness and accentuate inequalities, imbalances and excesses that would ultimately reduce the well-being of most members of both the present and future generations. However, as Chapra (2008) perceives, placing primary reliance on the redistributive method of *zakat*, would be a mistake because minimizing poverty is possible through development of wealth. In this regard, developing a mechanism for savings and investment is crucial through *maqasid al-Shari'ah*. These

notions are well observed in the OIC Ten-Year Programme of Action as the programme proposes actions for poverty alleviation, as evidenced by the subsequent OIC Five-Year Cotton Action Plan, and resource mobilization for enhancing trade of OIC countries as a crucial supplement.

Before going into product development and case study details of Islamic finance in the essays as per the OIC Ten-Year Programme of Action and OIC Five-Year Cotton Action Plan mandate, main aspects of Islamic Finance, in the context, are explained herein within the relevant literature.

As indicated by Loqman (1999) the Islamic finance system is characterized by the absence of interest-based transactions, short-selling, manipulation, doubtful transactions which may include unlawful activities within the Islamic Jurisprudence. As he defines, the objective of an Islamic financial system, based on Islamic *Shari'ah*, is to transfer funds from surplus to the deficit units. In this regard, Islamic finance as viewed by Muslims is an alternative healthy development tool to interest-based financial systems (Khan, 1992). Siddiqi (2008) highlighted various Islamic finance contracts which exclude interest (*riba*), avoiding major uncertainty (*gharar*) and does not include gambling features (*maysir*) as:

(i) *Murabahah* (Cost plus sale): is the most popular short-term trade finance contract which is akin to working capital facilities of conventional finance. There would be three parties in *murabahah* transactions namely, the bank, the purchaser and the supplier. The bank would buy the needed commodity from the supplier and sell to the purchaser who in prior promised to purchase commodities from the bank with a predetermined mark-up. One can argue the similarity of interest and predetermined mark-up as a contradiction to Islamic finance but this practice is well accepted by Islamic jurists given that the bank cannot charge the same rate in case of late payment to be incurred by itself. In this regard, Islamic banks developed the *waqf* funds to transfer late payment charges for humanitarian purposes. Usmani (1998) provided legal explanation of *bi-thaman ajil* (Credit sale) with *murabahah* for increase in pricing due to deferment.

(ii) *Musharakah* (Partnership or joint venture): The contract by which the debtor does not seek hundred percent financing but contributes some equity capital of a project is referred as *musharakah* in Islamic finance. Even in such a partnership a *murabahah* contract is to be signed and by which the debtor would be exposed to capital loss in proportion to its contribution, while in standard *murabahah* contracts all financing will be provided by a bank which assumes all capital loss risk. In *musharakah* contract profit and loss are shared in proportion to the capital participation. *Musharakah* contracts are used when a bank asks for small participation of the debtor as it is the case with letter of credit.

(iii) *Mudarabah* (Profit and loss sharing): As explained, in the case of *mudarabah* contracts one party, *rab al-mal* contributes all capital while *mudarab* provides its expertise to invest for predetermined profit/loss sharing. Islamic bank deposit accounts work based on the *mudarabah* contract in which the bank is *mudarab* and depositor is *rab al-mal*.

(iv) *Salam* (Sales contract): is a contract by which the seller abides to deliver a specific commodity on a future date against cash received in advance. The price is paid immediately to the seller of the commodity while the commodity is to be provided in the future. In Islamic banking *salam* works as such: the bank pays the price in the sale contract to the seller of the commodity so the seller can use this fund to cover his costs to produce specific commodity to be delivered to buyer on a due date. The Islamic banks would have several options at the date of delivery:

- (a) It can sell the commodity for cash or on credit;
- (b) It can appoint a seller to sell the commodity on its behalf ;
- (c) It can instruct the seller to deliver the commodity to the third party which promised to purchase the commodity from the bank previously.

In any case, at the delivery the commodity would be sold through a sale contract between the third party/buyer and the Islamic bank. The Islamic bank can sell the commodity for cash or on credit with a higher price than *salam* purchase price it paid to seller/producer. As the scheme implies, *salam* contract is employed to meet capital requirement and cost of operations in farming, industry, contracts and craftsmanship. As expected the bank

would benefit from lower price with *salam* purchase as compared to cash purchase. This price difference between *salam* purchase price and expected cash price would secure the bank against price fluctuation, as can be the case with price decrease from *salam* contract date to delivery date. Wilson (2004) describes *salam* as akin to forward contracts which are forbidden, if any uncertainty with the contract, *gharar*, not been eliminated, in Islamic *Shari'ah*. In order to eliminate *gharar* the buyer/bank should pay the amount in full without leaving any outstanding payments. In addition, *salam* can only be used for commodities of measurable quality and quantity standards. Kaleem and Wajid (2009) draw the attention to the need of farmers for financing and explore application of *salam* contract as an alternative financial instrument for farmers in Pakistan. This chapter also draws the attention to the need for agricultural financing as per the OIC Five-Year Cotton Action Plan by proposing *salam* to avail funds to be used for procurement of agricultural inputs as an extension to the case study in which resource are mobilized by *mudarabah*.

(v) *Ijara* (Leasing contract): This Islamic contract type is widely used for real estate, car and machinery financing by which one buys a required item, leases it for a specific time and sells it to the debtor at the end of the pre-specified time.

(vi) *Qard Al-Hasan* (Interest free loan): As the name implies it is interest free and the use of this contract is limited.

(vii) *Istisna* is widely used by Islamic banks to finance the construction of buildings, ships, machines and equipment, *etc.* In Arabic the term *istisna* means 'asking someone to manufacture'. In this contract, the buyer of the above- mentioned items would pay in advance for delivery with predetermined specifications by sellers in the future.

### **3.4.1 Salam for Agricultural Financing: Special Focus**

This chapter proposes implementation of *salam* contract for agricultural financing, but the use of Islamic finance contract might not prevent embedded bottlenecks with agricultural financing. Hence, careful tailoring should be presented to issues with agricultural financing in order to implement *salam* contract effectively.

As observed by Adams and Fitchett (1992), the agricultural sector is constrained in cash, because financial institutions are reluctant to avail funds for small farmers who supposedly have high default rate, results in high transaction costs due to small amounts involved and may not be in a financial position to provide collateral. By using these reasons, however, consequent higher interest rates cannot be recommended as a solution as this would give rise to adverse selection (Coleman, 2006).

Regardless of such financial micro problems, the agricultural sector should financially be supported. For example, Binswanger and Khandker (1995) focused on formal credit of subsidized interest rate impact in India and found that formal credit increases rural productivity and income in a way that benefit exceeds the cost of the formal system by more than 13%. In addition, Diagne and Zeller (2001) highlight the fact that in Malawi interest rates are not considered to be an important determinant by households in choosing which financial institutions to apply from. It is rather non-price attributes of loans provided in the form of restriction on use and auxiliary financial services provided are considered as important determining factors. They found that local banks and cooperative societies in Malawi incline to provide funds to the households with diversified assets and income portfolio.

Moreover, in search for the impact of interest rates, Kahndker and Faruqee (2003) also assessed the performance of Agricultural Development of Pakistan in formal credit, discounted interest rates. As they found, a 10% increase in formal credit enhances agricultural productivity and cost by 1%, while only 0.04% increase was observed in consumption. More importantly they observed the main purpose of formal credit as hiring labour and purchase of fertilizer as well as other inputs. In addition to formal credit, informal lending has an important role in credit markets for rural households of developing countries.

It should be noted that, as highlighted by Van Zyl (1995), informal rural borrowings are mainly for consumption purposes and they place a heavy burden on farmers due to the high interest rate involved. Surprisingly, one third of informal credit transactions originated from resourced mobilized from formal credit sources (Aleem, 1990). Aleem

(1990) calculated an average of 25% interest rate for input financing, which is much higher than the average rural credit of 19% by the informal market. Average rural formal credit is 5% lower than informal credit, which implies possibility of unjustified arbitrage opportunity for informal credit providers. Another important aspect of rural credit is possible exploitation of farmers through borrowing for consumption items.

In support of this, for example, in India, Bhalla (1976) found that farmers tend to borrow consumption items from shopkeepers to be paid through labour, below market wages, to landlords who would consolidate accounts with the shopkeepers for the grain purchased and sold. In the case of Philippines, middlemen usually have some collateral assets in agricultural commodities in their lending deals to farmers and developed extensive relationships with big traders by frequent dealings (Floro and Yotopoulos, 1991). These brokers/middlemen possess extensive knowledge of harvest time, farmer reputation and yield. Besides, they are very effective in handling of post-harvest loan repayments and pre-harvest loan distribution. In evidencing this, Klinefelter and Penson (2005) draw the attention to the fact that local lenders are in a position to monitor the condition and performance physically as the farmers operate in a limited geographic area.

The literature suggests that success of even informal lending in rural areas rely on effective monitoring systems in harvest, input and loan distribution akin to collateral management and monitoring and lending facility agent activities of formal lending. In Pakistan, for example, Mansuri (1998) found that informal credit suppliers do not have capacity to control and monitor borrowing farmers. Again Mansuri (2007) indicates that farm households with some land borrow from middlemen exclusively while landless tenants borrow from their landlords in Pakistan. He found that in Northern Punjab, 16% of total rural debt is from landlords, while the remaining comes from middlemen. This strongly reflects more equally distributed lands in the region. On the other hand, landlords' share in rural lending goes up to two thirds in southern Punjab and Sindh where landholding is more concentrated.

As Dorward *et al.* (1998) highlighted purchase price paid to farmers is depressed in case of political inference at management level and lack of competition. Besides, they

observed that farmers tend to present collective wilful default when defaulters are not punished and there are some parties politically defending them in their default. Bramvilla and Guido (2006) explored the case of cotton producers in Zambia, who take loans from one financial institution and sell their cotton during harvest season to another one. This structure gave rise to less profitable farming business and, hence, increased the farmers' default.

By referring to another aspect of agricultural financing, Khandker *et al.* (2006) found that government policies in the form of formal discounted credit can enhance household incomes for rural populations directly and indirectly through input subsidies and transportation facilities, which increase agricultural productivity in Bangladesh. They specifically emphasised the importance of not only input financing but also key infrastructure facilities to boost productivity. In the same lines, Renos *et al.* (2003) showed the importance of transaction cost of selling agricultural products in determining which market (distant market, local market of farm gate) to be used by farmers. They also measure the cost of access to alternative markets for farmers to sell their products.

It should be mentioned that the literature review suggests the importance of availing formal credits to farmers so as to enhance agricultural productivity and efficiency. In case of non-existing formal credits, farmers end up with private brokers charging high interest rates and bind farmers to sell their crops in harvest at below the market price. While providing formal credit is important, the literature also suggests precautionary measures to avoid adverse selection in the form of wilful default, delay in payments *etc.* In addition, the literature highlights the importance of infrastructure development for increasing agricultural productivity and reducing cost of transaction in order to make farming in developing countries a sustainable business.

With reference to the above-mentioned literature and discussion, it is obvious that availing more funds to rural areas in the form of discounted formal credit would help alleviating poverty subject to:

- (i) The discounted funds with formal credit should be assured to reach farmers but not informal credit providers which may include local banks, landlords, and unscrupulous

managers of agricultural cooperatives who may apply local market interest rates to poor farmers while enjoying discounted funds mobilized through formal credits.

(ii) The funds should focus on procurement of inputs for agricultural production but not purchase of consumption items giving rise to impoverished farmers. In this regard, availed funds should be monitored to ensure that they are used for procurement of input to boost agricultural production.

(iii) Formal discounted credit should be accompanied by several infrastructure development projects in the form of transportation, irrigation, *etc.* which targets to increase agricultural productivity to make agricultural input financing sustainable by assuring reasonable level of yield for harvest and market access for sale of yield.

The experience in the field suggests that any formal credit targeted to rural development should observe these concerns. A successful discounted formal credit programme can be streamlined in structured trade finance to assure usage of credit in procurement of inputs but not consumption items. In addition, the same structure should ensure that formal discounted credit should not end up as opportunist informal credit to intermediaries. A collateral management company can audit distribution of inputs to farmers against the possibility of usage for consumption items while a facility agent for discounted formal credit may assure concern on financial intermediaries and ensure discounted formal credits are enjoyed by farmers but not intermediaries. A structured trade finance scheme can be transformed into complete supply chain financing starting from input financing through a *salam* contract to ensure successful implementation of discounted formal credits for poverty alleviation.

## **3.5 CONCEPTUAL DEFINITIONS**

### **3.5.1 Structured Trade Finance<sup>66</sup>**

Structured Trade Finance can be defined as “the means through which capital solutions (both funded and non-funded) are provided outside the traditional fall-back on securities

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<sup>66</sup> Based on the book “Trade Finance Infrastructure Development Handbook for Economies in Transition (2005)”, United Nations Publication



– the focus shifts from the “strength” of the borrower to the underlying cash flow and structures that enhance safe financing”.<sup>67</sup> In other words, structured trade finance is cross-border trade finance in emerging markets where the financial strength of the beneficiary is not sufficient for traditional financing and repayment is devised as the liquidation of a flow of commodities. Accordingly, it turns to be an increasingly important area of emerging-markets lending. However, its potential pitfalls led to a poor image among the finance community. Notwithstanding anything to the contrary in the foregoing provisions, compared to any other form of lending or investing in the emerging markets, structured trade financing has demonstrated a solid track record of "survivability" under extreme testing.<sup>68</sup>

**Table 3.1: Estimates of Net Incremental Earning from Maize with STF in Ghana**

Year	Harvest Time Price/Bag	Loan/Bag (75 % of A)	Cost of Loan and Other Storage Costs (actual)	Selling Price/ Bag (actual)	% Increase from Harvest to Sales Price (D-A) /A*100	% Net Incremental Benefit to Farmer (D-(A+C))/ A*100
	(A)	(B)	(C)	(D)	(E)	(F)
1994/95	8,000	6,000	3,096	29,566	270 %	231 %
1995/96	15,000	11,250	4,667	24,347	62 %	31 %

\* Inflation for Ghana over the same period should be taken into account in reviewing the true level of profits to the farmer. The inflation rate (GDP deflator, percent) was: 24 percent, 20 percent, 21.5 percent in 1994, 1995 and 1996 respectively. Inflation statistics taken from “World Bank Live On-line Database: Africa Summary Briefings.

Source: Kwadzo (2000)

As the definition reveals, STF focuses on mitigating or externalizing the identified risks associated with transactions to parties who have potential to bear these risks. Hence, identifying the role of different parties in terms of their potential to bear risk in the funding and reimbursement process in order to affect the transaction positively turns to be the main concern. It should be mentioned that there are many risks inherent in trade financing. Commodity price volatility, for example, is a major concern of the financiers to deal with enterprises involved in commodity production, processing or trade. However,

<sup>67</sup> World Bank Institute definition

<sup>68</sup> John MacNamara (2008), “Structured trade and commodity finance: What can go wrong and how to avoid it”, Woodhead Publishing Limited.

evidences from the practice indicate that even under unfavourable price fluctuations STF can still turn to be mutually beneficial for both financiers and beneficiaries.

Table 3.1 shows an example of the benefit of STF facility to the farmers under both favourable and unfavourable price fluctuation. Still, credit providers can obtain price hedging, insurance for country risk or guarantees/transition collateral as well as export receivables as the delay of payment would leave very little options for financiers to enforce their right in case of extreme circumstances. Let us briefly go through warehouse receipt financing and export receivable models for risk mitigation in STF for the sake of the case to be presented herein.

### **3.5.2 Warehouse Receipt Financing**

The exporter's promise to reimburse the credit provider with the cash generated through sale of existing products is not perceived to be solid by credit providers. However, the goods under the control of an independent third party, the warehouse operator, can be the base for secure collateral given that the goods have not been pledged previously and the credit provider has the first call on the goods if the necessity arises.

In warehouse receipt financing, the warehouse operator issues a receipt upon the arrival of the goods from producers. This receipt guarantees the particular quality, quantity and grade as a basis of financing. The producer can use the receipt as collateral to request a loan from a financial institution and the credit providers can use the receipt as a fallback guarantee in case of non-payment. Given the nature of the transactions, the legal framework for warehouse receipts ought to be well established in a developing country to allow its producers to fully benefit from such line of financing.

### **3.5.3 Export Receivable-Based Financing**

As the name suggests, financing is based on the payments to be made by the off-takers once the commodities are exported. In this way, exporters use their future trade flows to raise self-liquidating financing at better cost while credit providers externalize country risk by receiving payments in an offshore escrow account and credit risks by the

assignment of export contracts and receivables. It should be noted that the credit provider still keeps the security on the physical commodity under local law.

### **3.6 FIVE-YEAR OIC COTTON PLAN OF ACTION**

Persistently, West African countries carry the issues of the cotton sector in the agenda of international organizations as evidenced in the Doha Development Round. By June 2003, Benin, Burkina Faso, Chad and Mali (very often referred to as the Cotton-4 group) proposed the Sectoral Initiative on Cotton, or in short 'Cotton Initiative'. Cotton-4 countries are all OIC members.

As is defined in this chapter, West Africa would be confined to these four countries plus other neighbouring OIC member cotton-producing countries such as Togo. In these five countries, Cotton-4 plus Togo, cotton provides income to about 10 million people and cotton exports rank at the top of export items and the main foreign exchange earner as indicated by Baffes (2009).<sup>69</sup>

In order to show the importance of the cotton sector for these countries, Baffes compiled data from the Food and Agricultural Organization, IMF and World Bank. As he indicated, for example, cotton's export share in the region is as high as 76.6% in Burkina Faso. In the case of Benin, Mali, Chad and Togo cotton export shares are respectively, 36.9%, 30%, 19.7% and 16.4%. Hence, the foreign exchange revenue from cotton export is very valuable for these countries to enable themselves to import necessary fertilizer so they can sustain reasonable staple production for food security, that is, peace in the region.

There are several external challenges to the cotton sector in West Africa. These countries share the same currency of CFA Franc fixed against the Euro and their cotton sectors are affected from exchange rate fluctuations of the Euro. Indeed, fluctuation of cotton prices is already a serious problem for the West African Countries as it adds burden on ginners to resort financing for the bad years so the sector can survive until the price level returns

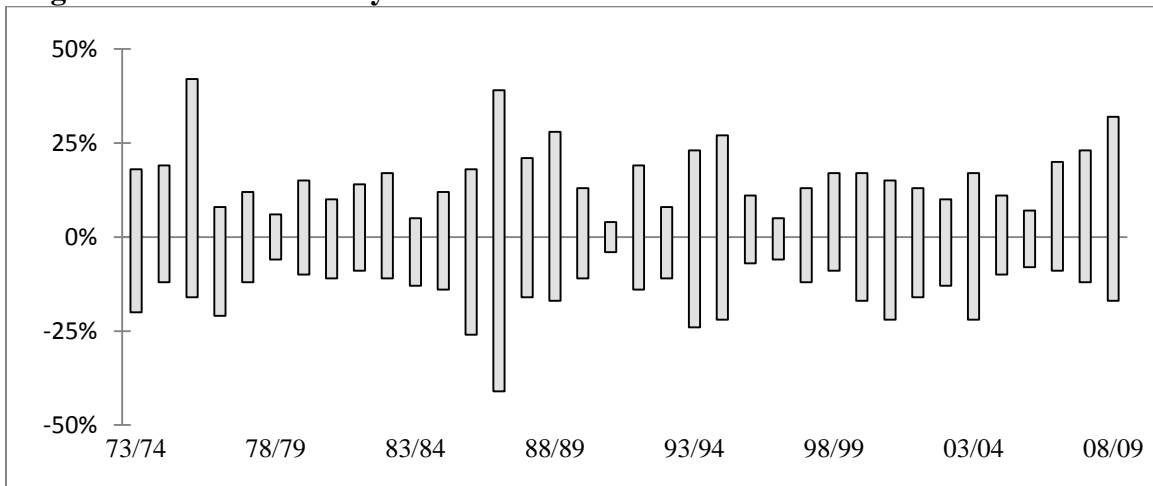
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<sup>69</sup> Available at: <http://www.agecon.purdue.edu/staff/masters/Africa%20e-book%200309.pdf#page=519>. Last accessed on 03 June 2010.

to reasonable levels. Exchange rate fluctuation on top of price fluctuation can easily dry up fertilizer funds, and input financing is needed to revitalize the sector.

As explained in detail throughout the International Trade Centre (ITC) Cotton Exporter’s guide, reference of the cotton price is based on Cotlook A-Index, Liverpool UK or latest future contract listed in USA’s International Commodity Exchange (ICE) in New York. Nevertheless, determination of the cotton price in transactions is determined by delivery schedule, quality, location and relationship among prices within the supply chain implying that it changes constantly. Figure 3.1 provides evidence for such volatility.

**Figure 3.1: Price Volatility in the Cotlook-A Index**



Source: International Cotton Advisory Committee

Cotlook A-Index is at the top of the list when it comes to identifying an indicator for international prices average. The index itself is compiled by a company called Cotlook Ltd. in Liverpool, United Kingdom, which receives cotton prices across the globe from buyers and sellers. Even prices reported to Cotlook from the same place would vary especially for those quotations with small volumes. Hence, Cotlook determines the prevailing price from each origination based on its own judgement. In reality, Cotlook take the average of the cheapest five prices of middling grade cotton of 1-3/32 inches length delivered from nearby shipment to East Asia.

In the same fashion, Cotlook post A-Index and B-Index for short-fibre cotton for North Europe. Hence, in many cases actual price of transaction would be different than Cotlook

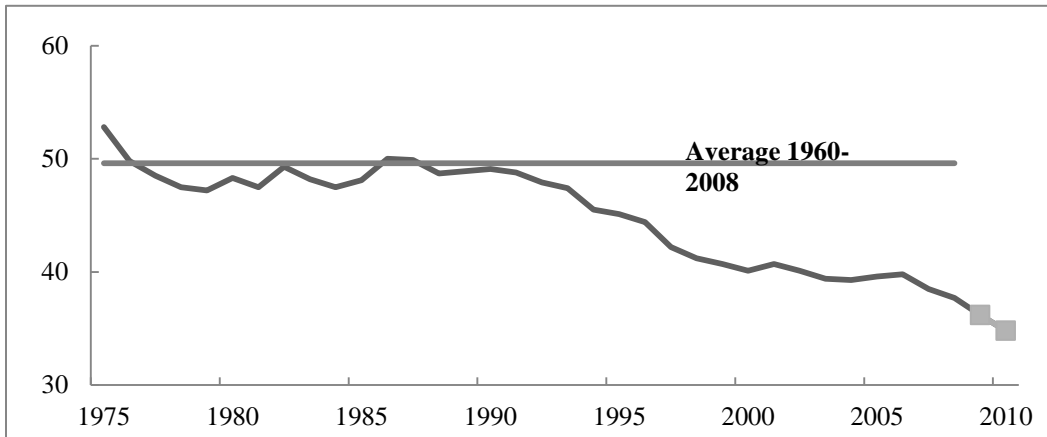
indices yet Cotlook A-Index sustain its place as a primary indicator of average price levels prevailing in the market.

As opposed to the Cotlook indices, future prices are specific prices for certain transactions with indicated description, delivery location and dates, hence, present actual prices. The price of each transaction with specific variety, delivery location and dates is determined based on public auctions through special computer systems. That is, unlike the Cotlook indices there is no judgement in determination of reference prices. However, as the quotations are in the USA, future prices may not be good indicators for price trend or cotton prices out of the USA.

Another important aspect of cotton pricing is variation of mill-delivered (to ginners) prices, together with prices received by farmers, and reference international prices. Mill-delivered cotton prices include various costs from farm to ginner's warehouse. These costs include transportation, insurance, loading and storage. In developing countries farmer prices are usually based on seed cotton prices at the collection point. In some countries, on the other hand, farmers are paid based on cotton fibre out of the seed cotton they placed for the ginning process.

As a main argument developed by Cotton-4 in the Doha Round, trade-distorting production and export subsidies of developed countries are the prime cause of low prices and declining exports revenue for West African countries. Although there are substantial literature on the price-depressing effect of subsidies, there is another side of the coin, which is the decreasing share of cotton in textile fibre consumption due to competing synthetic alternatives. Figure 3.2 depicts the trends in cotton's share of world end-use textile fibre consumption.

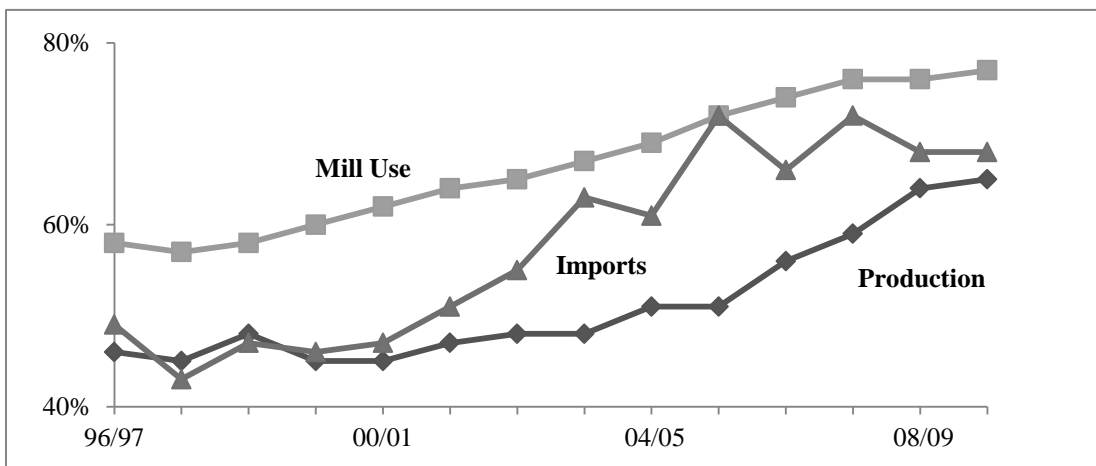
**Figure 3.2: Cotton's Share of World End-Use Textile Fibre Consumption**



Source: International Cotton Advisory Committee

There are two further externalities affecting the cotton prices. As defined by the International Cotton Advisory Committee, increasing concentration in the world market might have decreased the bargaining power of West African cotton producers. As indicated in Figure 3.3, share of Asian in world cotton trade has been increasing as the region imports more and more cotton fibre from the rest of the world. Given this fact, Cotlook adjusted its cotton price reporting to take this fact in to the consideration.

**Figure 3.3: Share of Asia in World Trade**

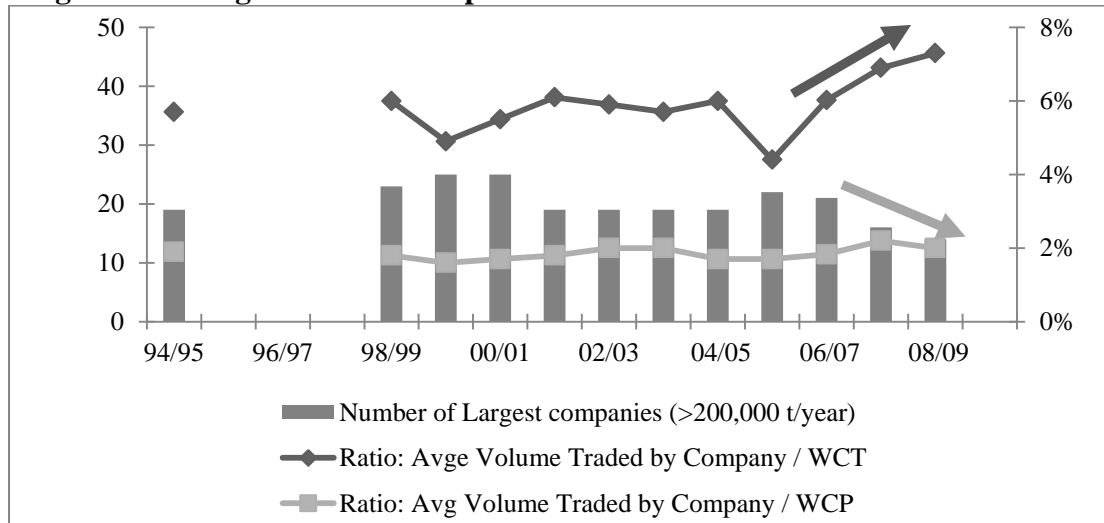


Source: International Cotton Advisory Committee

It should be noted that traditionally, cotton is traded by a limited number of international cotton-trading companies, which was mentioned as an important impediment of fair trade for cotton farmers. However, one should note the importance of these companies to

facilitate cotton trade by providing export contracts at the beginning of the season. On the other hand, economic rationale advises to avoid such concentration which may create a monopsony at the expense of cotton farmers. However, recently, concentration of these cotton-trading companies has even increased as indicated in Figure 3.4.

**Figure 3.4: Largest Cotton Companies**

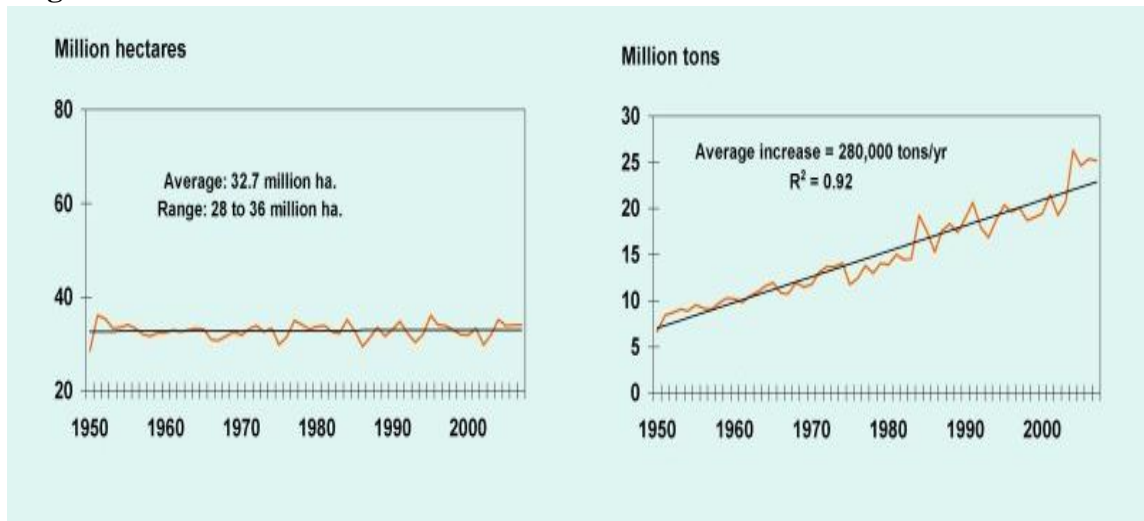


Source: International Cotton Advisory Committee

Addressing these externalities such as subsidies, global market structure, decreasing the use of synthetic fibre might not be viable yet as it requires global joint effort from many parties and awareness of fair trade. Should we expect consumer to pay extra for cotton shirts than synthetic shirt? As Adam Smith stated centuries ago in his book the *Wealth of Nations*, perhaps “we are not ready to suspect any person of being defective in selfishness”. However, until we can suspect business community, politicians and consumers of being defective in selfishness, there are several issues which can be addressed within a territory of governments in West Africa.

As indicated in Figure 3.5, since the 1950s there has been a substantial increase in world cotton production though cotton cultivation areas remain almost as they were. Obviously, this substantial cotton production growth is to be attributed to yield per hectare, which is efficiency gain. Many countries across the globe enjoyed the increased efficiency coming from mechanization, application of fertilizer, increased agronomy know-how, etc.

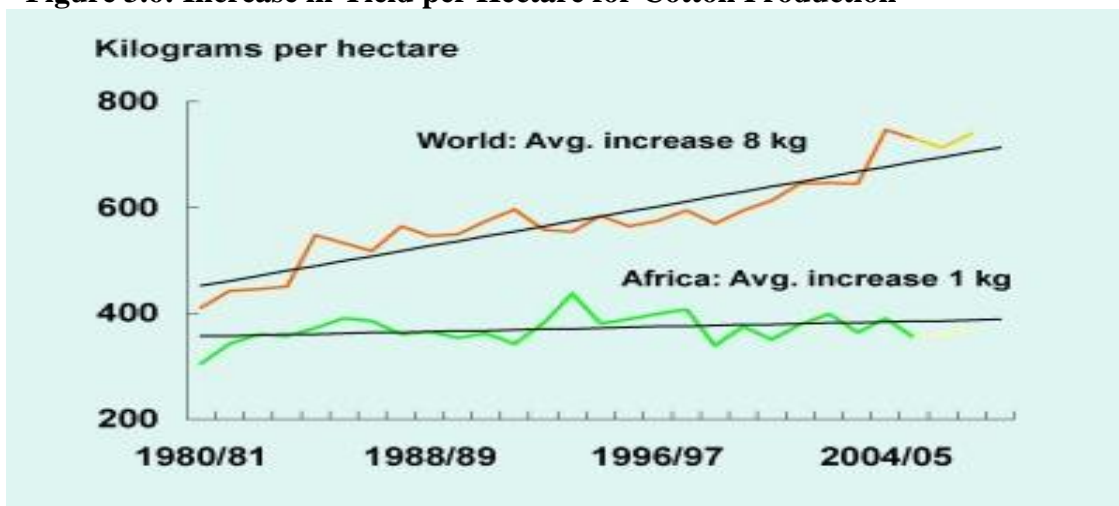
**Figure 3.5: Trend in World Cotton Yield and Area of Cultivation**



Source: International Cotton Advisory Committee

Since then yield per hectare more than doubled as indicated in Figure 3.6. However, Africa has not showed the similar performance to keep up with world.

**Figure 3.6: Increase in Yield per Hectare for Cotton Production**



Source: International Cotton Advisory Committee

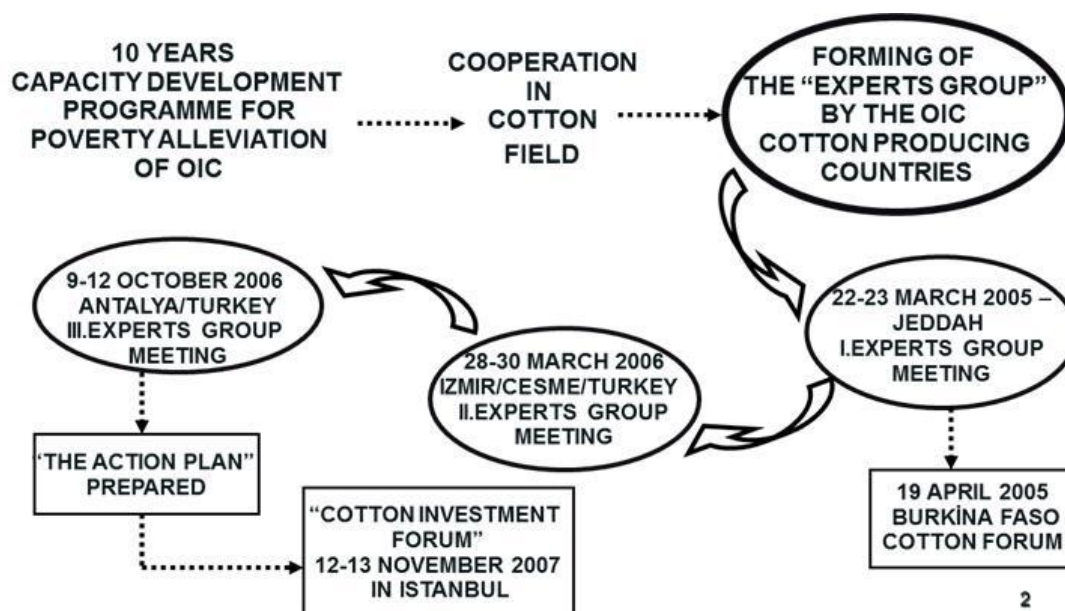
This reality alone would show the major bottle-neck for development of the cotton sector for West African OIC member countries. The income generated out of cotton production can be determined by three factors: price, quality and quantity. As explained above, it might not be viable to address externalities to sustain fair international prices. However, observed efficiency increase in the rest of the world in higher yield per hectare can be



replicated for West African countries. Besides, higher quality cotton in West Africa can also be subject of a regional initiative.

Given the importance of the sector and outstanding issues to be addressed, West African countries continue to succeed in sustaining the case for the development of the cotton sector at the top of OIC agenda. As a crucial crop for public finance and major exports item to stimulate employment and economic growth in many OIC countries, special emphasis is given to the development of the cotton sector under the OIC Ten-Year Programme of Action. The brief background of this issue is explained in Figure 3.7.

**Figure 3.7: Cotton Initiative in OIC Ten-Year Programme of Action**



Source: Ministry of Industry and Trade, Turkey as the Steering Committee Chairman for OIC Cotton Action Plan

OIC General Secretariat in cooperation with IDB and ICDT has organized a series of Expert Group Meetings on Cotton. Then, SESRIC prepared a study to justify the inclusion of cotton sector development into the OIC Ten-Year Program of Action agenda as:

- (i) Among the top 40 cotton-producing countries in the world, 22 were OIC members and their production of cotton accounted for 26% of world production, as per data provided by SESRIC in Table 3.2:

**Table 3.2: OIC Cotton Production in Million Tonnes, 2006**

	<b>Production</b>	<b>Share in World (%)</b>		<b>Production</b>	<b>Share in World (%)</b>
Pakistan	2.145	8.6	Cameroon	0.09	0.4
Uzbekistan	1.208	4.9	Nigeria	0.087	0.4
Turkey	0.773	3.1	Benin	0.082	0.3
Syria	0.327	1.3	Sudan	0.081	0.3
Burkina Faso	0.294	1.2	Azerbaijan	0.071	0.3
Mali	0.223	0.9	Chad	0.071	0.3
Turkmenistan	0.212	0.9	Kyrgyz Rep.	0.046	0.2
Egypt	0.201	0.8	Mozambique	0.036	0.1
Kazakhstan	0.147	0.6	Togo	0.03	0.1
Tajikistan	0.136	0.5	Senegal	0.02	0.1
Iran	0.115	0.5	<b>Total</b>	<b>6.504</b>	<b>26.2</b>
Cote d'Ivoire	0.109	0.4			

Source: SESRIC

- (ii) As a group, the OIC countries were considered as the second largest exporter of cotton in the world after the USA.
- (iii) The share of OIC members in Sub-Saharan Africa in world cotton exports was 11.3% and the share of cotton in total merchandise exports of West African OIC countries was substantial.
- (iv) Going through Table 3.3, , 11 OIC countries were among the top 40 cotton-importing countries in the world, namely, Turkey (number 2), Bangladesh (number 3), Indonesia (number 4) and Pakistan (number 7). Their share in world total imports of cotton accounted for 24.3%.

**Table 3.3: OIC Cotton Imports in Million Tonnes, 2006**

	<b>Imports</b>	<b>Share in World (%)</b>		<b>Imports</b>	<b>Share in World (%)</b>
Turkey	0.737	7.7	Morocco	0.037	0.4
Bangladesh	0.482	5	Tunisia	0.022	0.2
Indonesia	0.479	5	Bahrain	0.016	0.2
Pakistan	0.361	3.8	Iraq	0.015	0.2
Egypt	0.114	1.2	Nigeria	0.015	0.2
Malaysia	0.042	0.4	<b>Total</b>	<b>2.32</b>	<b>24.3</b>

Source: SESRIC

The world cotton production for the harvest season 2009/10 is reported at 22.38 million tonnes by the International Cotton Advisory Committee (ICAC). This represents a decrease of 5% compared to 2008/09 production. Table 3.4 summarizes the progression of world cotton production from the 2003/04 harvest to the 2009/2010 harvest season:

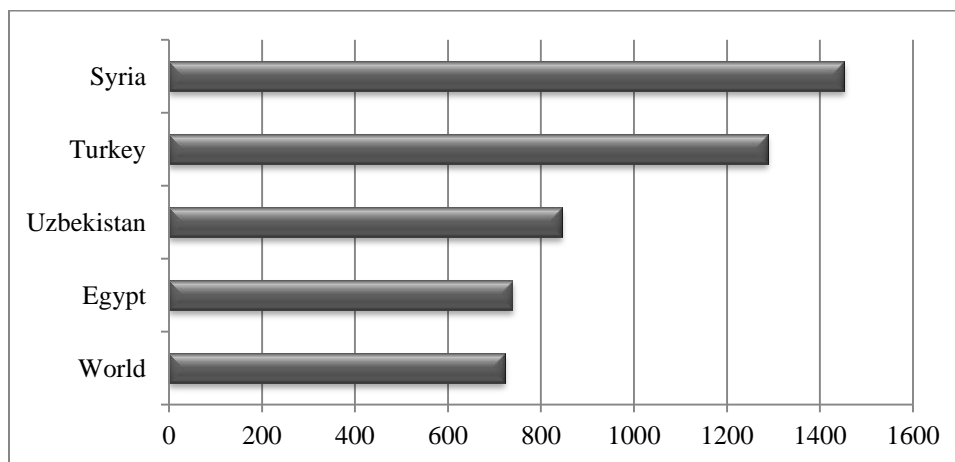
**Table 3.4: World Cotton Production in Millions Tonnes**

	2004/05	2005/06	2006/07	2007/08	2008/09	2009/10
China	6.32	5.82	6.73	8.08	7.91	6.86
USA	5,062	4.2	4.70	4.18	3.09	2.72
India	4.080	3.81	4.59	5.36	5.46	5.28
Pakistan	2.482	2.31	2.09	1.85	1.92	2.05
Brazil	1.318	1.27	1.43	1.56	1.39	1.18
Uzbekistan	1.134	1.1	1.15	1.22	1.15	958
Others (Inc. Africa)	5.808	5.3	4.64	4.03	3.78	3.33
Total	26.204	24.40	25.33	26.28	24.70	22.38

Source: International Cotton Advisory Committee

It should be noted that low yields, subsidies of developed countries, volatility of cotton price, shift to synthetic fibres, lack of capacity for implementation of testing/classification procedures for cotton, lack of a spinning industry and contamination of cotton during harvest leading to a decrease in cotton collected were cited among the major problems faced by the cotton sector in OIC countries.

**Figure 3.8: OIC Cotton Cotton Yield (Kg/Hec), 2006**



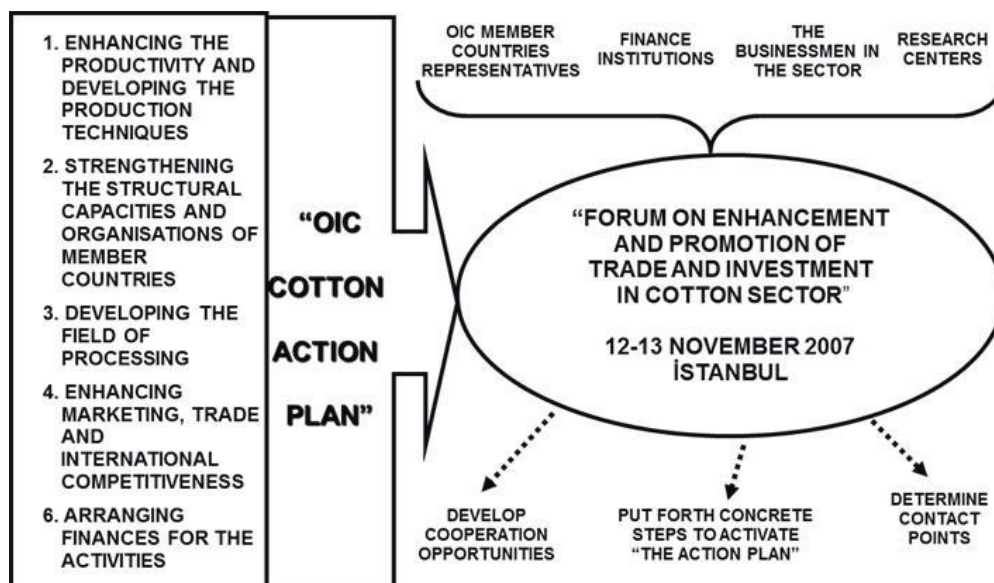
Source: SESRIC

The OIC countries show strong potential for cooperation to enhance trade and production capacity in the cotton sector. For example, Syria, Turkey, Uzbekistan and Egypt yield per hectare is higher than the world average while in West Africa cotton yield per hectare is less than world average. These four countries can transfer their skills to contribute increasing efficiency in Sub-Saharan African countries. OIC activities on cotton, as indicated by SESRIC, should be focused on these types of reverse linkages.

Providing trade finance would be another remedy for the sector. The third EGM on Enhancing Production Efficiency and International Competitiveness in OIC Cotton-Producing Countries, held in Antalya, Turkey, in October 2006, adopted the Five-Year OIC Cotton Plan of Action (2007-2011).<sup>70</sup> It was again the resolution of this meeting which states:

Focus should be given to supply chain financing, start from providing input to post-harvest seed cotton purchase from farmers. To accommodate this supply chain financing, existing structural trade finance designs need to be expanded to some more OIC countries-

**Figure 3.9: OIC Cotton Action Plan**



Source: Ministry of Industry and Trade, Turkey as the Steering Committee Chairman for OIC Cotton Action Plan

<sup>70</sup> This plan of action available on line at <http://www.oic-oci.org/english/conf/comcec/Cotton%20Action%20Plan-En.pdf>, last access on 29 April 2010.

The 22<sup>nd</sup> Session of the COMCEC also endorsed the action plan. The plan aims at strengthening trade, investment and technology transfer in cotton-producing member states, particularly to West African countries. As indicated in Figure 3.9, the OIC Cotton Initiative developed an Action Plan to address major challenges. Based on identified obstacles and challenges, the action plan as compiled in Figure 3.9 is developed. The five cooperation areas are identified as

- (i) Enhancing productivity and developing production techniques;
- (ii) Strengthening the structural capacity and organisations of member countries;
- (iii) Developing the field of processing;
- (iv) Enhancing marketing, trade and international competitiveness;
- (v) Arranging financing for the activities.

Details of these cooperation areas, particularly in enhancing productivity and developing production techniques, are provided in Appendix II.

### **3.6.1 Cotton Sector in West Africa**

Selling cotton at a fair price directly contributes to increase in quality of life, health and expansion of opportunities and hope for West African farmers, and hence facilitate the process of reducing poverty in West Africa. Thus, being a productive base helps to develop the capacity of the societies of these countries.

The fact is that farmers in West Africa are able to produce higher quality cotton at a lower cost than their counterparts in North America or Europe. Hence, they can command a higher price as compared to the average Cotlook A-Index price on the market. The national cotton sectors in West African countries are, hence, profitable at an international market price exceeding US\$ 0.60/pound as highlighted by ITFC.

#### **3.6.1.1 Contracts and cotton-pricing system in West Africa**

International cotton prices are expressed in US dollars, but West African cotton ginneries and exporters pay their production expenses in CFA francs. Exchange rates are volatile and unpredictable. However, cotton prices converted in CFA francs have been less

volatile than those expressed in US dollars, because commodity prices in dollars tend to be negatively correlated with the weighted exchange rate of the U.S. currency.

Exchange movements are an additional risk that needs to be managed and add additional pressure to cotton producers and exporters. Exchange rate volatility affects revenues and costs.

The cotton marketing calendar (and therefore, the financial cycle) of one specific season ( $t/t+1$ ) extends over 30 months, from the middle of the year ( $t$ ), when the ginning companies open *L/C* to order inputs, shipment of fertilizer, storage and distribution of fertilizer to farmers, to the end of the year ( $t+1$ ), when export sales are completed, proceeds received and farmers are get fully repaid. In the countries where a bonus is distributed to producers based on the profit of the previous season, the calendar may extend five more months.

Most contracts between ginners and international traders are private contracts concluded during visits or on the phone. Written contracts incorporate all the major terms of sales. Quantity is specified in metric tons; usually 500 to 10,000 tons per contract in one to three monthly shipments, and smaller quantities for prompt shipment at the end of the season. In addition, quality is stipulated 'on type', meaning that cotton is sold on the basis of exporter's private type or sample for grade and colour. Staple length, micronaire, and strength (if applicable) are separately guaranteed.

It should be noted that payment is mainly against usual shipping documents. Le Havre rules and arbitration (Association *Française Cotonnière* or AFCOT) apply to most contracts between ginners and off-takers. Most contracts are concluded FOB (free on board). In other words, the seller (ginning company) pays the cost of transportation of cotton from the gin to the shipping port and loading the cotton on board the ocean vessel. The most common method used in the CFA countries by the cotton ginner is to sell lint through a forward contract with an international trader. These sales can be in advance of planting the crop, during the season or after ginning. About 50% of expected production is generally sold forward before ginning, more when traders are bullish. Most cotton is sold prior to being actually ginned, except the remaining balance at the end of the season.

Sale and pricing are generally simultaneous, at a fixed price, in Euro per kilogram. Some basic pricing is done on call the Cotlook A-Index, African Franc zone quote in Cotton Outlook or on call New York future. Minimum guaranteed price is not frequent.

It should also be noted that the terms and conditions of contracts between international traders and spinning mills differ from those of the contracts between traders and ginners. Cotton is generally sold forward at fixed prices in US cents per pound CFR port of destination. Spinners usually start covering their needs around March, and buying pressure is stronger when prices are rising. Some mills buy on call New York futures, and sales on call Cotlook A-Index are exceptional. LCA (Liverpool Cotton Association) rules and arbitration apply to most contracts between traders and spinners, except for sales to China (Mainland), where Chinese terms apply. Payment is generally by irrevocable L/C at sight (up to 150 days in certain markets); however, cash payment against documents or upon arrival is less common.

The mechanism for the establishing seed cotton price paid to growers is essentially a two-stage process. In the first stage, the official minimum procurement price for seed cotton is announced before planting, generally in March or April, taking into account the estimated cost of production (including an opportunity cost for the family labour) and anticipated world prices less ginning and transportation costs, or according to a multi-year agreement between the ginning companies and the producers. Pan-seasonal and pan-territorial pricing is the rule. Discounts apply to lower qualities (one and two only). The price of inputs to be deducted from the sales of seed cotton is announced at the same time. In some countries, notably in Burkina Faso and Cameroon, the floor price is eventually supplemented by a bonus (*ristourne*), corresponding to a partial distribution of profits of the ginning company during the previous season.

Ginners usually base their prices on the Cotlook A-Index, valued at the prevalent exchange rate for the shipping period considered. Ginners are always reluctant to start selling new crop below their provisional cost of production. New York cotton futures are not a reasonable base for pricing African franc-zone cotton. Export prices follow the

Cotlook A-Index since the West African zone quote in Cotton Cotlook is most of the time among the cheapest five quotations taken into account in the calculation.

### **3.6.1.2 Allocation of risk in West Africa**

With the current system, producers face essentially two risks namely, production (volume) risk and late payment risk. The biggest risk for producers is the risk of late payment for their crop, (and even of non-payment in some seasons), which is correlated with the storage risk. As mentioned before, the Islamic finance product developed in this chapter aims at addressing this specific non-payment risk by structuring the transaction in such a way that a payment is made upfront at the ginning level to the producers contributing, while involved in a commercial transaction, to alleviate poverty in OIC member countries.

Most of the risks for the ginners lie on the buying side of the seed cotton from the producers. The financial risk is high since inputs and crop financing extend over two and a half years. Cotton companies are *de facto* credit guarantors during the period starting with the opening of the letter of credit for importing inputs to the end of payments by cotton importers. The input recovery risk is low thanks to the linkage between input supply and seed cotton marketing and to the producers' joint liability. Recovery rates exceed 95% but tend to decline in the countries where ginning has been liberalized.

On the selling side of the cotton fibre to the merchants, ginners offset the exchange risk by pricing their cotton in Euros. The counterpart risk is low and the contract performance risk is moderate to low because buyers are selected long-standing established players. However, defaults of buyers and, more frequently, delayed shipments, increase when prices drop between the contract date and shipment. Nevertheless, ginners seldom apply carrying charges to late shipments, and storage cost is not factored into the contract for late shipment.

On the buying side from ginners, the financial risk for merchants is low, except in the case of pre-financing or pre-payment. In contrast, the price risk is high, because the purchase price is generally fixed before cotton is delivered. The exchange risk is high



because cotton is purchased in Euros and sold in dollars. Delivery risk is moderate, as ginners are reliable established players, with a few exceptions among the private newcomers. Volume risk increases with competition among ginners, particularly when there is a ginning overcapacity (the case in Benin). Quality risk is significant as contracted quantities and qualities may not be available for shipment.

Financial risk for input suppliers and banks is high. Governments are also exposed to price risk with the fixed-price system, due to the economic and social importance of cotton in the West African countries. The fixed-price system offers the best protection to cotton producers in West Africa. The systems of minimum guarantee prices appear to generally satisfy producers.

Volume of production is not a problem for ginning in West Africa, which enables them to sell forward. Forward sale fixed-price contracts have been used extensively for decades, primarily as a way to secure input and crop financing. Sales are contracted in Euros, offsetting the exchange risk. About half of each anticipated crop is generally sold before ginning starts.

Ginning uses ‘caution collective’ (joint liability) from producers to guarantee input credit recovery and select buyers to guarantee contract performance. When they are unable to ship the contracted volume, ginners are generally able to renegotiate contracts (rolled to the next crop, at a discount price or not) in order to avoid invoicing back. When unable to ship the contracted quality, ginners usually apply higher quality at the same price or apply lower quality at a discount with buyer’s approval. However, shipping a quality above the contract does not allow the seller to request a premium from the buyer.

### **3.7 COTTON IN BURKINA FASO**

Burkina Faso is one of the largest producers of cotton in Africa. Cotton plays a major role in Burkina Faso, as in most West African countries such as Mali, Benin, Chad, Ivory Coast, Cameroon *etc.*

Cotton production in Burkina Faso is a major source of income-generation in the country. Like most of the other cotton-producing countries, the economy of Burkina Faso is driven

primarily by the cotton sector. At the macro-economic level, cotton represents around 8 % of the GDP formation but 50-60 % of the total export revenues for Burkina Faso (ahead of livestock and gold). It is a main foreign exchange revenue earner and a major source of employment. The sale of seed cotton is the main or only source of cash revenue for farmers in rural areas. Hence, it is critical to support seed cotton production in the fight against poverty.

As mentioned, seed cotton cultivation is the major source of income in the rural areas; as a result, it can be an important instrument for the fight against poverty in Burkina Faso and an engine of technical progress for rural development. The major players in the cotton industry in Burkina Faso are the producers, the cotton ginners, the cotton research institute, the banks, the ancillary private sector service providers (transporters, the input suppliers and the cotton oil refiners) and lastly, but not least, the government of Burkina Faso. In this respect, the government has been instrumental in redefining the national policy on cotton since 1996, shaping the new landscape for the industry and the regulatory and control framework for the memorandum of understanding between the producers and the ginners. Hence, 1996 was a turning point in the history of the Burkina Faso cotton industry. Since the inception of a restructuring policy in 1996, SOFITEX has been working with the government, the farmers and local financial institutions. With the introduction of a number of initiatives including new monitoring and follow-up procedures and the close working relationship with the farmers (and direct involvement) and the government (acting as regulatory authority), the sector has recorded unprecedented growth and performance. Cotton production has grown 19% a year from 1996 to 2006. This achievement definitely positioned Burkina Faso as the largest cotton producer in Sub-Saharan Africa.

Total surface area under cotton cultivation has grown considerably since 1993 from 152,000 Ha to reach 410,000 Ha for the 2008/09 harvest season. At the same time, the average yield of seed cotton has improved to 469 kg per hectare. As explained earlier, this is the result of the combination of many factors, including better seed variety sowed, use of 'delinting' seed, effective use of pesticide, and training provided in innovative planting techniques.

As indicated in Table 3.5, the ginning out-turn has been consistently high in Burkina Faso at around 42% with a peak of 42.8%. As regards to quality, significant progress has been made and today nearly 80% of the total current production of the up market bola/boby super varieties, which are equivalent to the standard Good Middling & Middling in the US market. Moreover, 95% of the fibre are 11/8' (28,58 mm) in length.

**Table 3.5: Trend in the Cotton Sector from 2001 to 2009**

Harvest Season	01/02	02/03	03/04	04/05	05/06	06/07	07/08	08/09
Area (ha), thousands	342	407	460	480	546	615	365	410
Production (tons), thousands	360	409.8	483.4	514	601.5	557.6	310.6	450
Yield (kg/ha)	444	423	444	465	469	388	359	469
Cotton fibre Ginned (tons), thousands	151.9	172.5	203.7	215	253	238	130.8	192.2
Ginning Outturn (%)	42.18	42.09	42.28	42.0	42.17	42.83	42,14	42,72
Av Exp Price (Fob) (FCFA/kg)	630	709	780	584	635	590	688	736
Producer Price (FCFA/kg)	175+5	175+10	175+35	175	175	165	145+10	165

Source: SOFITEX

On the export market, the major market outlets are today, predominantly South East Asia (China, Taiwan, Indonesia, Thailand, Malaysia) while it was Europe earlier. Most if not all of the sales are marketed through international traders such as Reinhart, Devcot, Olam, Copaco, Louis Dreyfus, *etc.* 90% of exports are executed under documentary collection and the balance 10% of export sales are paid against payments through L/Cs. The main transit routes for loading and export of Burkina Faso cotton fibres are Abidjan (Cote d'Ivoire), Lomé (Togo) and Tema in Ghana. The bulk of the shipment was done via Tema in Ghana whereas the shortest and most cost efficient route is undoubtedly Abidjan.

### 3.7.1 Organizational Structure of the Cotton Sector

Going through the presentation of Leonce Kone, Minister of Commerce Burkina Faso, during the '13<sup>th</sup> Round of Consultation on Cotton Development Assistance' in WTO headquarters on 7<sup>th</sup> June 2010, there are 320,000 cotton producers in the form of small family businesses. The size of a cotton farming unit varies from 2.4 Ha to 65 Ha for the large ones, with an average size of 8.4 Ha per unit. The average number of people working in a unit is 11 (usually the whole members of the family). The cotton plantations consist of small producers, producing an average of 2 tons of seed cotton as cash crop and keeping a portion of their land for subsistence farming such as producing cereals and vegetables as follows:

- (i) 50% of the land for cotton;
- (ii) 40% for cereals (corn, millet, sorghum);
- (iii) 10% for others (mostly vegetable).

It should be noted that the level of agricultural mechanization is very low: 35% of the producers work totally manually. 40% have a pair of cows pulling a rudimentary plough; and 24% have a fairly good range of agricultural tools and equipment, while only 1% have tractors and mechanized equipment.

To better manage and supervise the production of seed cotton, the 320,000 producers are organized into associations, known as *Groupement des Producteurs de Coton* (GPC). These are operationally organized structures adapted to the cotton sector with following mandate:

- (i) Supervising the distribution of inputs, such as fertilizer, to their members;
- (ii) Managing short-term and medium-term credit facilities for farmers;
- (iii) Planning cotton harvest, collection of seed cotton and selling of seed cotton to ginneries (including weighing, and sales collection);
- (iv) Organizing other activities of socio-economic nature for the benefit of their members.

There are a total of 9,000 GPCs in Burkina Faso (6,000 alone in SOFITEX zone). The GPCs are themselves regrouped at regional level (248), at provincial level (36) and finally all of them are full members of the national cotton producers' union of Burkina Faso (*Union Nationale des Producteurs de Coton du Burkina*) UNPCB. The organized

structure, set up since 1996, has considerably improved the parameters of the cotton sector in Burkina Faso, particularly following the entry of the UNPCB into the capital of SOFITEX with a 30% shareholding as a part of two-pronged strategy to manage the cotton sector by government.<sup>71</sup>

In 2010, there were three cotton ginning companies in Burkina Faso, namely SOFITEX, SOCOMA and FASOCOTON. Prior to September 2004, the cotton activity was solely dominated by SOFITEX with 12 ginning mills located in the west, south west of the country. As a result of a policy towards liberalization of the sector, formulated by the Government and the IMF/World Bank, SOFITEX sold its two units in the east and centre of Burkina Faso to SOCOMA and FASOCOTON (one each). This limited liberalization process was successfully implemented and SOFITEX kept the control of the west/south-west region which accounts for over 80% of the national cotton production capacity. Since then, SOFITEX has expanded its operation by installing three additional ginning units (in Banfaro, Kouroma and the new cotton zone of Diebougou on the Ghana border).

Similar to other West African countries, ginning companies in Burkina Faso are experiencing serious difficulties due to low world cotton prices and the appreciation of the Euro. The pricing mechanism was inflexible so the ginning companies had no means to timely pass through the lower world cotton prices to farmers. As a result, the ginning companies incurred tremendous financial losses due to the price difference between world market and minimum price guaranteed to the farmers. SOFITEX, the largest ginning company in Burkina Faso, incurred losses equal to more than one per cent of GDP. This trend urged development agencies to explore a way to finance the cotton sector in the country through ginning companies in a sustainable way. One crucial step toward ensuring the sector's viability was the adoption of a market-based producer price-setting mechanism, which was implemented for the 2007/08 harvest. The new mechanism aligns domestic producer prices with world market prices and thus makes producers share the part of the risk.

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<sup>71</sup> B.Essama-nssah, I. Samakéand, and J.Walliser, *Burkina Faso: A Macroeconomic Approach to Analyze Cotton Sector Reform*. Accessed from World Bank website: [http://siteresources.worldbank.org/INTPSIA/Resources/490023-1120841262639/ch3\\_burkinafaso.pdf](http://siteresources.worldbank.org/INTPSIA/Resources/490023-1120841262639/ch3_burkinafaso.pdf) on 29/12/2008.

### 3.7.2 Sofitex

SOFITEX is a state-controlled agro-industrial and commercial entity, involved in the whole cycle of production, processing of seed cotton to the export of cotton fibre. It was set up in 1979 as a public sector limited liability company by the major two shareholders, namely the Government of Burkina Faso and the formerly *Compagnie Francaise pour le Developpement du Textiles* (CFDT). SOFITEX is one of the largest cotton companies in West Africa along with the *Compagnie Malienne pour le Developpement des Textiles* (CMDT) in Mali. Until September 2004, SOFITEX had the monopoly over cotton processing in Burkina Faso. It was undertaking the full industrial and commercial activities relating to cotton export and ensuring the social development of the rural population. Presently, under its supervision it has 3 million farmers, representing approximately 25% of the total population of Burkina Faso. SOFITEX is the only company in the region to have seed production facility (delinting units) in order to improve quality of seed cotton, for better yield and more resistant varieties. Today SOFITEX is considered as a parastatal entity run on a purely commercial basis, though it is meant to perform a social developmental role in rural areas. SOFITEX has a strong management team with expertise from different fields and a general manager appointed by the Government for the last ten years. Its technical team consists of a large pool of agronomists (297) trained both locally and abroad, which has proved to be the major asset behind the reputation of the company for its high-quality cotton worldwide. Recently, SOFITEX increased its paid-up capital in the amount of FCFA 34.22 billion (or Euro 52 million), which reflect in its ownership structure as depicted in Table 3.6:

**Table 3.6: Shareholding Percentage of SOFITEX**

	<b>Percentage (%)</b>
State of Burkina Faso	35.16
<i>Developpement des Agro-Industries du Sud</i> (DAGRIS Group)	3.87
Cotton Farmers Producers' Union (Union Nationale des Producteurs de Coton du Burkina)	30.14
Domestic Banks (BIB & BICIA-B)	0.05
FBDES	30.28
Total	100

Source: SOFITEX

This diversified shareholding structure has proved to be the strength of SOFITEX as it incorporates the major players in the cotton sector, including the farmers and the government. The government has been instrumental for its active role in shaping the agricultural policy, development of rural infrastructures, in the implementation of regulatory framework.<sup>72</sup>

### **3.7.2.1 Business activities**

SOFITEX has a number of functions, both economic and social, to fulfil. Its mandates are various, but primarily cover the following:

- (i) Acquisition and distribution of fertilizers and other agricultural inputs;
- (ii) Support/advisory services to cotton producers on sowing, harvesting, use of seeds, insecticides, pesticides, *etc.*;
- (iii) Purchase, supervision and transport of cotton seed;
- (iv) Cotton ginning, packing, storing and classification;
- (v) Marketing and sale of cotton fibre, seed cotton and lint cleaner;
- (vi) Value addition to by-products (seed cotton 'delinting' to produce quality seed for next-year planting season).

The supply of fertilizers, as one of the most crucial task of SOFITEX, to the cotton producers consist of two components:

- (i) Acquisition of the fertilizers imported by SOFITEX through competitive bidding;
- (ii) The adequate and timely delivery/distribution to the producers.

Every year SOFITEX prepares tender documents and invites best offers from international suppliers through bidding procedures and order the required volume on the basis of cotton growing forecast made by the GPCs channelled to the UNPCB. For the payment to the fertilizer suppliers, request for financing is generally made by SOFITEX to the local pool of bankers, and foreign banks. The physical distribution to the producers is actually undertaken through the organized structure of the GPCs (provincial, district, regional levels), under the close monitoring of UNPCB. It is delivered to them on a deferred payment basis (known as input credit). This activity also involves a local commercial bank which is a major player in the sector. It acts as an important intermediary between SOFITEX and the farmers for the

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<sup>72</sup> In addition to the monitoring of the cotton sector through its mediation on the MOU signed between the producers and the ginners, for fixing of the minimum guaranteed price of see cotton.

management of the input credit, and ensures a smooth repayment of the fertilizers through direct deduction from the sales proceeds of cotton seed to SOFITEX. The local bank works with the GPCs as the latter provides joint and several guarantees on behalf of all its members, as information provided by ITFC.

### **3.7.2.2 Sofitex production capacity**

SOFITEX is Burkina's largest ginning company, by the size of its industrial set-up, the equipment and the workforce (1,660 permanent staff and 2,400 seasonal workers). Compared to 1995, SOFITEX ginning capacity has nearly doubled from 2,500 to 4,500 tons of seed cotton daily in 2008. During that same period, the number of units increased from nine in 1996 to 15 in 2005 (including the two delinting facilities), despite that two ginning units have been sold to the private sector in September 2004. The acquisition of these two 'delinting' units (the first one set up in March 1996) enabled the company to be the first highly integrated cotton company in all West Africa. These two units allow the company to sort, process part of the seed cotton, in such a way to remove all residual fibres and add a chemical coating that gives germination success exceeding 90%. The seed may be more expensive but a subsidy is received from the government and, without this process, it may take up to five cotton seeds for one to germinate and produce a plant.

The SOFITEX is equipped with a state-of-the-art post-harvest quality control laboratory and grading centre.<sup>73</sup> Its laboratory undertakes detailed analysis on 40 per cent of all sample cotton from each cotton bale produced. The SOFITEX laboratory works in close coordination with the national research institute for sharing data and other information, towards production of higher productivity seed varieties, improving the planting techniques and better protection of the cotton plants against parasitic attacks. The findings are then channelled to the farmers through training and workshops organized at GPC levels jointly by SOFITEX and the Research Institute. SOFITEX agronomists and agents are also well present in the fields to provide the necessary technical advice. Lastly, the Laboratory is currently under process to be certified at the highest level for the ISO 17025 norms. This is a strong recognition of SOFITEX ability to produce quality cotton

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<sup>73</sup> This facility is considered to be the 3rd best in the world, behind the US and Greece.



consistently and improving the seed varieties that have the properties of having a higher yield ratio, producing longer fibre and being further resistant to parasites.

### 3.7.2.3 Financial analysis of Sofitex

SOFITEX is currently the only company in Burkina Faso which places the reporting of its activities and financial positions at a higher level of transparency. Management annually reports two (2) sets of statements of its operating and financial activities to its shareholders. The first set of audited financials at the end of December of every year is mandatory as required by the Organization for the Harmonization of Commercial Laws in member countries of the West African Economic and Monetary Union (ODAHA). The following set of audited financial reports as of the end of December of each year, relates to the cotton campaign cycle over a twelve- (12) month period. The review provided below analyses the company's financial performance over a period spanning from 2005 to 2008. The financial statements provided by the company were audited by the Abidjan (Cote d'Ivoire) office of Price Waterhouse Coopers SA (PWC SA). The auditors have given an unqualified/clean opinion for each fiscal year presented, in strict compliance with International Accounting Standards and ODAHA's principles. The key indicators of financial performance are outlined and summarized below from detailed reports audited by PWC SA. SOFITEX has also been evaluated and granted a rating of BB+ base for its central role in the country economy and the strategic and continuous support of the Government of Burkina Faso.

**Table 3.7: Sales & profitability Indicators**

	12/31/2005	12/31/2006	12/31/2007	12/31/2008
Net Sales (US \$ 000s)	354.03	339.72	356.38	301.61
GP Margin %	10.99	15.7	11.32	14.88
SG & A (% of Sales)	21.9	21.19	21.88	21.93
Financial Charges( % of Sales)	5.08	6.48	4.73	6.38
Net Profits (\$ Mn)	-54.84	-39.4	-51.31	-24.58
Net Margin %	-15.49	-11.6	-14.4	-8.15

Source: SOFITEX

As can be seen in Table 3.7, SOFITEX may not appear as success, but its significant role as organizer of the important cotton sector for the country and as provider of agricultural

input to farmers cannot be ignored. Besides, cotton ginning investment has no alternative use and abandoning would cost the loss of invested resources. Dixit and Pindyck (1994) indicate that when investment expenditures are firm and industry specific, they are sunk cost and irreversible. That is, once infrastructure built, ginning facility in case of SOFITEX, it would have little salvage value. One of the main reasons for unfavourable financials of the SOFITEX is unfavourable prices. Dixit and Pindyck (1994) also note the concept of 'economic hysteresis' whereby investment decision would not reverse itself even if with fully reversed underlying causes. Accordingly, the firms would not exit immediately upon prices falling under long-run average cost, but there would be an area of probability for the lower threshold to be exceeded for exit. They also argue that such advance thinking undermines the standard neoclassical investment models' theoretical foundations.

The sales have decreased steadily over the period, with a major drop in 2008 from US \$356.38 million in 2007 to 302.61 in 2008. This negative trend is the impact of two major drawbacks:

(i) falling US dollar exchange rate against the Euro and ultimately to the CFA Franc as the commodity currency; and

(ii) the severe drop of world cotton prices. The effects of the falling US dollar have increased the costs of exporting goods from landlocked countries such as Burkina Faso relatively. Exchange rates fluctuations affect not only the price of cotton ready for export, but also the cost of shipping and related charges. Cotton prices have been decreasing since 2004 due to many reasons, topped by cotton subsidies programs of developed countries, and China's stock policy, which had the effect of boosting world prices from 1992 to 1998 through massive purchases to build up its stockpiles; and to subsequently depress them from 1998 via release of surpluses. Gross profit margins increased by approximately 3.5 percentage points from 2007 to 2008 as direct improvement in cotton prices in 2008. The company's Net Losses reduced from US (\$51.31) million in 2007 to US (\$24.58) million in 2008, corresponding to an increase in Net Margin from -0.14% in 2007 to -0.08% in 2008. The change in these figures comes primarily from increase in

cotton prices. This improvement is also a result of better productivity at ginning level through production of higher fibre quality fetching a better premium on sales and improvements in productivity are highlighted by the decrease in SG&A charges. The company has made some improvements in cost reduction, as evidenced by lower financial charges in proportion to Net Sales in 2008.

**Table 3.8: Liquidity and Working Capital indicators**

	31/12/05	31/12/06	31/12/07	31/12/08
Current Ratio	0.89	0.79	0.93	0.74
Quick Ratio	0.19	0.27	0.3	0.21
Days Receivable	41	88	56	52
Days Inventory	176	212	142	126
Days Payable	164	217	162	139
Cash Conversion Cycle	53	83	36	39

Source: SOFITEX

As briefed in Table 3.8, during the period under review, the liquidity position of SOFITEX is considered satisfactory for the industry standards. It is a reflection of the seasonal nature of its activity. Inventory is built up towards the end of the fiscal year, as seed cotton is being purchased and delivered to the ginning mills. At year end 2008, inventories represent 30% of the company's current assets (raw materials and finished products). Considering this seasonal aspect of the industry, and noting that the company's inventory is readily saleable, a current ratio of 0.74 in 2008 provides confidence in SOFITEX's ability to meet its short-term financial obligations. The company's day receivables decreased from 88 days in 2006 to 52 days in 2008. This drop is an indication of the company's commitment to recovery of the payments due from buyers. In general, SOFITEX terms of sale do not exceed 45 days as benchmark. The length in the collection of accounts receivables is due to delays in loading instructions from off-takers given the changes in the cotton market. The day's inventory is high, but in line with the market benchmarks, as would be the case in a similar industry with a long business cycle. In 2008, this ratio has significantly improved at 126 days, compared to 142 days in 2007. This fact again, highlights improvement in the SOFITEX management system in achieving efficiencies in the

cotton production cycle. SOFITEX's Days Payable ratio decreased from 162 in 2007 to 139 days in 2008. Even though the improvement is relatively a long period for settling current obligations, this is attributable to an increase in stocks of seeds purchased on credit from suppliers, but not used due to late absence of rainfall, which inevitably limits cultivable areas. The cash conversion cycle has been satisfactory and has improved from 83 days in 2006 to 39 days in 2008, reflecting management's improved practices of achieving efficiencies.

**Table 3.9: Cash Flow Analysis**

	<b>31/12/05</b>	<b>31/12/06</b>	<b>31/12/07</b>	<b>31/12/08</b>
Gross Operational Cash Generated	(\$41.11) Mn	(\$27.04) Mn	(\$39.01) Mn	(\$11.27) Mn
Net Cash Flow	(\$129.14) Mn	\$2.04 Mn	\$1.25 Mn	(\$8.30) Mn
Fin. Charges Coverage (x)	-1.95	-0.71	-1.94	-0.2

*Source: SOFITEX*

The Cash flow performance has been erratic over the period under review as shown in Table 3.9, but has shown little improvement in 2008, with Net Operating Cash Flow decreasing from US \$1.25 million in 2007 to US (\$ 8.30) million in 2008. Gross Operating Cash Generated has been decreasing over the period with signs of recovery from US (\$39.01) million in 2007 to US (\$ 11.27) million in 2008. These figures are offset by a positive change in both Net Receivables and Inventories from 2007 to 2008, reflecting a delay in loading instructions from off-takers.

SOFITEX long-term debt drops from US\$ 106.06 million in 2007 to US\$89.90 million in 2008 as a direct consequence of retirement majors to Banks in 2008. The company's long-term debt comprises mainly consolidated short-term debt over five years, and a bond loan for the building of two new ginning mills (Leo and Bondoukuy), which has been operational now since the 2008/2009 season. These weak results out of financial analysis clearly make SOFITEX out of regular lending client for any banks. Obviously, there needs to be a creative way, through tight control of business transactions, to sustain this important business for the country. It is obvious that with the above-mentioned financial highlights and paid-up capital of about Euro 50 million, there is not way of extending Euro 60 million financing to

SOFITEX with clean lending. That is, introduction of structured trade finance is much needed in order for financiers to engage.

#### **3.7.2.4 Strengths**

The success of the Burkina Faso cotton industry in recent years is a combination of strong willingness of SOFITEX and the cotton producers to work together and the implementation of solid mechanisms of follow-up and transparency at every stage of activity in the cotton industry. The strengths of SOFITEX and the sector are mainly characterized by:

- (i) As information provided by SOFITEX, Strong donor supports to SOFITEX, the cotton sector and the country as materialized through:
  - a) EU grant of Euro 10 million to the *Union National des Producteurs de Coton Burkinabè*, which owns 30% of SOFITEX, to help recapitalize the company,
  - b) The African Development Bank (AfDB) grant in the amount of US \$ 60 million over a five-year period to build up the textile industries in Burkina Faso, Benin, Chad and Mali,
  - c) A credit line in favour of SOFITEX, worth Euro 65 million (\$ 95 million) from a consortium of French and German Banks to finance cotton ginning and the purchase of inputs was approved for the 2007/08 season.
- (ii) A strong shareholding structure (including the state and the producers);
- (iii) A common involvement of the company and the producers towards achieving the same objectives. The producers feel wholeheartedly to be part of the SOFITEX;
- (iv) A unique network and well-organized structure of producers at every level;
- (v) A better mechanism for mitigating the world cotton price volatility through the creation of an indemnity fund;
- (vi) A world-class quality control and grading centre, that give a consistent high quality of cotton;
- (vii) Availability of 'delinting facilities ' to improve the productivity of seed cotton used for planting purpose;
- (viii) The close collaboration of the company with the cotton research institute, which is itself partly sponsored by the former, is a unique example in West Africa.

- (ix) Modern and up-to-date ginning equipment that enables a high ginning out-turn exceeding 42.8% in 2008/09.
- (x) SOFITEX robust management procedures and production control parameters enable it to be the most competitive in the region with the lowest production cost per tons of fibre exported.

### **3.7.2.5 Weaknesses**

Despite the numerous satisfactions of the Burkina Faso cotton sector improvements and the good performance recorded in recent years, there are still obstacles that may constrain the productivity and the return of the industry. These are:

- (i) The volatility of the world cotton prices, currently at a low level is characterized by the strong subsidies given by the US Federal Government to its cotton farmers. These annual subsidies amount to US\$ 3.6 billion. Under the WTO ministerial decision in Hong Kong (December 2005), all forms of export subsidies for cotton were to be eliminated by developed countries by 2006. In addition, it is agreed that trade-distorting domestic subsidies for cotton production will be more quickly and ambitiously reduced than the general formula to be agreed. Unfortunately, the recent Geneva talks between WTO cotton-trading countries failed to deliver the expected results on the matter;
- (ii) The increasing price of inputs imported;
- (iii) The high price of energy;
- (iv) The low level of mechanization among the cotton farmers;
- (v) Insufficient storage infrastructures at the village level;
- (vi) High cost of maintenance of rural roads to pick up cotton seed;
- (vii) The isolation of Burkina Faso as a landlocked country, making it costly to export;
- (viii) Its dependency on the neighbouring countries such as Ivory Coast, for transit passage of its cotton to seaports, making it vulnerable to external political instability and security concern. The present situation in Ivory Coast for the last five years had led SOFITEX to divert traffic away from the port of Abidjan.

## **3.8 STRUCTURING OF THE FACILITY**

Given the high risk in post-harvest activities, conventional financiers are not willing to provide financing until cotton fibre reaches a safe port. As for Islamic finance, there is a

room to mitigate risks of farmers and ginners, SOFITEX, as well as financiers while stimulating cotton production in the country.

Without any financing facility, farmers face essentially two risks namely, production (crop) risk and late payment risk. The biggest risk for producers is the risk of late payment for their crop, which also gives rise to the storage cost risk. Proposed cotton financing facility aims to address this specific non-payment risk by structuring the transaction in such a way that a payment is made upfront at the ginning level to the farmers. Hence, they are assured the reward of their efforts.

SOFITEX, in the present structure of the cotton sector in Burkina Faso, is *de facto* credit guarantor during the period of production starting with the opening of the letter of credit for importing inputs, such as fertilizers, to the end of payments by off-takers. That is, its involvement extends from pre-harvest to post-harvest period. The financial risk is high, since inputs financing during pre-harvest period and crop financing during post-harvest period extend over two and a half years. The input recovery risk is low thanks to the linkage between input supply and seed cotton marketing and to the farmers' joint liability through agricultural cooperatives in Burkina Faso. However, most of the risks for the ginners, SOFITEX, lie on the buying of the seed cotton from the farmers as post-harvest activity.

On the selling side of the fibre bales to the off-takers, ginners offset the exchange rate risk by pricing their cotton in Euros. The counterpart risk is low and the contract performance risk is moderate to low because off-takers are selected among longstanding established players. Defaults of off-takers and delayed shipments increase when prices drop from the contract date to the shipment date. Ginners seldom apply carrying charges to late shipments, and storage costs are not factored into the contract for late shipment.

As intimated, this section aims to show a creative way to fulfil financing needs of entities involved in post-harvest seed cotton processing activities while mitigating inherent risks by Islamic Structured Trade Finance design from the case of SOFITEX to facilitate production, ginning, transportation and warehousing at seaports, and shipping processes with the hope to pioneer literature in the area. In the real-life case presented herein, there

are two contracts: First contract is the *mudarabah* contract between *mudarab* and *rabb al mal* to delegate authority for undertakings of this financing operation. Second contract is a *murabahah* contract between *mudarab* and the beneficiary by which *mudarab* purchase cotton fibre from cotton producers and sell it to the beneficiary by a predetermined mark-up.

### 3.8.1 Security Structure for Financiers

Though the financing profession requires financiers to assume some risk, in order to decrease financial stress on their beneficiary, they also need to mitigate their risk. Below are some remedies for mitigating the risk of financiers in this specific structure.

- (i) Letter of Comfort from the Government of Burkina Faso, as per model provided by *mudarab*, to be provided.
- (ii) Pledge to *mudarab* of the export contracts with pre-approved off-takers from the financed cotton campaign, for a global amount equivalent to 110 per cent of the financing to be provided.
- (iii) Pledge of the nominated Debt Service Account (Escrow account) opened with an acceptable bank, whereby all amounts from the pledged exports will be credited and used exclusively for the repayment of the facility to be provided.
- (iv) A pledge of the physical cotton for a value equivalent to 115% of the facility amount produced from the financed cotton campaign, by way of warehouse Receipt issued by a Collateral Management Company acceptable to financiers, on a volume of cotton fibre equivalent to the financing remaining to be repaid.
- (v) The primary source of repayment is to be the assignment of the part of the export receivables arising from the financed cotton harvest, to be credited to the nominated debt service account (Escrow account) opened with a bank acceptable to *mudarab* out of Burkina Faso. This assignment will be made on the basis of a mechanism to be agreed between the *mudarab* and the Beneficiary, following the export calendar of cotton fibre to be communicated by the Beneficiary.

It should be noted that in this structuring Escrow Account would mitigate the foreign exchange and country risk for financiers. Warehouse receipt would guarantee the physical control of the commodity to financiers while the export contract would assure timely repayment of the financing facility. In the following section, implementation schedule is provided with more comprehensive understanding of the security package for financiers.



### 3.8.2 Security Package and Schedule for Implementation

Prior to the declaration of effectiveness, a collection account (Escrow Account) denominated in Euro/US\$ in the name of the *mudarab* or its agent is opened with a bank acceptable to *mudarab*. This account will be pledged to the *mudarab* (if not in the *mudarab* name) and through which part of the export receivables will be channelled, to be used as a source of repayment to participating financial entities. Table 3.10 shows the time of activities and their owners, spanning from Quarter 2 of the “Year (t)” to Quarter 3 of “Year (t+1)”.

**Table 3.10: Schedule of Cotton-Financing Cycle**

Operation	Q 2–(t)	Q 3–(t)	Q 4–(t)	Q 1–(t+1)	Q 2– (t+1)	Q 3– (t+1)
Distribution of inputs to farmers (SOFITEX)						
Sowing of seeds (FARMERS)						
Rainy season						
Harvest (FARMERS)						
Collection (Cooperatives)						
Disbursement of facility (FINANCIERS)						
Ginning (SOFITEX)						
Export (SOFITEX)						
Export proceed (OFF-TAKERS)						

*Source:* International Islamic Trade Finance Corporation of Islamic Development Bank Group

In coordination with the Beneficiary, SOFITEX, a bank/agent will be nominated by the *mudarab* as Facility Agent to perform the tasks, on behalf of the *mudarab* and all participants to receive and perform reasonable checks on the following documents for authenticity, accuracy, relevancy, *etc.* as submitted to them, for verification of:

- (i) The list of pre-approved off-takers;
- (ii) Sales contracts amounting to at least 110% of financing amount;
- (iii) *Takaful* policies (loss payee clause);
- (iv) The Pledge duly notified to all off-takers;
- (v) Off-takers confirmation for receipt and duly acceptance of the written notification to pay in Escrow Account.

A pre-approved list of off-takers is agreed with the *mudarab*. These are selected according to their reputation and longstanding business relationship with SOFITEX and the other ginners (in terms of size of turnover, consistency and mode of payment). As early as September of year (*t*), export contracts will be signed with the selected off-takers. These export contracts will be assigned to the *mudarab* for an aggregate value representing 110% of the disbursement amount. Off-takers acknowledge assignments of sales contracts and accepts to domicile payment to the nominated Escrow Account or commonly known also as the Collection A/C (Through the Notice of Assignment forwarded by the Facility Agent).

A CMMC (Collateral Management & Monitoring Contract) shall be signed in September but not later than October of year (*t*) between SOFITEX and the *mudarab* of *rabb al mal* and a reputable Collateral and Monitoring Manager. SOFITEX arranges and renews an all-risk comprehensive storage and transport *takaful* with a first class *takaful* company (or consortium of insurers) with specific clause for the *mudarab* as loss-payee before the disbursement of the facility.

After collection of cotton by GPCs from farmers, the *mudarab* enters into a *murabahah* agreement with SOFITEX by which the *mudarab* buys cotton fibre from GPCs upfront and sells it to SOFITEX on a deferred base with a mark-up at the time of exports.<sup>74</sup> The facility is disbursed to the Beneficiary according to tranches based on a call option as follows:

**(i) Tranche 1 – At the ginning level**

$$75\% * \{ \text{Ginning Outturn} * \text{Quantity of Seed Cotton} * \text{Average Price} \}.$$

**(ii) Tranche 2 – Upon shipment of cotton fiber**

$$85\% \{ (\text{Effective Price} * \text{Quantity of Cotton Fibre}) \} - \text{Disb. Tranche 1}$$

or

$$85\% \{ (\text{Average Price} * \text{Quantity of Cotton Fibre}) \} - \text{Disb. Tranche 1}$$

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<sup>74</sup> SOFITEX act as agent of the Mudarab in Murabaha Agreement

where :

*Ginning Outturn* stands for Ginning average rate of 0.42 (42%) into fibre;

*Quantity of Seed Cotton* stands for Quantity of Seed Cotton delivered at the ginning mills;

*Average cotton price* stands for the lowest average price of the cotton market prices or the average cotton market of the export contracts;

*Effective Price* stands for the price stated on sales contracts pledged to the *mudarab* signed between SOFITEX and pre-approved off-takers;

*Quantity of Cotton Fibre* stands for Quantity of Cotton Fibre delivered after the ginning process;

The basic idea with the tranches is that the financing amount shall remain less than the market value of the commodity at hand in Ginning Warehouse (Seed Cotton) and Port Warehouse (Cotton Fibre Bale). That is, the *mudarab* disburses the financing facility based on the market value of seed cotton and cotton fibre bale in the warehouses.

SOFITEX will get seed cotton from GPCs as an agent of the *mudarab* to its ginning mills under the supervision of Collateral Monitoring Manager (CMM), as designated. SOFITEX gins the seed cotton, packed into bales, graded and stored, placed under the custody of the nominated CMM at the premises of SOFITEX and/or ready to be sent by trucks to the terminal warehouse at the ports of export. Every time that the *CM* acknowledge receipt of cotton bales, the latter issues a Warehouse Receipt (*WR*). Control over the physical cotton is maintained through the *WRs*. When the time for executing corresponding exports (as per the list of contracts pledged to the *mudarab*) approaches, the cotton fibre bales are stuffed in containers. The Freight Forwarder under the supervision of the CMM prepares the export documentation as per the normal business practice. The necessary application is submitted to the Facility Agent, which undertakes the due diligence, as per security package.

After each shipment, Freight Forwarder hands over the shipping documents to the Facility Agent for checking and verification purposes, before submission, alongside the collection order to the collecting banks for negotiation and payment by the off-takers. Payment shall be received in the nominated Escrow Account. The amount in the Escrow Account and/or the utility proceeds assigned to the *mudarab* in the Escrow Account shall be kept committed as long as there remains any due amount. Any excess funds thereafter held in the Escrow Account may be drawn by the Beneficiary. In the event that the *mudarab* does not receive on the due maturity date any sum due under the Facility, then the Beneficiary shall pay (on first demand) the sum (or any shortfall therein) due to the *mudarab* (including any costs or expenses) together with further penalty to be levied on behalf of *rabb al mal*. The details of export cash flow are schematically provided as in Appendix III.

### **3.8.3 Collateral Management**

The Collateral Management Company has a pivotal role in all this transaction process. Hence, the following Collateral Management System is again explained for the clarification on its role in the structure.

A reputable CMM capable of field warehousing at the ginning mills and shipping services in every West Africa ports and experience in cotton collateral activities needs to be appointed. A CMMC (Collateral Management and Monitoring Contract) is signed immediately between SOFITEX, the *mudarab*, and the CMM, which will be in charge, amongst others, mainly of the following tasks:

- (i) Monitoring of truck arrival with seed cotton at ginning mills;
- (ii) Oversee the weighting of the truck at the weighbridge of the factory;
- (iii) Oversee the issuance of the weighting ticket for each truck load at each ginning mill for seed cotton;
- (iv) Oversee the ginning process;
- (v) Review of documents prior to submission to Facility Agent for disbursement;

- (vi) Provision of a storage certificate for fibre production indicating the quality, the quantity and the weight of the cotton bales produced (to be converted to warehouse receipt);
- (vii) Reconciliation of the quantities exit from the factories to those received in the harbour warehouse stores.

The nominated CMM will start monitoring the ginning process and cotton production and packaging into bales, on arrival of seed cotton at the mills. The cotton bales are to be placed under the custody of the nominated CMM at the premises of SOFITEX, the ginner, and in the CMM-leased warehouses at the ports of export. The *mudarab* is to be ranked first as far as pledge of the cotton stock is concerned. The CMM will provide a 'Professional Indemnity *Takaful*' that will cover against the risk associated with losses/deterioration or decrease in value of the collateral, in its custody or expenses incurred, arising out of negligence, default and wilful misconduct, *etc.* by itself and its employees in the performance of the CMMA.

Every time that the CMM acknowledges receipt of cotton bales, it issues *WR*. Control over the physical cotton is maintained by way of the *WRs*. These *WRs* are pledged to the *mudarab* on account of all participants, issued in the name of SOFITEX, acting for and on behalf of the *mudarab*. The *mudarab* is to be entitled to receive *WR* for a quantity of cotton equivalent in value to the tonnage at the average price, stipulated in the export contracts signed with pre-approved off-takers. At any point in time, the value of the *WRs* should be higher than the outstanding amount due. CMM should also determine the number of good and damaged bales prior to issuance of *WRs*.

Cotton bales are stored at the premises of SOFITEX at different locations and progressively sent to the nominated ports by trucks or for transit storage prior to shipment. Each time there is transfer, CMM should issue bales transfer and delivery notice statements. Upon arrival at port, CMM will reconcile quantities shipped from the factories to those received in the harbour (terminal) warehouse stores.

SOFITEX may request authorization from the Facility Agent of the *mudarab* to release for shipment, upon either:

- (i) Remittance of the appropriately worded L/Cs from the pre-approved off-takers, checked by the *mudarab*'s nominated Facility Agent for conformity;

or

- (ii) Against formal instructions (with copy to the Facility Agent) giving details on quantity, price, loading, shipping line and destination, from the pre-approved off-takers to ship the good to final destination, under Documentary Collection. Under this arrangement, the Facility Agent will be acting as Remitting Bank for presentation of shipping documents along with Collection Order to the Collecting Bank to receive payment and release of documents.

After each shipment, the CMM presents the documents to the Facility Agent for checking and verification purposes, before submission to the banks of the off-takers for negotiation and payment.

As mentioned earlier, payment will be received in the nominated Escrow Account. Besides, any *WRs* remained in the custody of the Facility Agent, after full repayment will be surrendered to SOFITEX/other ginners, after endorsement. Any balance remaining in the nominated Escrow Account, after full repayment of all amount due, shall be transferred to the account designated by SOFITEX.

### **3.9 EVALUATION OF THE STRUCTURE**

Much of the benefit from the perspective of the Beneficiary, SOFITEX, is lost through having to pay money up front into an Escrow Account. The whole amount of export receivables remains in an account, albeit SOFITEX may receive interest revenue, until full repayment of the facility. The current structure may be revised as follows: when the farmers bring their seed cotton for ginning, ginners process this seed cotton to cotton fibre and the *mudarab*, on behalf of *rabb al mal*, purchases the cotton fibre. Let's assume the *mudarab* on behalf of *rabb al mal* purchased 70,000,000 kg of cotton fibre, it will only buy for 85% of the prevailing cotton fibre value, and the prevailing market price for cotton fibre is 1 Euro. The *mudarab* on behalf of *rabb al mal* purchases 70,000,000 kg of cotton fibre for  $70,000,000 * 1 * 0.85 =$  Euro 59,500,000. After processing of seed cotton, the *mudarab* on behalf of *rabb al mal*, has the ownership of 70,000,000 kg of cotton fibre. Let's assume three months after the purchase of seed cotton, the Beneficiary of the financing wants to sell 20,000,000 kg of cotton fibre. The *mudarab* on behalf of *rabb al*

*mall* sells this amount for  $20,000,000 * 0.85$  (purchase price for 3 month back)  $*(1+0.07/4)$  = Euro 17,297,500 to the Beneficiary. Note that 0.07 is assumed to be predetermined mark-up per annum for illustration purposes. Each time of the sale, only this part of the export receivable shall be asked to be transferred to the escrow account. And, any profit of the Beneficiary, from increased cotton fibre prices and profit margin of export sales, remains in its account.

As a matter of fact, the existing *murabahah* structure is not a perfect fit. *Salam* would be much more suitable for this kind of operation. If we divide the cotton production as pre-harvest and post-harvest, the structure designed herein is targeted to finance post-harvest activities through a straightforward *murabahah* financing. However, there is a huge potential of poverty alleviation through pre-harvest financing. Accordingly, to be more effective, the financing ought to be provided at the beginning of the cycle in the pre-harvest period during the procurement of fertilizer, pesticides, urea, seed, *etc.* as input financing. This would assure the timely delivery of input to farmers and the start of the production cycle. A *mudarab* could get into a *salam* contract with the cooperative, *GPCs*, or the ginner as per the mechanism as follows. The necessary inputs are pre-ordered with input providers, and distributed according to the cotton crop agenda. Distribution shall be through cooperatives, *GPCs*, which have the responsibility for distributing them to farmers. CMM (under a collateral management agreement) oversees the stocks of inputs at the level of the gins and the cooperatives, and monitors the whole process of distribution, tallying and weighing the actual movements of inputs from the input providers to the farmers. The principle is that individual farmers have to pay, through deduction from the proceeds of their seed cotton sales after harvest, for the inputs that they have received. Farmers deliver their seed cotton to their cooperative, and receive a delivery ticket acknowledging delivery. This delivery ticket is matched with the earlier input deliveries, enabling a correct deduction of input costs. The cooperatives deliver the seed cotton to the cotton gins, where it enters into warehouses controlled by CMM, which, at this stage, issues warehouse receipts for the seed cotton in cotton fibre equivalent terms, based on each gin's processing ratio. Based on this, the *mudarab* gets the ownership of seed cotton.

At the next step the *mudarab* can choose between *istisna*, Islamic manufacturing contract, and *musharakah*, Islamic joint-venture, finance. *Istisna* may not fit this kind of short-term transaction. In any case, pre-harvest financing would decrease the financing burden of 2.5 year on the ginning company, SOFITEX, and the public sector while assuring valuable foreign exchange earnings for the country. For illustration purposes, simplified price calculation for *salam* agreement is provided as below in Table 3.11.

**Table 3.11: Salam Price Calculation**

<b><u>Question: How to define price in Salam contract for Structured Cotton Trade Financing?</u></b>				
Assumption: Pre-determined mark-up is 7 % per annum.				
Time	March 1, 2010	December 1, 2010	February 1, 2011	March 1, 2011
<b>Point for Scenarios</b>	<b>Time-1</b>	<b>Time-2</b>	<b>Time-3</b>	<b>Time-4</b>
Cotton Fiber price per Kg	1 Euro	0.9 Euro	1.2 Euro	1.3 Euro
Cotton Fiber price per tons	1000 Euro	900 Euro	1200 Euro	1300 Euro

**First Scenario:**

**Time-1**  
*MUDARAB* disburses Euro 10 million, by which *MUDARAB* can buy 10,000 tons of cotton fibre at current price of 1 Euro/Kg from the market. The cooperative or ginner agrees to provide 30,000 tons of cotton fibre in December 1, 2010 under *salam* contract for the disbursement amount.

**Time-2**  
*MUDARAB* assumes pledge of 30,000 tons of cotton fibre in warehouses monitored by CMMC.

**Time-3**  
The ginner asks for the release of 20,000 tons of cotton fibre. *MUDARAB* receives only the following amount in an escrow account to release the cotton fibre (*MUDARAB* sales the cotton fiber of 20,000 tons for):

$$(10,000/30,000)*20,000*1,000 \text{ Euro}*(1+(0.07*(11/12)))=$$

$$6666.667*1,000 \text{ Euro}*1.064167= 7,094,444 \text{ Euro}$$

Mark-up= 7,094,444-6,666,667  
Mark-up= 427,777 Euro

**Time-4**  
The ginner asks for the release of 10,000 tons of cotton fiber. *MUDARAB* receives only the following amount in an escrow account to release the cotton fibre (*MUDARAB* sales the cotton fibre of 10,000 tons for):



$(10,000/30,000)*10,000*1,000 \text{ Euro}*(1.07)=$   
 $3333.333*1,000 \text{ Euro}*1.07= 7,094,444 \text{ Euro}= 3,566,667 \text{ Euro}$

Mark-up= 3,566,667 - 3,333,333

Mark-up= 233,333 Euro

**Total mark-up for the first scenario= 427,777 + 233,333 = 661,111 Euro**

## **Second Scenario:**

### **Time-4**

The ginner asks for the release of 30,000 tons of cotton fibre. *MUDARAB* receives the following amount in an escrow account to release the cotton fibre (*MUDARAB* sales the cotton fibre of 30,000 tons for):

$(10,000/30,000)*30,000*1,000 \text{ Euro}*(1.07)=$   
 $10,000*1,000 \text{ Euro}*1.07= 10,700,000 \text{ Euro}$

On March 1, 2010 Euro 10,000,000 disbursed and a year later amount repaid back with Euro 700,000 mark-up

**Total mark-up for the second scenario= 700,000 Euro**

*Source:* The author

While evaluating the post-harvest *murabahah* financing alone or extended *salam* pre-harvest financing followed by *musharakah* post-harvest financing, the single most important issue remains as ensuring the full control of quality commodity. Hence, *takaful* during storage from a reputable *takaful* company is essential. However, *CMM*'s role as quality and quantity assurer turns out to be as important as *takaful* of commodity in warehouses. Any misconduct or default by *CMM* would destroy all this structure. Hence, the *mudarab* needs to mitigate the risk transferred to *CMM* by requiring *CMM* to provide Professional Indemnity *takaful*, again, from a reputable *takaful* company. Under necessary *takaful* coverage and structure designed herein, by which most of the risk transferred to the parties able to handle those risks, some other 'Islamic Structured Trade Finance' deals can be successfully conducted as a tool to alleviate poverty and make this sustainable through the assurance of timely repayment of financing amount back to credit providers.

### 3.10 RISK ANALYSIS

After explanation of the facility structure and extended structure for supply chain financing it is imperative to have a comprehensive risk analysis to identify possible risk, their causes, preventive actions and contingencies. In the process, 11 risk areas are identified for risk management. Throughout this section, the exporter or the beneficiary refers to SOFITEX Risk and their likely causes are summarized in Table 3.12 for commodity risk area.

**Table 3.12: Addressing the Commodity Risk Area**

Risk Areas	Risks	Likely Causes
1.Commodity	Inferior Quality and/or Quantity	1. Inability of Farmers to procure fertilizer and insecticides 2. Low quality seeds planted by farmers 3. Drought, Floods
	Defective title / counterfeited titled documents	1. Fraud by Exporter 2. Cotton stolen 3. Dispute over ownership of Cotton
	Cotton encumbered	1. Exporter has lien over Cotton in respect of storage/processing expenses.

Source: Designed by the author

Inferior quality risk and its likely causes would be addressed by securing input financing through *salam* contract and SOFITEX supervision on inputs used by farmers. As per contingencies:

- SOFITEX reconciles the Price from the Export Contract price (reverse downward) to the intake offered for purchase by the Cooperative;
- SOFITEX rejects inferior quality;
- Export Contract makes provision for Force Majeure.

In the same fashion defective title and counterfeited titled documents would be addressed by warranty from Exporter as to his good title, no defects, *etc.*, use of a collateral manager to oversee warehouse storage and movements of cotton, and Collateral Manager' request for confirmation of payment from the Exporter to producer or original

seller of the Cotton. As a contingency measure the Facility Agent may visit stocks in any time. Besides, ‘Professional Indemnity *Takaful*’ from CMC might be resorted to. As for the possible lien by exporter on cotton for storage and processing expenses, following mitigants/contingency measures should be put in place:

- (i) Costs are paid by Facility Agent directly for storage and Processing (No lien of Exporter);
- (ii) Warranty from Exporter as to his good title, no defects, *etc.*;
- (iii) *CMMC* requests confirmation of payment from SOFITEX to producer or original seller of the cotton;
- (iv) Waiver and Consent from Exporter lifting all their rights on the cotton delivered against payment.

Second risk area in the proposed structure is associated with storage and transportation as outlined in Table 3.13:

**Table 3.13: Addressing the Cotton Storage and Transport Risk Area**

Risk Areas	Risks	Likely Causes
2. Cotton Storage & Transport	Loss of Cotton	<ol style="list-style-type: none"> <li>1.Lack of controls at Processor/ Cooperative</li> <li>2.Incompetent personnel</li> <li>3.Collusion between Parties and Exporter</li> <li>4.Force Majeure</li> <li>5.Weight recording incorrect</li> <li>6.Quality recording incorrect</li> <li>7.CMMC supervision during transport Inadequate</li> </ol>
	Damage to Cotton so Exporter cannot supply it to Off-takers	<ol style="list-style-type: none"> <li>1.Storage facilities sub standard</li> <li>2.Manpower requirements inadequate</li> <li>3.Theft or Misappropriation</li> <li>4.Force Majeure</li> </ol>
	Stored Cotton infected/ contaminated with disease and Facility Agent still collects document proceeds from Off-takers with potential subsequent claim for damages	<ol style="list-style-type: none"> <li>1. Insect infestation.</li> <li>2.Negligence of Processor /Cooperative</li> <li>3.Willful default by Exporter</li> </ol>

*Source:* Designed by the author

There are substantial risks associated with loss, damage and contamination in the process of storage and transportation of seed cotton. To address the likely cause of these risks

reputable transporters and stores would be used. Storage agreements would define responsibility of collateral managers, who hold liability *takaful*, to ensure adequate system for document title of ownership in the form of warehouse receipt. Also, the facility agent utilizes exclusively approved Processors/Warehouse/Forwarder to minimize collateral management and monitoring risk. As a contingency measure, claim can be placed against professional indemnity *takaful* for misappropriation by collateral management company.

Third risk area is associated with the Beneficiary/Exporter (SOFITEX in the case presented herein). There might be closure of ginning miles of the beneficiary due to breakdown or repair of machines. These are identified in Table 3.14.

**Table 3.14: Addressing the Beneficiary/Exporter Risk Area**

Risk Areas	Risks	Likely Causes
3.Beneficiary/ Exporter	Non-performance of the beneficiary	Closure of ginning mills due to breakdown of machines and repair

*Source:* Designed by the author

As a result, the beneficiary should be long-established as ginner with extensive technical expertise. The track record on international markets should be checked. In the case specific to this facility, SOFITEX as a beneficiary/exporter has many ginning machines in different regions of the of the country so in case of breakdown in one location the capacity of ginning machines in other locations can be employed. Still, a letter of comfort on capacity of the beneficiary to operate from the government should be arranged.

There can emerge risk with warehouse/processor not maintaining, storing or processing cotton due to change in statutory status, management and standards of storage.

**Table 3.15: Addressing the Warehouse and Processor Risk Area**

<b>Risk Areas</b>	<b>Preventive Action</b>	<b>Contingency</b>
4. Warehouse & Processor	a) Due diligence assesses Exporter's abilities and competency b) Storage agreement with 'licensed' Processors/Warehouse/Forwarder states that CMMC is holding the pledge (the Cotton) in favour of its legal owner (Facility Agent) c) CMMC of behalf of Facility Agent utilizes exclusively Processors/Warehouse / Forwarder to minimize risk that are "licensed" and fully controlled by them	Claim against Professional Indemnity <i>Takaful</i> from CMMC  Utilize alternate Processor / Storer (Facility Agent owns the Cotton through warehouse receipt) to complete transaction

Source: Designed by the author

For this risk preventive action and contingency actions are outlined as in Table 3.15. In the same fashion, substantial risk of non-payment due to insolvency, economic downturn and financial distress by Off-takers exist. In Table 3.16, corresponding preventive and contingency actions are outlined for reference.

**Table 3.16: Addressing the Off-takers Risk Area**

<b>Risk Areas</b>	<b>Preventive Action</b>	<b>Contingency</b>
5. Credit on Off-takers	a) Facility Agent still owns the cotton and can resell it in the trade or tender it on commodity exchange b) If not satisfying, non-rated Off-takers will have to open LCs. c) On FOB basis, Bill of Lading and other export docs to the order of Facility Agent. d) Off-takers cannot lift docs unless paid e) Off-takers are pre-approved by <i>mudarab</i> f) Off-takers are long-established with proven records and working relationship with the Beneficiary, SOFITEX in this case	Sell balance of cotton in open market, as there is a very liquid international cotton market

Source: Designed by the author

In case preventive actions do not prevent failure of the structure, the *mudarab* can sell the cotton on the open market as the cotton market is liquid and ownership stays with the *mudarab* in this structure.

There is a substantial risk associated with sale value of the cotton to be pledged for financiers due to drop in demand for cotton in the world market due to oversupply and economic downturn. Besides, low quality of cotton pledged would decrease the sale value of the cotton pledged.

**Table 3.17: Addressing the Cotton Value (Sales) Risk Area**

Risk Areas	Preventive Action	Contingency
6. Cotton Value (Sale)	a) Rights in Forward Sale Agreement ceded to Facility Agent. b) Facility Agent reconciles price at intake from Exporter with Export Contract fixed price and quality/quantity congruence with export Contract terms. c) Analysis of the Supply/Demand on both local and international level at commencement of the season.	Export Contract is fixed price-based with only approved Offtakers.

Source: Designed by the author

For this reason as shown in Table 3.17, analysis of Supply/Demand in both local and international markets need to be done at the beginning of the season to define safety margins on amounts of cotton to be pledged. In case of expected low global demand, cotton pledge of up to 150% of the financing facility might be sought. In any case, fixed price-based export sale contracts, as they need to be provided to the *mudarab* before the financing, would create enough contingency to sustain certain levels of value for cotton to be pledged.

However, the nature of export sale contracts necessitates supply of certain quality cotton. Any bottleneck in providing so would create a serious risk of export transaction as Off-takers may refuse to honour their obligation due to unfit cotton quality described in export sale contracts. This may happen in case of incompetence or fraud by the collateral management monitoring company in the process of issuing warehouse receipts by overstating the quality of the cotton.

**Table 3.18: Addressing the Cotton Value (Purchase) Risk Area**

Risk Areas	Preventive Action	Contingency
7. Cotton Value (Purchase)	a)CMA states duties of CMMC b)Facility Agent and CMMC are informed of the Export Contract’s Quality and Quantity requirement c)CMMC involved from intake at factory gates – substandard cotton will not be taken in on warehouse receipts (WHR i.e. “LTD”) by CMMC	Claim against Professional Indemnity <i>Takaful</i> from CMMC

Source: Designed by the author

In case preventive action does not work, a claim can be placed at any time on the professional indemnity *takaful* of the collateral management monitoring company to cover possible loss out of substandard cotton admitted to warehouses. As indicated in the above preventive action in many risk areas, the role of the facility agent is detrimental in this structure. Incompetency of the facility agent in the form of items highlighted in Table 3.19 may give rise to serious operational risk.

**Table 3.19: Addressing the Facility Agent Risk Area**

Risk Areas	Risks	Likely Causes
8. Operational (Facility Agent)	1.Fraud/ Misappropriation 2.Inadequate controls 3.Statutory 4.Documentation 5.Administration 6.Information Technology	1.Inadequate internal controls 2.Breakdown in basic controls 3.Changes to Act and Regulations 4.Documentation not legally binding 5.Administrative burden too big for administrative department

Source: Designed by the author

It should be noted that serious preventive action in the form of internal and external audit of the facility agent, hence, would be crucial after background checks for the internal capacity of the facility agent to carry out these serious tasks during the selection process. The same process of selection needs to be carried out on the collateral management and monitoring company. The capacity of the facility agent and collateral management and monitoring company is also an important preventive measure to address risk areas for grading, transportation, processing and storage. The components of these risks are highlighted in Table 3.20 below.

**Table 3.20: Addressing the Grading, Transport, Processing and Storage Risk Area**

Risk Areas	Risks	Likely Causes
9. Grading, Transport, Processing, Storage	1.CMMC's graders not properly trained 2.Grading not 100% accurate 3.Loss (Quantity) due to Perils	1.Insufficient training and experience 2. Spillage 3. Theft 4. Accident 5. Weighbridge errors 6. Fire and others 7. Errors and omissions by CMMC

Source: Designed by the author

Again, professional indemnity *takaful* of the collateral management and monitoring company constitutes a valuable contingency measure. As a result, *takaful* risk caused by inability of the *takaful* company to honour its obligations, inadequacy of *takaful* coverage or unidentified risk under *takaful* policy should be addressed by the preventive actions as outlined in Table 3.21.

**Table 3.21: Addressing the *Takaful* Risk Area**

Risk Areas	Preventive Action	Contingency
10. <i>Takaful</i> (CMMC Prof. Indemnity and cover against perils)	a)CMMC uses exclusively rated underwriters b)Complete <i>takaful</i> policy for “All Risk” plus misappropriation - with Facility Agent as loss payee – within maximum warranted value per location and occurrence c)CMMC Professional Indemnity Cover limit within maximum warranted value per occurrence d) <i>Mudarab</i> ’s Legal involvement in <i>takaful</i> policy inclusions e)Detailed report from Insurer on exposure on claims deriving from massive events (terrorist attacks, natural disasters, etc.)	<i>Takaful</i> Industry Risk

Source: Designed by the author

Regardless of due diligence on *takaful* policies, industry risk for the *takaful* sector would persist as it is not within the means of financiers to address industry risk of the *takaful* sector. Therefore the risk areas outlined in Table 3.22 should also be addressed.



**Table 3.22: Addressing the Industry Risk Area**

<b>Risk Areas</b>	<b>Risks</b>	<b>Likely Causes</b>
11. Industry	1 .Production exceeds international demand 2.Statutory taxes increased 3.World prices decreases 4.SOFITEX cotton not the 'preferred choice' product in the industry 5.Protective measures or legislation removed by Government	1.Bad marketing of the cotton production and change in international market lifestyles 2.Government decision to increase its revenue 3.World population reduces consumption 4.Cheaper landed prices from other sources, quality issues on SOFITEX cotton 5.Influence of International traders leads Government to leave the industry to them

*Source:* Designed by the author

The fixed export contracts (in which quality, quantity, price/premium and delivery terms spelled out, with licensed off-takers or secured/approved off-takers' payment terms approved by the facility agent) can prevent any possible losses from industry risk. Fixed export contracts assure certain levels of certainty for the future against industry risk.

### **3.11 CONCLUSION**

This chapter aimed to show that Islamic finance instruments provide enough room to fulfil financing needs in extreme cases as a better alternative to conventional financing tools and extend the existing Islamic-structured trade finance structure into a supply chain financing. Different Islamic finance instruments need to be evaluated for different cases. The real-life case presented here, for example, shows the superiority of *salam* over *murabahah* for complete supply chain financing starting from the phase of input financing for the cotton sector.

In doing so, we can create benefits to different parties. From the case presented here, *rabb al mal* has excess liquidity but does not have expertise in neither the cotton sector nor structured trade finance. With this structure it can place its money into a secure financing transaction with a higher yield than regular financing transaction. *Mudarab* exercises its intellectual expertise to structure a safe transaction and attain a *mudarab* fee. The beneficiary gets a partner financing upstream production processes and reduces its

financial stress even under unfavourable financial situations as in the case of SOFITEX. Farmers get input on time through *salam* for pre-harvest activities. They immediately collect monetary reward for their effort in growing the crop as soon as they distribute their crops to the ginner's warehouse. They would not, hence, wait for 6-8 months to receive their money from exports receivables to purchase their basic necessities.

To conclude, this case study shows how to employ Islamic finance instruments in a structured trade finance deal as an alternative to conventional financing. The concept of Islamic supply chain financing starting from input financing to post-harvest pre-export finance is explained with real-life examples. This goes beyond explaining the existing case and proposes *salam* contract for complete supply chain financing starting from input financing and extend to post-harvest financing in order to pioneer literature in the area.

## Chapter 4

# TWO-STEP *MURABAHAH* AS AN ALTERNATIVE RESOURCE MOBILIZATION TOOL FOR ISLAMIC BANKS IN THE CONTEXT OF INTERNATIONAL TRADE

### 4.1 INTRODUCTION

The question for the Islamic finance industry is now whether to replicate entire conventional systems by creating instruments identical in substance through “combining a redundant succession of trade and label with an Arabic name” (Moddy, 2008) with the objective of form-related compliancy or innovate and streamline new products compliant to *Shari'ah*. As highlighted by Siddiqi (2007), the Islamic finance industry today tends to replicate conventional instruments by making it more complicated, while it stands vulnerable to the flaws of the conventional system.

After recent experience with the financial crisis, Islamic finance with focus on tangible assets and *Shari'ah* principles is perceived to have potential to prevent similar sufferings caused by the conventional system. However, the perception that Islamic finance is ‘immune to the excesses of the financial crisis’ is challenged by recent defaults of *sukuk*, which resulted in loss of confidence by investors (Islamic Finance, 2010).

In a nutshell, Islamic principles cannot buffer bad investment and it should be directed to support sustainable economic activities to create more wealth for a human-centred economic development. Hence, the recent *sukuk* defaults urge for alternative resource mobilization and liquidity management tools to be harnessed for economic growth while serving the needs of Islamic financial institutions.

Islamic financial institutions very often avoid borrowing from other banks so as to avoid any interest transactions which is prohibited in Islam. As it is obvious from its basic principles, Islamic law introduces many restrictions on commercial contracts in order to ensure justice in the transaction, avoid possible prospective legal disputes, avoid *gharar* (highly risky and uncertain transactions), speculation, *gambling* and ultimately give rise to a stable economic and financial system for society. Traditionally, Islamic banks recourse to *sukuk* and *commodity murabahah* instruments to mobilize resources.

However, recent failures in the *sukuk* market and common dissatisfaction with *tawarruq* - based *commodity murabahah* urge for development of alternative Islamic resource mobilization tools.

The *commodity murabahah*, inter-bank deposit/placement instrument, is perceived as rather a liquidity management tool as treasurers of Islamic banks to place excess money for a return through *commodity murabahah*. It is resource mobilization for the bank raising funds through *tawarruq* and liquidity management for the bank placing money through *murabahah* sale. The transaction involves buying and selling of metal commodities to supposedly provide conformity with Islamic principles. The market is dominant by the conventional banks which mobilize resources from Islamic banks through *tawarruq*.

In the real-life, there are four parties to the transaction namely, an Islamic bank, a conventional bank as an agent, and two separate brokers to effect sales of metal commodities. The Islamic bank buys commodity from the first broker, through an agency of the commercial bank, and sell it to the second broker with a mark-up in deferred payment.<sup>75</sup> This kind of circumventive initiation remind us first of serious challenges of usury within Western Christianity, when Hispanus introduced the notion that “although usury was prohibited, a lender could charge a fee if his borrower was late in making repayment”.<sup>76</sup> The result of this verdict gave rise to the legal ploy of *Contractum Trinius*. As the name reveals it is a three party contract by which a lender would engage in a profit/loss sharing deal with a merchant, get insurance against any loss and return any profit above pre-specified amount back to the merchant. After this first hole in the wall, interest-bearing loans had become legal in many countries within the Christian world. The experience of Western Christianity might urge Islamic bankers to curb their greed and vigilantly present responsible attitudes in this regard. Besides, an organized *tawarruq* arrangement somehow recalls recent financial scams. Case Box I related to Enron is provided to show resemblance in circumventing regulatory frameworks with a hidden agenda.

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<sup>75</sup> Bahrain Monetary Agency, *Islamic Banking and Finance in the Kingdom of Bahrain*, Bahrain Monetary Agency, 2002, p.30.

<sup>76</sup> Information on Vincentius Hispanus, <http://faculty.cua.edu/Pennington/1440i-p.htm>

### Case Box I: Enron, J. P. Morgan, and Offshore Special Purpose Vehicle

When Enron declared bankruptcy on December 2, 2001, J.P. Morgan Chase Bank had \$965 million in losses from payments due on oil and gas contracts with Enron. J.P. Morgan Chase Bank thought the contracts were hedged with surety bonds. The surety bonds were advance payment bonds that guaranteed Enron's credit risk on pre-paid oil and gas forward delivery contracts.

Surety bonds are a form of insurance, and protect against losses on specific assets. The insurance companies or sureties included Citigroup's Travelers Property Casualty, Liberty Mutual Insurance, and St. Paul companies among others. The insurers claimed J.P. Morgan Chase Bank and Enron used fraudulent inducement to cause them to enter into the contracts. They used this as a defense against not making immediate payments under the terms of the surety bonds. J.P. Morgan Chase Bank ("J.P. Morgan") sued in an attempt to recover payments.

J.P. Morgan lost a pre-trial bid in the Southern District of New York to get immediate payment from the insurance companies. As reported by Bloomberg news, in an affidavit filed in New York District Court, David Wilson outlined the gist of Enron's transactions, and the following is a possible reconstruction of one of the transactions based on my interpretation of that account.

J.P. Morgan lent \$330 million to Mahonia, an offshore special purpose vehicle also known as a special purpose entity, a corporation set up by J.P. Morgan in Jersey, one of the U.K.'s Channel Islands. In December 28, 2000, Enron sold gas forward to Mahonia, and agreed to make a series of deliveries from April 2001 to November 2005. J.P. Morgan bought protection in the form of surety bonds on Enron's obligation to deliver the gas, but the insurers are challenging the contracts with Mahonia Ltd., which were "guaranteed" with surety bonds. Mahonia Ltd. got a 7% discount from Enron for the gas, and prepaid \$330 million to Enron. Enron booked the upfront payment of \$330 million from Mahonia for the forward sales as revenue. At the same time, Enron bought gas forward from Stoneville Aegean Ltd., another offshore special purpose entity, a corporation set up by J.P. Morgan in Jersey. In fact, Stoneville and Mahonia had the same address and the same board of directors, and it appears Stoneville was under the control of Mahonia. In exchange for a series of forward deliveries from Stoneville, Enron agreed to make a series of ongoing payments to Stoneville totaling \$394 million.

The following diagram shows the cash flows of the transactions involving J.P. Morgan, Enron, Mahonia, and Stoneville:



It appears as if the \$330 million J.P. Morgan lent Mahonia ended up at Enron. It further appears that the loan payments due from Mahonia to J.P. Morgan are originating from Enron. Furthermore, it appears that Enron is booking what could be a \$330 million loan as upfront revenue instead of booking it as a liability.

Mahonia prepaid the amount owed for the forward delivery of natural gas. Mahonia Ltd. and Stoneville Aegean Ltd. had the same address in Jersey and the same board of directors. The proposed deliveries of natural gas Enron owed Mahonia matched the proposed deliveries Stoneville owed to Enron. It appears the contracts would be matched off, and there was never any intention to make delivery in the first place.

The surety bonds cover obligations by Enron on the series of forward deliveries to Mahonia, which are similar in value to the series of cash flows Enron owed to Stoneville. The upfront payment of \$330 million Mahonia made to Enron appears to match the amount of the \$330 million loan J.P. Morgan made to Mahonia. The series of monthly payments owed by Enron to Stoneville seems identical to the series of monthly payments owed to J.P. Morgan by Mahonia. The cash flows Enron owed to Stoneville seem to be the present value of cash flows on a series of loan payments at 7% interest, which would equal the amount lent to Mahonia by J.P. Morgan. Although ownership of the offshore vehicles isn't disclosed, it is possible that Stoneville is 100% owned by Mahonia.

The insurers claimed the loan and the forward contracts were linked, and they were victims of a fraudulent scheme between J.P. Morgan and Enron. They claimed J.P. Morgan and Enron tried to disguise a loan from J.P. Morgan to Enron by using offshore vehicles and sham forward contracts. Surety providers cannot insure loans under applicable New York law, so they claimed that by entering into these transactions, J.P. Morgan and Mahonia could induce the surety providers to insure the loans.

The insurers argued that since they provided the surety bonds based on fraudulent inducement and fraudulent concealment, they had a valid defense against having to perform under the surety bonds. J.P. Morgan denies the forward contracts were a de facto loan and that the transactions were linked. J.P. Morgan also denies knowing that Enron employed creative accounting and booked the forward sales as upfront revenue.

*Source:* Tavakoli (2004)

The main motivation behind this hustle of transaction is to fit liquidity management needs of Islamic banks into Islamic principles. Obviously this mechanism has some shortcomings as evidenced by different *Shari'ah* interpretations and there is no universal acceptance of commodity *murabahah*. Indeed, organized *tawarruq* was disallowed by Islamic *Fiqh* Academia as explained in the literature review section of this chapter.

The *murabahah* sale in these transactions has no purpose of facilitating trade for economic development. These transactions would rather dry funds for real-life trade financing, hence, undermine economic development. The mobilized resources from Islamic banks would be availed in developed countries but not developing countries. Besides, allocating of metals for commodity *murabahah* transaction would deprive industry, as needed materials would huddle in these kinds of transaction. Many proponents of commodity *murabahah* argue that this is not the case as the transaction of buying and selling of metals with commodity *murabahah* is not real. Then, *Shari'ah* issues rise as fake buying and selling of commodities is not enough to comply with Islamic finance principles.

Chapra<sup>77</sup> proposed that Islamic finance should be focused on equity share and profit-and-loss sharing. However, as he stated, greater reliance on equity does not necessarily mean ruling out debt financing, because all financial needs cannot be satisfied by equity and profit-and-loss sharing. Hence, debt financing in the modern economy due to the particular and prevailing modes of production being capitalism is indispensable given that it does not promote nonessential and wasteful consumption as well as unproductive speculation. It should, however, be noted that Islamic finance would differ from conventional ones in creating debt through sale or lease of real assets by modes of financing such as *murabahah*. The primary condition would be genuine trade transactions related to real economy activity with full intention of giving and taking delivery which is obviously missing with commodity *murabahah*.

As a matter of fact, one of the most widely used transactions in Islamic banking is *murabahah*. In the basic form of this sale, the buyer would know the price at which the bank and seller purchased the subject goods to be financed, and the buyer again accepts the repayment with a mark-up over the purchase price of the seller.<sup>78</sup> The main reason behind the widespread usage of the *murabahah* contract is low processing cost compared to other tools. There is a straight disbursement to the *exporter* at the initial stage and collection of profit, very often referenced from the corresponding disbursement day LIBOR, at the time of repayment. The financier takes the risk of beneficiary against balance sheet strength, collateral in the form of bank guarantee, mortgage, warehouse receipt, *etc.* This nature paves the way for successful resource mobilization and makes it very popular for Islamic Finance Entities.

This chapter, thus, proposes introduction of ‘two-Step *murabahah*’ to replace commodity *murabahah* for good. Islamic banks can place their excess funds to refinance letters of credit under *murabahah* agreements between a bank and an *importer*. To contextualise, let’s assume an *importer* in the Gambia needs to import yarn from Egypt by opening a letter of credit through its local bank as per the request of the Egyptian *exporter*. After

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<sup>77</sup> In his lecture in Institute of Islamic Banking and Insurance, London on 10<sup>th</sup> November 2008

<sup>78</sup> Going through the literature one may come across the narration on ‘Ibn Mas’ud ruling that there is no harm in declaring percentage profit margins. Technically, one may approach an Islamic financial institution and say “purchase these goods on my behalf at this price, and I shall give you a profit margin of 7%”. The statement may be perceived to make explicit reference to a percentage payment should not be of concern, since it is not Riba if the sale satisfies the conditions of Murabahah contract.

receiving financing request from the *importer*, the local Gambian bank can mobilize resources through the Islamic bank. The Islamic bank would buy yarn and sell it to the local Gambian bank with a mark-up in a deferred payment and the Gambian bank would sell it to the *importer*. As opposed to commodity *murabahah*, in this scheme the Islamic bank manages its liquidity by supporting trade and, hence, contributing to the economic development of a least developed country.

As stated above, the objective of this chapter is to show how to mobilize resources to make them available for SMEs, particularly in LDMC OIC countries, under Direct *murabahah* Sale transformed into a 2-Step *murabahah* scheme. The detailed structure of 2-Step *murabahah* is explained throughout the chapter.

Throughout the chapter there would be five entities namely, *Bank-A*, *Bank-B*, *Bank-C*, *Importer* and *Exporter* for illustration purposes. *Bank-A* and *Bank-B* are recognized financial institutions and they operate internationally while the operations of *Bank-C* are limited to the domestic market. The examples revolve around *Bank-B*'s business processes. It is *Bank-B*, which provides imported input to the *importer* under Direct *murabahah* Sale. Again, it is *Bank-B* which mobilizes resources from *Bank-A* through *mudarabah* and alternative Reverse 2-Step *murabahah* agreements in favour of the *importer*. The details of disbursement for line of financing provided by *Bank-B* to Local *Bank-C* to be utilized by the *importer* through 2-Step *murabahah* Agreement are also provided for Letter of Credit and Documentary Collection settlements.

In the next section, aims and objectives are elaborated. In the third section methodology is explained. In the fourth section literature review is provided. In section five some definitions are explained. Sixth section explains Direct *murabahah* Sale in the context of international trade. Seventh section shows the *mudarabah* as a tool for resource mobilization for Direct *murabahah* Sale. Section Eight explains Reverse 2-Step *murabahah* agreement for *Bank-B*'s resource mobilization from *Bank-A* as well as 2-Step *murabahah* agreement by which *Bank-B* provides line of financing to *Bank-C* to facilitate international trade in favour of the *importer*.<sup>79</sup> Ninth section explains the details of the

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<sup>79</sup> What makes 2-Step Murabaha Agreement reverse or not is Bank-B's point of view. From Bank-B's point of view, the agreement is



disbursement mechanism for line of financing provided to *Bank-C* from *Bank-B* through 2-Step *murabahah* Financing. Chapter ten goes through the 2-Step *murabahah* Agreement between *Bank-C* and *Bank-B* for the disbursement process explained in the previous section. The final section evaluates the proposed structure and concludes.

## 4.2 AIMS AND OBJECTIVES

This chapter aims to show how to mobilize resources through Islamic financial instruments to be utilized by importers in the context of international trade. It presents another real-life case study to avail more funds for trade finance accessible to SMEs in LDMC OIC countries. The aim, thus, is to propose 2-Step *murabahah* as a strong alternative to traditional Islamic resource mobilization/liquidity management tools, namely *sukuk* and commodity *murabahah*. It is aimed to indicate that Islamic financial industry can rise on 2-Step *murabahah* as an alternative to *sukuk* or commodity *murabahah*. This structure is to be evaluated to suggest 2-Step *murabahah* to be embedded in stock exchanges in order to transform real-trade transaction in service of the Islamic finance industry for liquidity management in the last chapter.

The model proposed in this chapter is, thus, based on a real-life case study, which provides the strength to the proposed model, as it demonstrates how the proposed model can also be applied in real life.

## 4.3 METHODOLOGY

This chapter aims to introduce the concept through a case study. As stated, throughout the chapter there would be five entities namely, *Bank-A*, *Bank-B*, *Bank-C*, *Importer* and *Exporter*. *Bank-A* and *Bank-B* are recognized financial institutions and they operate internationally while the operations of *Bank-C* are limited to the domestic market. The examples revolve around *Bank-B*'s business processes. It is *Bank-B* which provides imported input to the *importer* under Direct *murabahah* Sale. Again, it is *Bank-B* which mobilizes resources from *Bank-A* through *mudarabah* and alternative Reverse 2-Step *murabahah* agreements in favour of the *importer*. The details of disbursement for line of

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Reverse 2-Step Murabaha if Bank-B raises funds from other financial institutions for its own Direct Murabaha Sale to the beneficiary. The agreement would be called 2-Step Murabaha if Bank-B provides line of financing to another financial institution.

financing provided by *Bank-B* to Local *Bank-C* to be utilized by the *importer* through 2-Step *murabahah* Agreement are also provided for Letter of Credit and Documentary Collection settlements. The disbursement procedures are fully explained for 2-Step *murabahah* transactions in the case of the Gambian importer and Egyptian exporter of yarn.

As in the previous chapter, it should be noted that the information provided here is based on the researcher's work experience, which he gained through involvement in such cases. However, generic information is provided from ICC and ITFC/IDB, which have been referenced. Considering the nature of the information, the originality of the research presented here should be acknowledged.

#### **4.4 RESOURCE MOBILIZATION AND LIQUIDTY MANAGEMENT IN THE CONTEXT OF ISLAMIC FINANCE: LITERATURE REVIEW**

Based on the Islamic finance contracts, which were explained in the literature part of the previous chapter, Islamic banks have developed products for resource mobilization. Traditional Islamic finance resource mobilization tools have been *sukuk* and *tawarruq*-based Commodity *murabahah*. Both instruments give rise to serious debates on their economic impact and suitability to Islamic principles. In this section some insight on first Commodity *murabahah* and then *sukuk* is provided from the literature.

Chapra and Ahmad (2002) addressed the liquidity management difficulties with Islamic Banks in their work 'Corporate Governance in Islamic Financial Institutions'. As they state "two of the primary reasons for this are: the non-availability of adequate *Shari'ah*-compatible investment opportunities and the difficulty of raising liquidity in a *Shari'ah*-compatible manner". As Dusuki (2007: 2) states:

"Liquidity is an important characteristic of banks. By their very nature, banks transform the term of their liabilities to have different maturities on the asset side of the balance sheet. At the same time, banks must be able to meet their commitments such as deposits at the point at which they become due. Thus, liquidity management

lies at the heart of confidence in the banking operation”.

Dusuki (2007) counts liquidity risk as a significant one for Islamic banks due to limited availability of *Shari'ah*-compatible money-market tools. Accordingly, he counts introduction of the commodity *murabahah* tool on *tawarruq* as an innovative liquidity management tool.

In his position paper presented at the workshop on “*Tawarruq: A Methodological Issue in Shari'ah-compliant Finance*”, Siddiqi (2007) examined the impact of *tawarruq* on the economy. As he mentions, every *tawarruq*-based transaction for resource mobilizing party (*mutawarriq*) would create debt which is larger than cash transferred to the liquidity managing party (Islamic banks in present practice). In both Islamic *tawarruq* and conventional forms debt paper resulted subject to repeated financial speculative transactions. Though *tawarruq* transactions are based on real assets at the start, as a consequence the link with real assets would be severed without creating any wealth but debt. This process, as it implies, gives rise to an inverted pyramid of financial instruments underpinned by a small asset base. *Tawarruq* moves transaction from real economy to the money (debt) market where equilibrating mechanism is no longer linked to the real economy. Then, he scrutinized the consequences of this very creation of debt which is larger than cash generated and counts the harms and benefits of *tawarruq* as:

- (i) It gives rise to creation of debt which tends to accelerate;
- (ii) It emerges as exchange of money with money which is deemed to be unfair in the context of risk and uncertainty involved;
- (iii) It leads to speculation from gambling through debt proliferation;
- (iv) As it is debt financing, the practice seeds instability in economy. In a debt-based economy money supply is linked to debt which gives rise to inflationary expansion;
- (v) This practice is likely to deteriorate income distribution and inefficiently allocate resources;
- (vi) As a debt-financing practice this contributes to anxiety in society and destruction of the environment.

As he suggests, the harmful consequences of *tawarruq* are much greater than the benefits. He concludes that a financial tool whose harm is greater than its benefit shall not be deemed as *Shari'ah*-compliant.

Indeed, the issue of debt and instability was, very prominently, brought to the attention by Minsky (1977), who saw increasing fragility of financial system by debt inflation. He, therefore, embarked with insight of Keynes concerning the investment volatility, as he pointed out underlying uncertainty of cash flow from any investment would have repercussions for the balance sheet of businesses. Hence, governments would intervene with expansionary monetary policies to impede debt deflation so as to decrease risk in the process. As Minsky (1986) argued, such intervention by the government would not lead to long period of equilibrium but give rise to another investment boom through new debt. Consequently, such vicious circle created by government intervention lead to progressive build-up of debt, prevent debt contraction and, hence, economy would end up financially being much more fragile.

Shalhoob (2010), studied organized *tawarruq* in Islamic Law and suggested that organized *tawarruq*, as is the case with commodity *murabahah*, does not seem to be acceptable in Islamic Law. On the other hand, he counts organized *tawarruq* less unacceptable than usury, which is obviously prohibited in Islamic law. He further states that in case the money needed for an unimportant need, Islamic jurisprudence does not recommend involvement in organized *tawarruq*.

Iqbal and Molyneux (2005), with reference to the Islamic doctrine of universal permissibility in business practices which revolve around: “everything is permissible unless it is clearly prohibited”, explain the causes for rejection of conventional banking in Islamic Law and establishment of Islamic Banks operating under a profit-and-loss sharing principle. They introduced the principles and theoretical underpinning for Islamic banking and its instruments as *musharakah*, *mudarabah*, *murabahah*, *ijarah*, *salam* and *istisna*. On the other hand, they did not mention *tawarruq*, one of the most controversial instruments which has been practiced by Islamic banks regardless of declaration of

*Majma' al Fiqh al-Islami's* proceedings which counts *tawarruq* as non-compatible with Islamic Law.

Again, Dusuki (2007) highlights the importance of liquidity management for banks and provided some insight for the mechanism of commodity *murabahah* as a liquidity management tool for Islamic financial institutions. He also reviewed the *Shari'ah* issues related to the underlying contract of commodity *murabahah* namely, *tawarruq*. He identified *tawarruq*-based commodity *murabahah* as a value-added product which can meet investment interests of Islamic financial institutions which are uncomfortable with *inah*-based instruments. As Al-Zuhayli (1989) explained *bay al-inah* is an arrangement in which one party sells an asset to another party with deferred payment. Unlike *murabahah*, there is no third party and the selling party buys back the asset from the buying party before the payment of the deferred price and for cash of a lesser amount than the deferred price. As Ali (2007) states, the majority of Muslim jurists nullified *bay al-inah* as it is a red herring to circumvent *riba* transactions. Ahmad (2007) highlighted the purpose with *tawarruq*-based commodity *murabahah* as attaining liquidity for the buyer and resource mobilization for the other party in the transaction in which the buyer purchases an asset from the other party with deferred payment and subsequently sells the asset to a third party on cash of a lesser amount than the purchase price.

Although the forms of *bay al-inah* and alternative *tawarruq*-based commodity *murabahah* have different forms, both instruments serve the same economic substance. In both cases, the transaction is liquidity management for one party and resource mobilization for the other. There is no touch to the economy in the form of trade finance, infrastructure development or financing industry. In this form both instruments are akin to disguised loans in conventional financing. Accordingly, as once happened to *bay al-inah*, the underlying contract for commodity *murabahah*, *tawarruq*, has been tackled by Islamic jurists. Two rulings have been issued by the Islamic *Fiqh* Academy. In its 15<sup>th</sup> session, September 1998, the Academy permitted *tawarruq* given that the buyer of the asset, the customer of Islamic banks, does not sell the asset to its original seller in order to eschew *inah* which has been disallowed as it is perceived to be a legal trick for circumventing prohibition of *riba*. Nevertheless, the Islamic *Fiqh* Academy in its 17<sup>th</sup>

session, held in December 2003, classified *tawarruq* as real *tawarruq* (*tawarruq haqiqi*) and organized *tawarruq* (*tawarruq munazzam*). The real *tawarruq* has been allowed but the organized *tawarruq*, practiced by Islamic financial institutions, is disallowed as it is perceived to be synthetic and fictitious like *bay al-inah*.

Among other instruments, *sukuk* or Islamic bonds have been the main resource mobilization tools for Islamic banks for some time. However, recent failures of *sukuk*, particularly *murabahah sukuk*s and real estate *sukuk*, and dissatisfaction with commodity *murabahah* increased the importance of alternative Islamic resource mobilization tools. This research, hence, dwells on alternative Islamic resource mobilization tools.

*Sukuk*, the plural of the word *sakk*, are certificates of equal value representing undivided shares in ownership of tangible assets, usufruct and services or (in the ownership of) the assets of particular projects or special investment activities, however, this is true after the receipt of the value of the *Sukuk* the closing of the subscription and employment of funds received for the purpose for which the *Sukuk* is issued (AAOIFI Definition).<sup>80</sup> It is also known as an Islamic equivalent of a bond. As fixed income or *riba* (interest-bearing) bonds are not permissible in Islam, *sukuk* are securities that comply with Islamic Law. Although *sukuk* were extensively used in medieval Islam for transferring obligations originating from commercial activities including trade, in modern times *sukuk* relate to asset securitization. In its simplest form, *sukuk* transform future cash flow of an asset, existing or to be available in future, to present cash flow. It is a certificate of usufruct or ownership of an asset which entitles the owner to have return generated by the asset. This certificate is issued through a Special Purpose Vehicle (SPV) which acquires the asset and declares a trust in favour of the holder of the certificate. The certificate might present ownership of the asset or entitlement of rental income (Sukuk.me, 2010b). Therefore, this certificate provides return to the holder from either profit from rental, profit of sales or combination of both. In return the certificate owner takes the credit risk of the underlying asset (Sukuk.me, 2010c).

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<sup>80</sup> Available at [www.aaoifi.com/aaoifi\\_sb\\_sukuk\\_Feb2008\\_Eng.pdf](http://www.aaoifi.com/aaoifi_sb_sukuk_Feb2008_Eng.pdf) last accessed on 11 May 2012.

Like commodity *murabahah*, *sukuk* is also based on mainstream Islamic contracts as *musharakah*, *mudarabah*, *salam*, *murabahah*, *ijara*, *istisna* or a hybrid of these contracts. That is both resource mobilization and liquidity management instruments of commodity *murabahah* and *sukuk* are based on standard Islamic contracts. Valente (2009) accounts *sukuk* as a major driver for the Islamic finance industry.

With reference to the *Zawya sukuk* Monitor, from December 1996 to September 2009, 747 *sukuks*, valued at USD 106.6 billion, have been issued. By September 2009, USD 12.6 billion has matured and USD 94 billion is still outstanding to mature. About 74 per cent of *sukuk* is under USD 100 million. With the global financial crisis, there has been a slowdown in *sukuk* issuance as evidenced from USD 564 million issuance in the first two months of 2010 compared to USD 2.5 billion issuance in the first two months of 2009 (Cochrane, 2010). As Duyn (2009) highlights, 2007 was a peak with USD 25 billion *sukuk* issuance. He counts the financing arm of General Electric as the first western industrial company issuing *sukuk* in 2009 for USD 500 million. The *sukuk* market is rather dominated by construction and real estate followed by governments and the financial sector. Another characteristic of the market is fixed return rather than floating return. Besides, almost half of the *sukuk* have been rated.<sup>81</sup> Some *sukuk* have also been listed on stock exchanges.<sup>82</sup>

Since the first issuance in late 1996, there have been several *sukuk* failures of defaults though there is no clear definition of *sukuk* default of failure in *Shari'ah*. However, in a technical perspective it is basically the inability of the obligor with *sukuk* to make payments on the due date. The *sukuk* itself implies the presence of underlying assets owned by the certificate owner so entire failure is not perceived to be possible. In case of *sukuk* default, the obligor seeks rollover on payments or restructuring, otherwise embarking on litigation. Recent defaults in the market indicate two main causes:

- (i) Global Financial Crisis: in post-September 2008, gave rise to loss of liquidity and investors' confidence, imprinted Islamic financial industry due to debt

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<sup>81</sup> The majority of rated issues originated from Malaysia where rating is mandatory.

<sup>82</sup> Only 108 (14%) of total Sukuk issues were listed on stock exchanges. The Indonesian Stock exchange has the highest number of listed Sukuk (25), while Nasdaq Dubai has the highest value of Sukuk listings (USD 16.5 billion) (Zawya, 2009).

- restructuring, originator insolvency and defaults (Murdoch, 2010a).
- (j) Real Estate Sector Concentration: In connection with the global financial crisis, both real estate companies and financial institutions with heavy exposure to the real estate sector have adversely been affected. The *sukuk* market in the Gulf is mainly dominated by real estate developer as these assets are easy to structure and there has been an appetite for this sector after the collapse of the Gulf stock exchange in 2006 which directed excess liquidity to the real estate sector. In consequence, the asset quality of those Islamic banks in the Middle East deteriorated (Azzam, 2010). As Kaslowsky (2010) highlights, when the sector took the hit, underlying assets for these were *sukuk*, hence *sukuk* certificates backed or based on real estate, suffered. Even in the case of asset-backed *sukuk*, investors do not have confidence in legal claim for ownership rights on underlying assets in the Middle East due to undeveloped property law in the region. This fact is evidenced from the rating agencies evaluation of Middle East *sukuk* based on the credit rating of obligors rather than referencing to underlying asset (Valente and Richter, 2009). This implies the instability of real estate for underlying *sukuk* for some time though ease of structuring with real estate is likely to appeal to the industry again. In this period, the *sukuk* market might focus on production activities in the form of ship and aircraft lease, ship construction financing, energy and transportation (Kasolowsky, 2010; Uppal, 2010).

As studies in this research, *mudarabah* is introduced as an alternative resource mobilization tool. Chapra and Khan (2000) defined *mudarabah* as an agreement between two or more persons whereby one or more of them provide finance, while the others provide entrepreneurship and management to carry on any business venture whether trade, industry or service, with the objective of earning profit. The loss is borne only by the financiers in proportion to their share in total capital and the entrepreneur's loss lie in not getting any reward for his/her service. Those who provide funds in *mudarabah* are called *rab al-mal* and the entrepreneurship provider is called *mudarab*. Given the non liability of *mudarab* towards *rab al-mal* and lack of knowledge of *rab al-mal* on the financing details, potential of resource mobilization with *mudarabah* is limited. Hence, in this chapter 2-Step *murabahah*, (by which the entrepreneur is liable to the fund provider



(*rab al-mal*) is introduced as opposed to *mudarabah* for resource mobilization. 2-Step *murabahah* is also proposed as a liquidity management tool for Islamic Banks as an alternative to commodity *murabahah* operating on the controversial *tawarruq* scheme and *sukuk*.

Here above, main components of Islamic Finance in the context of resource mobilization is explained for ease of reference for case study and product development is introduced in this chapter, on 2-Step *murabahah* in the context of international trade, in pursuit of proposing Islamic finance means needed for implementation the OIC Ten-Year Programme of Action. 2-Step *murabahah* is a relatively new concept and not much, if not at all, is addressed in the literature. This research aims to pioneer in both subjects further academic endeavours in Islamic finance.

#### **4.5 OPERATIONAL DEFINITIONS: BUILDING THE MODEL**

International trade transactions usually involve many parties and instruments due to the cross-bordering nature of these transactions. As legal frameworks would change from one country to another, the international trade community developed special instruments to address different jurisprudence while mitigating risks for importers and exporters. In order to address these issues some instruments were developed by the trading community throughout history.

##### **4.5.1 Letter of Credit**

Letter of Credit (L/C), also known as Documentary Credit, is an undertaking by the issuing bank to pay a sum of money to a beneficiary (normally *exporter*) against presentation of documents stipulated in the credit on sight or deferred payment. In an L/C transaction *importer* would mitigate the risk of non-delivery by *exporter* and *exporter* would mitigate the risk of non-payment by *importer*. Based on the relationship between two parties several additional documents such as pre-shipment inspection certificate from a Collateral Management and Monitoring Company (CMMC) can be a part of L/C processing. Common documents used in Letter of Credit and Documentary Collection are as follows:

**'Financial Documents'** are: bills of exchange, promissory note or other similar instruments used for obtaining payment.

**"Commercial Documents"** are: invoices, packing list, certificate of inspection or any other documents which are not financial documents.

**"Shipping Documents"** are: bill of lading (B/L), air way bill, charter bill of lading or other similar documents used for obtaining goods.

**"Official Documents"** are: consular invoice, black list certificate, and certificate of origin or other related documents issued by a specific authority.

**"Takaful/Insurance Documents"** are: certificate of *Takaful*/Insurance and *Takaful*/Insurance policy used to insure the goods during shipment.

Parties to a Letter of Credit transaction would be:

**Issuing Bank:** The bank that issues the L/C upon request by its customer (applicant)

**Applicant:** The bank's customer who requests to open the L/C (normally *importer*)

**Advising Bank:** A bank who will receive, authenticate and advise L/C to a beneficiary. Normally this bank is the correspondent of the issuing bank and located in the beneficiary's country.

**Beneficiary:** A customer who will receive the L/C from the advising bank (normally *exporter*).

**Negotiating Bank:** A bank appointed by the issuing bank to receive and check the shipping documents before making payment to the beneficiary.

**Reimbursing Bank:** A bank nominated by the issuing bank to honour all claims from the negotiating bank.

**Confirming Bank:** A bank who adds confirmation to the L/C and carries the same responsibilities and liabilities like the issuing bank.

Letter of Credit can be irrevocable or revocable. In case of irrevocable L/C, a credit cannot be cancelled or amended unless the beneficiary, issuing bank and confirming bank agree. While in case of revocable L/C, a credit can be cancelled or amended by the issuing bank without consensus from the beneficiary or confirming bank (if any).

In outline, Letter of Credit works as follows:

- (i) The *importer* (applicant) and *exporter* (beneficiary) sign a contract.

- (ii) The *importer* fills in a standard application form requesting his bank to issue its irrevocable letter of credit in favour of the foreign exporter.
- (iii) The *importer's* bank issues its irrevocable letter of credit in accordance with the applicant's instructions and sends it to the advising bank.
- (iv) The advising bank notifies the credit to the *exporter*.
- (v) The *exporter* ships his goods based on the L/C terms and conditions and presents his documents to the bank for payment.
- (vi) The *exporter* presents the shipping documents to the negotiating bank for payment.
- (vii) The negotiating bank checks the documents and if everything is in order, pays to the *exporter*.
- (viii) The negotiating bank sends the documents to the issuing bank and obtains reimbursement.
- (ix) The issuing bank checks the documents and, if they comply with the L/C terms and conditions, reimburses the negotiating bank.
- (x) The *importer* collects the documents from the issuing bank and takes possession of the goods. He may have been required to make a cash deposit in advance with the bank or may have to reimburse it before receiving the documents.

#### **4.5.2 Irrevocable Commitment to Reimburse**

Irrevocable Commitment to Reimburse (ICR) is an undertaking by the refiner of an L/C to pay the negotiating bank for all negotiations under the L/C provided all terms and conditions of the credit are complied with. The ICR authorizes the negotiating bank to lodge its claim on the refiner's nominated paying agent by certifying to the refiner's paying agent that all terms and conditions of the L/C have been complied with.

The text of an ICR would look like as follows:

We hereby issue our Irrevocable Commitment for Reimbursement of claims under following L/C presented to our paying agent up to a maximum of USD..... provided the negotiating bank certifies to them by authenticated message that all terms and conditions of L/C have been complied with. We have sent a copy of this message to our paying

agent authorizing them to honour claims from the negotiating bank after receipt by them of the negotiating bank's certificate as noted above.

- I. L/C number :
- II. Issuing Bank :
- III. Applicant :
- IV. Beneficiary :
- V. Amount :
- VI. Expiry :
- VII. Latest shipment :
- VIII. Advising Bank :
- IX. Payment term :
- X. Bank charges :

In the event there are any discrepancies in or amendments to the above-mentioned L/C details or to (i) country of origin, (ii) description of goods, (iii) quantity of goods, (iv) *Takaful*/Insurance clause, prior approval of us must be obtained from the refinancer. Any other amendment issues by the L/C issuing bank do not require the approval of the refinancer.

#### 4.5.3 Documentary Collection

Collection means the handling of international trade documents by banks on instructions received from customer or bank. There are two types of documentary collection.

**Deliver commercial documents against Payment (D/P)**

In D/P situation the presenting bank is authorized to release documents to the *importer* only against cash payment.

**Deliver documents against acceptance (D/A)**

In D/A situation the presenting bank releases the documents to the *importer* against his acceptance of a bill of exchange.

There are some common terms used on bills for collection and their interpretation.

**Clean Collection** means: collection of financial documents not accompanied by commercial documents.

**Documentary Collection** means: collection of financial documents accompanied by commercial documents or collection of commercial documents not accompanied by financial documents.

**Sight Bill:** A bill which is payable at sight i.e. upon first presentation to the drawee (the *importer*).

**Usance Bill (Tenor Bill):** A bill which is payable on a specified future date. The bill to be presented for acceptance is done by the drawee (the *importer*) signing his name across the face of the bill. Once accepted, the acceptor i.e. drawee (the *importer*) agrees to pay the bill on its maturity date.

In the simplest case there are four parties to a documentary collection operation. These are as follows:

**Drawer (Principal):** In the context of a documentary collection operation, he is referred to as the principal, since he is the party on whose behalf the banks carry out the collection (*exporter*).

**The Remitting Bank:** This is the bank instructed by the *exporter* to send the documents for collection to a bank in the *importer's* country.

**Drawee:** Normally *importer* who receives the documents.

**The presenting bank (Collecting Bank):** This is the collection bank in the *importer's* country which presents the documents to the *importer* i.e. Agent for the remitting bank to release documents and collect payment from drawee.

In outline, Documentary Collection, as reference to ITFC guidelines, works as follows:

- (i) The sale contract is concluded between *importer* and *exporter*.
- (ii) The *exporter* makes the shipment directly to the *importer*.
- (iii) The *exporter* sends the necessary documents such as invoice, bill of lading, *takaful*/insurance certificate, certificate of origin *etc.* to his own bank (remitting bank) together with the collection order.
- (iv) The remitting bank then sends the documents together with the necessary instruction to the collecting bank.
- (v) The collecting bank informs the *importer* of the arrival of the documents and notifies him of the terms on which these documents will be released.
- (vi) The *importer* makes the payment (D/P, or accept a bill of exchange, or signs a promissory note (D/A) and in return receives the document.
- (vii) The Collecting Bank makes payment to the remitting bank.
- (viii) The remitting bank pays the *exporter*.

#### 4.5.4 SWIFT

SWIFT stands for the Society for Worldwide Interbank Financial Telecommunication. Found in 1973 in Belgium by 239 banks from 15 countries, it is a worldwide financial messaging exchange network operating between financial institutions. To give an idea about its dominance, as of November 2008, 8,700 financial institutions in 209 countries connected to the network.<sup>83</sup> The system operates through software on the SWIFTNET Network and ISO 9362 bank identifier codes popularly known among bankers as SWIFT Codes specific to each financial institution.

The vast majority of the financial institutions across the globe use SWIFT Network for secure communications in standard formats. That is, SWIFT does affect money transactions through secure communication between a financial institution and its corresponding bank. In brief SWIFT means:

- (i) Secure network between financial institutions for transmitting messages;
- (ii) Set of syntax standards for financial messages;
- (iii) Connection services and software enable financial institutions to transmit messages.

The definitions for ease of reference in this chapter are provided in Table 4.1. The reference transaction for the definitions is disbursement procedure explained in section 4.9 of this chapter where *Bank-C* mobilizes resources from *Bank-B* through 2-Step *murabahah* Agreement.

**Table 4.1: Definitions for Two-Step *Murabahah* Islamic Trade Finance**

Word	Meaning
Agent Bank	A bank responsible for administering a loan and acting as a conduit for all payments in a loan or syndicated loan.
Bill of Exchange	It is a written instrument which contains an unconditional order whereby the drawer ( <i>Seller/Exporter</i> ) directs the drawee ( <i>Buyer/Importer</i> ) to pay a definite sum of money to the payee or to his order.
Bills of Lading	It is a document of title to the goods and also an evidence of a contract between the <i>seller/exporter</i> and carrier.
Certificate of Origin	This document certifies the country of origin of goods described in

<sup>83</sup> Based on information obtained through the official website of SWIFT at <http://www.swift.com/> last accessed on May 6, 2010.

	the document.
Disbursement	A payment made by <i>Bank-B</i> at the request of a beneficiary, as per the guidelines and terms and conditions under 2-Step <i>murabahah</i> agreement.
Documentary Collection	A method of settlements in international trade where payment to the seller subject to the buyer's acceptance of the documents/draft presented to the buyer's bank (without L/C) as meaning given to it in URC.
Documentary Credit	Refers a method of settlement in international trade through LC
<i>Takaful</i> /Insurance Policy	It is issued by a <i>takaful</i> /insurance company to cover the risk involved in moving goods from one place to another.
Invoice	It is the accounting documents by which the seller claims payment from the buyer for the value of the goods being supplied.
Irrevocable Commitment to Reimbursement (ICR)	A mode of payment in which refiner of L/C, <i>Bank-B</i> , at the request of the beneficiary, irrevocably agrees to reimburse a commercial bank for payment to be made to a supplier under a letter of credit.
Letter of Credit (LC)	An instrument to facilitate international trade in goods and equipments as meaning given to it in UCP. It is an undertaking by a commercial bank to pay the beneficiary (supplier) upon presentation of documentary proof that all the terms and conditions of the LC have been fully fulfilled.
Modes of Disbursement	Four major methods used for payment of funds under <i>Bank-B</i> financing: Letter of Credit, Documentary Collection, Open Account and Reimbursement.
Mode of Financing	A <i>Shari'ah</i> -compatible instrument which is used by <i>Bank-B</i> to extend financing depending on the nature of the underlying project or operation and the party to which the financing is extended e.g. <i>murabahah</i> , loan, leasing, instalment sale, equity participation <i>etc.</i>
<i>Mudarabah</i>	A form of partnership where one party provides the funds and the other provides the expertise and management. Any profits accruing are shared between the two parties on a pre-agreed ratio, while the capital loss shared by all participants.
<i>Mudarabah</i> Agreement	A set of legal agreements signed between the parties to a syndicated financing, usually includes a financing agreement
<i>Mudarab</i>	A contracting party in a <i>mudarabah</i> financing which acts in a fiduciary capacity as the agent or fund manager.
<i>Mudarab</i> Fees	Fees payable to a <i>mudarab</i> in its capacity as the fund manager.
<i>Murabahah</i>	A contract of sale between a buyer and a seller in which a seller purchases the goods needed by a buyer and sells the goods to the buyer on a cost-plus basis. Both the profit (mark-up) and the time of repayment (usually in installments) are specified in an initial contract.
Proforma Invoice	It is the price quotation (a provisional invoice) given by the supplier.
Promissory Note	It is an unconditional promise in writing whereby the maker undertakes to pay a definite sum of money to the payee or to his order on demand or at a definite time.
Purchase Price	Means the price paid, or payable, by <i>Bank-B</i> to the Supplier/Exporter for each shipment of the Goods including <i>takaful</i> /insurance premiums, banking and other fees borne by <i>Bank-B</i> in connection

	with the purchase and shipment of the Goods.
Resource Mobilization	A process of generating resources from the capital market.
Sale Price	Means the price at which <i>Bank-B</i> sells the Goods to <i>Bank-C</i> (or importer in the case of Direct <i>murabahah</i> Sale) as determined in accordance with spread.
Shipping Documents	All documents related to shipment. Examples include invoice, bill of lading, certificate of origin <i>etc.</i>
Shipping guarantee	A document used to clear goods in absence of bill of lading.
Spread	Agreed percentage added to benchmark to arrive at the total mark-up to be charged in financing operations.
Supplier	An individual or a firm selected to provide equipment, materials or commodities against a specific contract (The <i>exporter</i> in this case).
SWIFT	Worldwide financial messaging exchange network operating between financial institutions to communicate within standard syntax to carry out international banking services.
Two-Step <i>Murabahah</i> Financing	A financing mode used by <i>Bank-B</i> to provide funding to other banks/ financial institutions such as <i>Bank-C</i> for financing their trade financing operations and/or <i>Bank-B</i> mobilizes funds, through reverse 2-Step <i>murabahah</i> , from the banks and financial institutions such as <i>Bank-A</i> for its trade financing operations.
UCP	Means the Uniform Customs and Practice for Documentary Credits (1993 Revision), International Chamber of Commerce Publication No. 500 and its revision thereof.
URC	Means the Uniform Rules for Collections (522 Version), International Chamber of Commerce.
Value Date	The date on which disbursements are debited from or repayments are credited to a designated <i>Bank-B</i> bank account.

Source: Compiled by the author

#### **4.6 DIRECT MURABAHAH SALE**

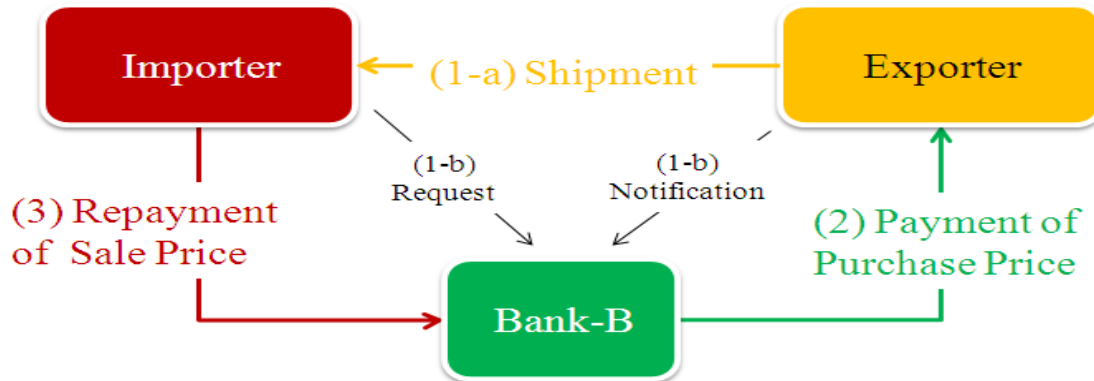
As an Arabic word standing for profit, *murabahah* is a type of cost-plus-profit sale trust trading. Presently, Direct *murabahah* sale is very popular among Islamic financial institutions as a mode of financing. As briefly explained earlier, a customer in need of purchasing specific goods requests a purchase of these goods from a financial institution with a certain amount of profit over purchase price as a repayment. For sure the seller is obliged to disclose the actual cost incurred in acquiring the goods, as a condition of an Islamic *murabahah* purchase orderer, before adding some profit thereon. As for the financial institutions, they buy the goods on behalf of the client and resell them at a mark-up, but in the period up to the resale the bank has title to the goods, and hence a legal responsibility as it is the case in a regular *murabahah* transaction.



Transactions in the case of international trade, as presented in Figure 4.1, flow as:

- (i) The *importer* requests *Bank-B* to purchase a quantity of goods.
- (ii) A Direct *murabahah* financing agreement would be signed between *Bank-B* and the *importer* by which:
  - *Bank-B* authorizes the *importer* to purchase the goods for and on behalf. The *importer* covenants that, when acting as an agent, it shall act as an undisclosed agent of *Bank-B* and it shall not disclose that it is acting as an agent of *Bank-B* to the third party.
  - In acting as an agent of *Bank-B*, the *importer* shall endeavour to act as if acting for its account and shall take all necessary measures to protect *Bank-B*'s rights and interests.

**Figure 4.1: Mechanism and Documentation for Direct Murabahah Sale**



Source: International Islamic Trade Finance Corporation of Islamic Development Bank Group

- (i) The *importer* submits the terms and conditions of the draft purchase contract for the approval of *Bank-B*. After the approval, the *importer* concludes the contract with no material amendment to or waiver or cancellation in the contract without obtaining prior written consent of *Bank-B*.
- (ii) *Bank-B* shall make the payment of “Purchase Price” directly to the *exporter*.
- (iii) The *importer* can clear the goods from customs based on this payment and shall repay the “Sale Price” directly to *Bank-B* at the time of maturity.<sup>84</sup>

As the transaction flow reveals, *Bank-B* takes the direct credit risk of the *importer*.

<sup>84</sup> The importer makes the disbursement request through a standard “**Form of Offer**” which indicates the “**Sale Price**”. Upon the receipt of this form, Bank-B responds to the Importer with a standard “**Form of Acceptance**” indicating the “**Purchase Price**”. Drafts of these forms for disbursement under L/C settlement are provided in the Appendix IV and Appendix V.

It should be noted that, the validity of a *murabahah* sale, which has its own implications in form of a valid sale, necessitates specific conditions to make the transaction acceptable in Islamic law.<sup>85</sup>

#### **4.7 RESOURCE MOBILIZATION THROUGH *MUDARABAH***<sup>86</sup>

Given the huge volume of international trade, as a usual practice financial institutions mobilize resources to meet the needs of their clients. Islamic banks often resort to a syndication process for their trade finance operations, which is expected to be used to cover large-volume financing amounts. Under this mechanism, banks invite commercial banks and financial institutions to participate in large-ticket operations, where the terms of financing are attractive and in line with the prevailing market rates. Each participant takes the direct risk of the beneficiary within its subscription.<sup>87</sup>

Transactions in the case of international trade, as indicated in Figure 4.2, flow as:

- (i) According to *Shari'ah*, a *mudarabah* Agreement to be signed first between *Bank-B*, other participants and *Bank-A*:
  - *Bank-B* acts as a *mudarab* on behalf of participating banks such as *Bank-A*.
  - *Bank-B* is the Arranger/Manager and responsible for and distribution of the repayment (Sale Price) to participating banks including *Bank-A*.
- (ii) Then, a *murabahah* Agreement to be signed between *Bank-B* and the *importer*.
  - The *importer* shall submit any effectiveness documents to start the utilization of the fund.
  - Upon the notification by the *exporter* and the request of the *importer*, *Bank-B* advises participating banks and *Bank-A* to transfer money (according to their contributions) to its (*Bank-B*'s) bank account in the paying agent bank. Then *Bank-B* as *mudarab* orders the payment of 'Purchase Price' directly to the *exporter*.

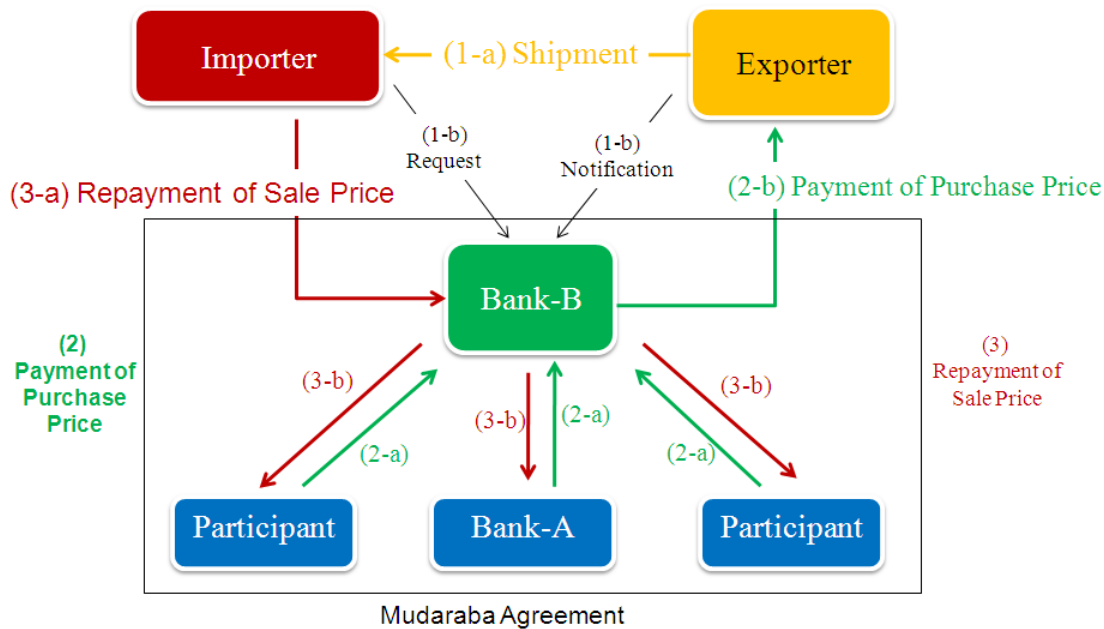
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<sup>85</sup> The details of these conditions can be referred from Accounting and Auditing Organization for Islamic Financial Institutions (AAOIFI)'s Sharia's Standards No.8 as. These standards for "Murabaha to the Purchase Orderer" was previously issued by the title of "Sharia's Rule for Investment and Financing Instruments No.(1)". One may refer to those for more details on Murabaha Sale.

<sup>86</sup> *Mudaraba* is a special kind of partnership where one partner provides the capital (*rabb-al-mal*) to the other (*mudarab*) for investment in a commercial enterprise.

<sup>87</sup> Note that Syndication is called co-financing facility in case of only one participant.

**Figure 4.2: Mechanism and Documentation for Direct *Murabahah* Sale through Resources Mobilized by *Mudarabah* Agreement**



Source: International Islamic Trade Finance Corporation of Islamic Development Bank Group

- The *importer* can clear the goods from customs based on this payment and shall repay the “Sale Price” directly to *Bank-B*, which in turns distribute the sale price to the participating banks such as *Bank-A* according to their contribution.

In this design *Bank-B*, *Bank-A* and any other participant share the direct credit risk of the *importer* up to their contribution amount. That is, each participant has to make his investigation and evaluation of the creditworthiness of the *importer* before deciding to participate in the syndicated operation.<sup>88</sup>

#### **4.8 ADDRESSING THE ISSUE BY REVERSE 2-STEP *MURABAHAH* AGREEMENT<sup>89</sup>**

The most problematic part of *mudarabah* type of resource mobilization is the sharing of credit risk of the *importer* by all participants. Very often potential participants are not familiar with the *importer*, the country or the subject sector. Hence, the resource

<sup>88</sup> Indeed, this is a very favorable structure for Bank-B as resources mobilized by *Mudarabah* would be off-balance sheet item, as the credit risk taken would be limited and as Bank-B would receive *Mudarabah* fee out of profit realized by the participants.

<sup>89</sup> As pointed earlier, what makes 2-Step *Murabaha* Agreement reverse or not is Bank-B’s point of view. From Bank-B’s point of view, the agreement is Reverse 2-Step *Murabaha* if Bank-B raises funds from other financial institutions for its own Direct *Murabaha* Sale to the beneficiary.

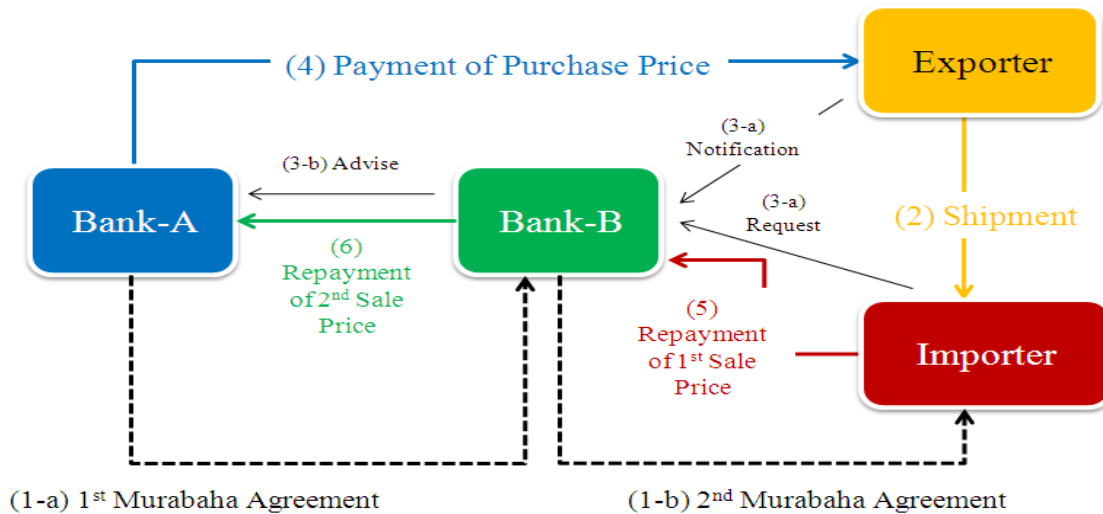
mobilization may turn to be a hurdle. Addressing this issue by an Islamic mode of finance by which participants take the risk of another financial institution rather than unknown *importer* would create space for mobilizing more resources.

Reverse 2-Step *murabahah* Financing Mechanism can be used to mobilize resources from other financial institutions and banks to meet the needs of *Bank-B* in this particular case. Under this mechanism, other financial institutions or banks provide the funds to *Bank-B* which the latter will then provide to its ultimate beneficiaries, the *importer*. The financial institutions or banks take the risk of *Bank-B* as such that *Bank-A* purchases the goods and sells it to *Bank-B* to be paid back with a mark-up on a predetermined maturity date. Then, *Bank-B* sells the goods to the *importer* based on the terms and conditions of the second *murabahah* agreement with the *importer*.

Transactions in the case of international trade, referring to Figure 4.3, flow as:

- A *murabahah* Agreement is signed first between *Bank-A* (as Fund Provider/1<sup>st</sup> seller) and *Bank-B* (as purchaser).
- Then, another *murabahah* Agreement is signed *Bank-B* (as 2<sup>nd</sup> seller) and the *importer* (as purchaser).
- The *importer* shall submit effectiveness documents.

**Figure 4.3: Mechanism and Documentation for Direct *Murabahah* Sale through Resources Mobilized by Reverse 2-Step *Murabahah* Agreement**



Source: International Islamic Trade Finance Corporation of Islamic Development Bank Group

- Upon notification by the *exporter* and the request from the *importer*, *Bank-B*

advises the fund provider, *Bank-A*, to make the payment of “Purchase Price” directly to the *exporter*.<sup>90</sup>

- The *importer* can clear the goods from customs based on this payment. Then at the time of maturity, it shall repay the first “Sale Price” directly to *Bank-B*, which in turns will be repay the second “Sale Price” to *Bank-A*.

This mechanism transfers the direct credit risk of the *importer* to *Bank-B* which will be the beneficiary of credit provided by *Bank-A*. Also note that this mechanism can be used in reverse by *Bank-B* to reach small and medium-size beneficiaries in different countries, by providing fund to the local financial institutions or banks for their ultimate beneficiaries. This kind of usage is ideal to penetrate Small and Medium Size Enterprises (SMEs) in high-risk countries. In this case, *Bank-B* assumes the credit risk of a local *Bank-C* rather than the *importer* and transfers cumbersome credit evaluation process to the party, local *Bank-C*, which can effectively manage it in a more efficient manner. In order to give a more clear idea on the structure, to be called 2-Step *murabahah* hereafter, in which *Bank-B* is fund provider disbursement mechanism under Letter of Credit (L/C) and Documentary Collection is explained in the next section. Also *Bank-B*'s business process map, keys are in Appendix VI, for the disbursement to *Bank-C* under 2-Step *murabahah* Sale is provided in Appendix VII. In Appendix VIII, *Bank-B*'s business process for repayment from *Bank-C* under 2-Step *murabahah* Sale through resources mobilized by a Reverse 2-Step *murabahah* from *Bank-A* or any other participants is provided.<sup>91</sup>

#### **4.9 DISBURSEMENT PROCEDURES FOR 2-STEP MURABAHAH AGREEMENT**

In international trade businesses, very often *exporter* would ask for Letter of Credit as a condition precedent to the shipment. A standard Letter of Credit transaction, with reference to ITFC guidelines, would follow as:

- (i) An export contract would be signed between the *importer* and the *exporter*;

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<sup>90</sup> In (4) Payment of Purchase Price, the payment would materialize at the date of maturity when the importer is supposed to honor the claim from the exporter as per the export contract. The details of disbursement procedures for 2-Step Murabaha under L/C and Documentary Collection are explained in Section-V.

<sup>91</sup> Going through the subject business process, since the resources mobilized through 2-Step Murabaha rather than Muaraba agreement Bank-B pays to participants or Bank-A first than separately lodge a claim on Bank-C. If the resources mobilized through Mudaraba agreement, participants or Bank-A would wait receipt of repayment from Bank-C to Bank-B first. Besides, they would be exposed to any default from Bank-C part.

- (ii) The *importer* fills a standard application form requesting his bank (*Bank-C* in this particular case) to issue irrevocable Letter of Credit in favour of the *exporter* overseas;
- (iii) The *importer's* bank (*Bank-C*) issues its irrevocable L/C in accordance with the *importer's* instructions and sends to the advising bank (usually the *exporter's* bank);
- (iv) The advising bank notifies the credit to the *exporter*;
- (v) Upon notification, the *exporter* ships the goods based on the L/C terms and conditions and presents the shipping documents, including Bill of Lading, to the negotiating bank;
- (vi) The negotiating bank checks the documents and if everything is in order, pays to the *exporter*. Then it refers to issuing bank for reimbursement. Issuing bank would reimburse to negotiating bank given the documents are in compliance with the L/C terms;
- (vii) The *importer* collects the document from the issuing bank (*Bank-C* in this particular case) and takes the possessions of the goods for custom clearance.

Under 2-Step *murabahah* financing, the *importer* can open an L/C in the *Bank-C* and *Bank-C* transmits a copy to *Bank-B*.<sup>92</sup> The main body of such an L/C would be indicated in Table 4.2. For the purpose of demonstration the *importer* from the Gambia applies to *Bank-C* for opening of L/C in favour of *exporter* in Egypt to import wool and polyester yarn under Two-Step *murabahah* Financing provided by international *Bank-B*.

**Table 4.2: Content of L/C in Disbursement under 2-Step Murabahah**

40A: Form of Documentary Credit IRREVOABLE 20: Documentary Credit Number CEN/92040198 31C: Date of Issue Date: 100330 40E: Applicable Rules UCPURR LATEST VERSION 31D: Date and Place of Expiry Date: 100630 Place: IN EGYPT 50: Applicant THE IMPORTER, ADDRESS OF THE IMPORTER, ACCOUNT NUMBER OF IMPORTER WITH BANK-C 59: Beneficiary Name &Address: THE EXPORTER ADDRESS OF THE EXPORTER
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<sup>92</sup> Unlike Direct Murabaha Sale, not the importer but Bank-C makes the disbursement request through a standard 'Form of Offer' which indicates the first 'Sale Price'. Upon the receipt of this form, Bank-B responds to Bank-C with a standard 'Form of Acceptance' indicating the 'Purchase Price'. Drafts of these forms under Direct Murabaha Sale for disbursement under L/C are provided in the Appendix IV and Appendix V. In the case of 2-Step Murabaha Sale, the importer shall be replaced with Bank-C in this forms.

TEL:XXXXX

32B: Currency Code, Amount

Currency Code: US Dollar

Amount: US\$ 312,500.00

41A: Available With ... By ...

Identifier Code: SWIFT CODE OF ADVISING/EXPORTER'S BANK  
ADDRESS OF ADVISING/EXPORTER'S BANK

By: PAYMENT

43P: Partial Shipments

ALLOWD

43T: Transshipment

NOT ALLOWED

44F: Port of Loading/Airport of Departure

ANY PORT IN EGYPT

44C: Port of Discharge/Airport of Destination

BANJUL, THE GAMBIA

45A: Description of Goods and/or Services

45,000 KGS COUNT NM 60/2 PW 60/40 BLEND 21.5 MICRON WOOL AND 2.5 DEN POLYESTER-YARN WORSTED COLOUR TBG.

AS PER PROFORMA INVOICE NO.7196 DATED 01/02/2010.

UP TO AGGREGATE AMOUN OF: US\$ 312750.00 AS CFR VALUE (UPTO US\$ 310500.00 AS FOB VALUE AND UPTO US\$ 2250.00 AS FREIGHT CHARGES)

46A: Documents Required

A)FULL SET OF CLEAN ON BOARD OCEAN BILL OF LADING ISSUED OR ENDORSED TO THE ORDER OF BANK-C IN 3-ORIGINALS AND 3 NON-NEGOTIABLE COPIES INDICATING NAME AND ADDRESSES OF SHIPPING CO'S REPRESENTATIVE IN THE GAMBIA MARKED FREIGHT PREPAID DATED NOT LATER THAN 09.06.2010 NOR PRIOR TO THE DATE OF THIS SWIFT, INDICATING SHIPMENT BY CLASSIFIED VESSEL FROM ANY PORT IN EGYPT TO BANJUL, THE GAMBIA.

B)SIGNED COMMERCIAL INVOICES IN 3 ORIGINALS, 1 OF WHICH CERTIFIED BY EGYPT CHAMBER OF COMMERCE AND INDUSTRY AND LEGALIZED BY GAMBIAN CONSULATE, PLUS 1 EXTRA COPY ALL INCLUDING BNF'S STATEMENT THAT GOODS HAVE BEEN SHIPPED IN STRICT COMPLIANCE WITH THE CONDITIONS STIPULATED IN RELATED PROFORMA INVOICES AND THE SUBSEQUENT AMENDMENT THERETO IF ANY.

C)SIGNED CERTIFICATE OF ORIGIN CERTIFIED BY EGYPT CHAMBER OF COMERCE AND INDUSTRY LEGALIZED BY GAMBIAN CONSULATE, IN 1 ORIGINAL CONFIRMING GOODS ORIGINATED IN EGYPT, PLUS 2 COPIES.

D)SIGNED DETALED PACKING LIST IN 3 COPIES

E)THE ORIGINAL INSPECTION CERTIFICATE ISSUED NOT PRIOR TO BILL OF LADING DATE BY APPOINTED COLLATERAL MANAGEMENT AND MONOTORING COMPANY(CMMC) OR ITS AGENT LETTERHEAD CERITFIYING THAT THE QUALITY, QUANTITY AND PACKING OF THE GOODS LOADED ARE STRICTLY COMPLYING WITH SPECIFICATION OF THE GOODS INDICATED IN THE RELATIVE PROFORMA INVOICE AND THE L/C AND ANY AMENDMENTS MADE THERETO AS PRESENTED TO THE CMMC BY THE APPLICANT/EXPORTER IN 1 ORIGINAL AND 1 COPY. SUCH PRESHIPMENT INSPECTION CERTIFICATE SHALL VERIFY THAT THE GOODS ARE IN CONFORMITY WITH GAMBIAN STANDARDS AS MENTIONED IN PROFORMA INVOICE AND CERTIFEID BY EGYPT CHAMBER OF COMMERCE AND INDUSTRY (INSPECTION CHARGES SHALL BE PAID BY THE APPLICANT/EXPORTER).

F)A DECLARATION SIGNED BY THE SHIPPING CO. OR ITS AUTHORIZED AGENT STATING

THAT THE CARRYING VESSEL IS A CLASSIFIED ONE PLYING ON REGULAR LINER SERVICES IN 1 ORIGINAL AND 2 COPIES.

G) SIGNED FREIGHT INVOICES ISSUED BY THE SHIPPING CO., THE CARRIER OR ITS AUTHORIZED AGENT IN 1 ORIGINAL WHICH TO BE CERTIFIED BY EGYPT CHAMBER OF COMMERCE AND INDUSTRY PLUS 1 COPY.

47A: Additional Conditions

1) NEGOTIATION RESTRICTED TO THE ADVISING BANK

2) ALL DOCUMENTS SHOULD INDICATE:

A) APPLICANT'S NAME AND FULL ADDRESS AS THE NOTIFY PARTY

B) L/C NO. CEN/92040198 AND REG. NO. OF 60801341

C) *TAKAFUL* CO'S NAME OF: ISLAMIC *TAKAFUL* COMPANY (for illustration purpose), POLICY NO. 4/0106/109971/9999/016000/1388

D) CUSTOMS TARIFF NO OF: 55095200

3) *TAKAFUL* EFFECTED IN GAMBIA

4) THIRD PARTY SHIPPING DOCUMENTS NOT ACCEPTABLE

5) THE ISSUANCE DATE OF ALL DOCUMENTS SHOULD BE WITHIN THE VALIDITY DATE OF THIS CREDIT.

6) THE REQUIRED DOCS. SHOULD BE FORWARDED TO BANK-C, CENTRAL BRANCH NO. 1701, BANJUL, THE GAMBIA BY DHL IN TWO SEPARATE SETS.

7) NEGOTIATION DATE OF DOCUMENTS SHOULD BE INFORMED TO BANK-C BY SWIFT.

8) A HANDLING CHARGES OF US\$50 WILL BE DEDUCTED FROM PROCEEDS FOR EACH DISCREPANT PRESENTATION (DISCREPANCY FEE).

9) ALL DOCUMENTS MUST BE ISSUED IN ENGLISH.

10) CHARTER PARTY BILL OF LADING NOT ACCEPTABLE.

11) PLEASE SEND ALL YOUR SWIFT MESSAGES TO BANK-C SWIFT AS 'BANKCGMBCEN' (for illustration purpose)

71B: Charges

ALL BANKING CHARGES OUTSIDE THE GAMBIA ARE FOR ACCOUNT OF THE BENEFICIARY/EXPORTER

48: Period for Presentation:

21 DAYS FROM THE DATE OF BILL OF LADING WITHIN THE L/C VALIDITY

49: Confirmation Instructions

WITHOUT

53A: Reimbursing Bank

SWIFT CODE FOR THE PAYING AGENT OF BANK-B

ADDRESS FOR THE PAYING AGENT OF BANK-B

78: Instructions to the Paying/Accepting/Negotiating Bank

THIS L/C IS SUBJECT TO THE ICC UNIFORMED CUSTOMS PRACTICES 2007 REVISION (BROCHURE 600) AND URR LATEST VERSION AND **THIS L/C IS TO BE REFINANCED UNDER REFINANCING 2-STEP MURABAHAH AGREEMENT DATED 07/11/2009 WITH REF BANK-B/2009/TF3/GAM/0001 BETWEEN BANK-C AND BANK-B FOR A PERIOD OF 360 DAYS. UPON RECEIVING THE DOCS. AND CERTIFYING TO US THAT THE TERMS AND CONDITIONS AF THE CREDIT HAVE BEEN COMPLIED WITH, YOU ARE AUTHORIZED HEREBY TO REIMBURSE YOURSELVES FOR YOUR PAYMENT UNDER THIS L/C ON BANK-B US DOLLAR ACCOUNT WITH BANK-B'S PAYING AGENT ON DUE DATE.**

72: Sender to Receiver Information

**THIS IS A CC MESSAGE FOR YOUR NOTIFICATION AND THE ORIGINAL ONE SENT TO ADVISING/EXPORTER'S BANK, ADDRESS OF ADVISING/EXPORTER'S BANK, SWIFT CODE OF ADVISING/EXPORTER'S BANK.**

BEST REGARDS,.

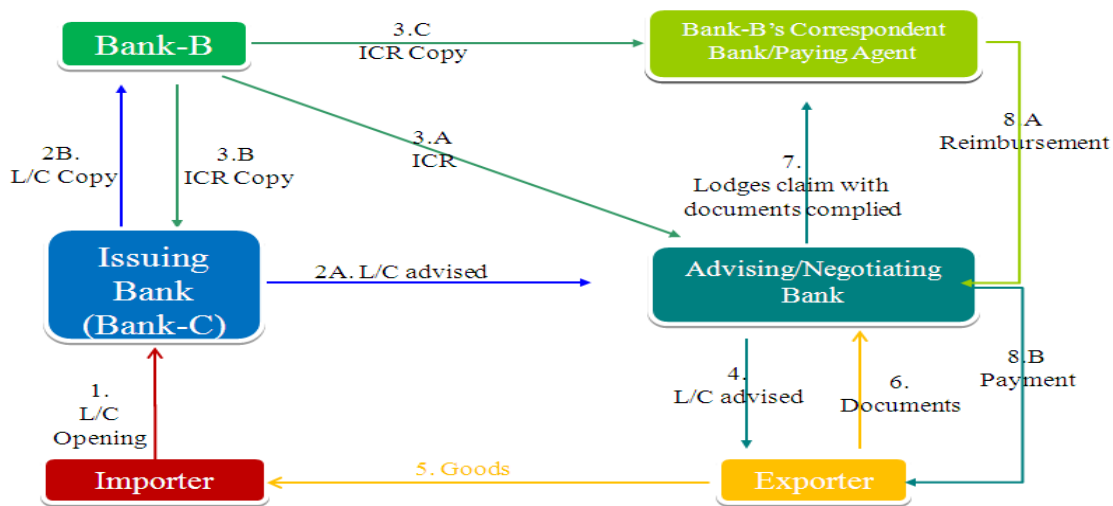


Source: Specimen prepared by the author based on draft provided by International Islamic Trade Finance Corporation of IDB Group

After receiving above copy of the L/C, *Bank-B* issues an ICR (Irrevocable Commitment for Reimbursement) and sends the ICR to:

- A. The negotiating bank
- B. The issuing bank (*Bank-C*)
- C. Its Paying Agent Bank

**Figure 4.4: Disbursement Procedure under L/C**



Source: International Islamic Trade Finance Corporation of Islamic Development Bank Group

With ICR, where *Bank-B* agrees to reimburse the negotiating bank the amount under the L/C opened by the *importer* from *Bank-C*. After the shipment by the *exporter*, *Bank-B*'s paying agent bank honours the claim from the negotiating bank based on satisfactory shipment documentation, such as Bill of Lading, invoice, *etc.*, identified in the L/C. Details of the transaction can be found in the Figure 4.4.<sup>93</sup>

In many cases, L/C issued by a bank in LDMCs is not perceived to be solid by *exporters* in other countries as these exports are not well convinced about capacity of banks in

<sup>93</sup> In (8.A), Paying Agent would reimburse at the date of maturity (i.e. 90 days from the date of Bill of Lading) if the L/C is not at Sight.

some LDMCs to honour their obligations with L/C issued, as indicated in Table 4.2, to affect payment upon fulfilment of shipping requirements highlighted. Very often, *exporters* ask L/C confirmation from another bank outside the country, which generates additional L/C confirmation cost for *importers* in LDMCs.<sup>94</sup> Hence, there is a potential trade facilitation opportunities in this area by reducing additional confirmation costs. The European Bank for reconstruction with its Regional Trade Facilitation Programme, which is a network of banks enjoying EBRD's guarantee, addressed this issue since 1998. EBRD provide guarantee to confirming banks and undertakes the political and commercial payment risk of issuing banks in developing countries.<sup>95</sup>

As the content of ICR indicates in Table 4.3, it acts as a replacement to L/C confirmation. Hence, this 2-Step *murabahah* structure, in addition to availing trade finance, can be remedy for cost associated with L/C confirmation for many OIC LDMCs.

**Table 4.3: Content of ICR in Disbursement under 2-Step *Murabahah***

<p>ATTN: TRADE FINANCE SERVICES WE HAVE ADVISED ADVISING/EXPORTER'S BANK, ADDRESS OF ADVISING/EXPORTER'S BANK, SWIFT CODE, AS FOLLOWS:-</p> <p>QUOTE ATTN: DOCUMENTARY CREDITS DEPT. OUR REF: DS/BANK-B/GAM 0001 (PLS QUOTE IN ALL CORRESP.) WE HEREBY ISSUE OUR IRREVOCABLE COMMITMENT FOR REIMBURSEMENT OF CLAIMS UNDER FOLLOWING L/C PRESENTED TO OUR PAYING AGENT BANK,UPTO A MAXIMUM OF US\$ 312,500 (UNITED STATES DOLLAR THREE HUNDRED TWELVE THOUSAND FIVE HUNDRED ONLY) PROVIDED THE NEGOTIATING BANK CERTIFIES TO THEM BY AUTHENTICATED MESSAGE THAT ALL TERMS AND CONDITIONS OF L/C HAVE BEEN COMPLIED WITH. WE HAVE SENT A COPY OF THIS MESSAGE TO OUR PAYING AGENT BANK AUTHORIZING THEM TO HONOUR CLAIMS FROM THE NEGOTIATING BANK AFTER 3 (THREE) WORKING DAYS OF RECEIPT BY THEM OF THE NEGOTIATING BANK'S CERTIFICATE AS NOTED ABOVE. L/C DETAILS:- 1.L/C NO.: CEN/92040198 2.ISSUED BY: BANK-C (CENTRAL BRANCH) BANJUL, THE GAMBIA(SWIFT CODE OF BANK-C) 3.BY ORDER OF: THE NAME OF THE IMPORTER, ADDRESS OF THE IMPORTER, TEL:XXXXX 4.FAVOUR: THE NAME OF THE EXPORTER, ADDRESS OF THE EXPORTER, TEL:XXXXX 5.AMOUNT: US\$ 312,500 6.EXPIRY: 30.06.2010 7.LATEST SHIPMENT: 09.06.2010 8.ADVISING BANK: SWIFT CODE OF ADVISING/EXPORTER'S BANK, ADDRESS OF</p>
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<sup>94</sup> Available at: <http://www.ebrd.com/apply/trade/about/tfpfacts.pdf> accessed on 25 April 2010.

<sup>95</sup> Available at: <http://www.ebrd.com/projects/eval/showcase/tfp.pdf> accessed on 25 April 2010.

ADVISING/EXPORTER'S BANK

9.PAYMENT: AT SIGHT

10.BANKING CHARGES:ALL BANKING CHARGES OUTSIDE THE GAMBIA ARE FOR ACCOUNT OF THE BENEFICIARY.

IN THE EVENT THERE ARE ANY DISCREPANCIES IN OR AMENDMENTS TO THE ABOVE MENTIONED L/C DETAILS OR TO (I) THE COUNTRY OF ORIGIN, (II) THE DESCRIPTION OF GOODS, (III) THE QUANTITY OF GOODS AND (IV)THE *TAKAFUL* CLAUSE, THE PRIOR APPROVAL OF THE BANK-B MUST BE OBTAINED IN ORDER THAT THIS COMMITMENT REMAINS OPERATIVE. ANY OTHER AMENDMENTS ISSUED BY THE L/C. ISSUING BANK DO NOT REQUIRE THE APPROVAL OF THE BANK-B. UNQUOTE.

**KINDLY HONOUR TO THE DEBIT OF BANK-B US DOLLAR CALL ACCOUNT NO.340000002 CLAIMS FROM THE NEGOTIATING BANK AGAINST THEIR TESTED MSG CERTIFICATE OF COMPLIANCE AS ABOVE. YOUR AUTHORITY TO PAY UNDER THIS COMMITMENT IS VALID FOR ONE MONTH AFTER THE EXPIRY DATE OF THE L/C.**

*Source:* Specimen prepared by the author based on draft provided by International Islamic Trade Finance Corporation of IDB Group

2-Step *murabahah* trade financing through ICR can not only be an effective tool to avail more financing in LDMC OIC countries but also play a trade facilitation role by eliminating need for additional confirmation outside the country. Hence, diffusion of this Islamic finance product would create substantial means for LDMCs to promote their trade.

Apart from L/C, another common method of international trade settlement mechanism is “Documentary Collection”. In its simplest form it means the handling of documents by banks on instruction received from the *exporter*.<sup>96</sup>

A standard Documentary Collection transaction would follow as also indicated in Figure 4.5:

- (i) An export contract would be signed between the *importer* and the *exporter*;
- (ii) The *exporter* directly makes the shipment to the *importer*;
- (iii) The *exporter* sends the necessary documents such as invoice, bill of lading, *takaful*/insurance certificate, certificate of origin, *etc.* to his own bank (remitting bank) together with a collection order;
- (iv) The remitting bank then sends the documents together with necessary instruction to the collecting bank (*Bank-C* in this particular case);

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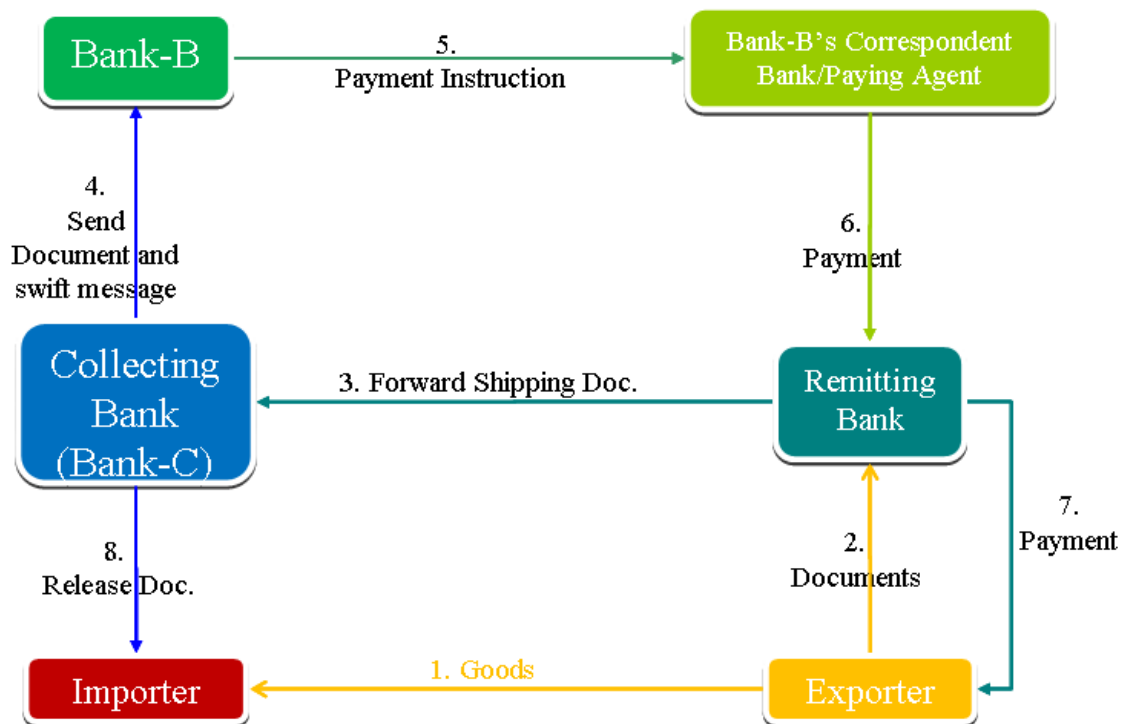
<sup>96</sup> There are two types of documentary collection:

- i. Delivery against Payment (D/P): The handling bank is authorized to release the documents for custom clearance to importers only against cash.
- ii. Delivery against Acceptance (D/A): The handling bank is authorized to release the documents for custom clearance to importers only against his acceptance of a bill of exchange.

- (v) The collecting bank informs the *importer* of the arrival of the documents and notifies him of the terms on which these documents shall be released;
- (vi) The *importer* makes the payment (or accepts a bill of exchange in case of Delivery against Acceptance) and in return receives the documents for custom clearance of the goods;
- (vii) Collecting bank makes payment to the remitting bank. Then, remitting bank pays to the *exporter*.

Under 2-Step *murabahah* operations, collecting bank (*Bank-C*) informs *Bank-B* of the arrival of the documents. Based on this notification, *Bank-B* instructs its paying agent to transfers money to the remitting bank in favour the *exporter*.<sup>97</sup> Upon the transfer of the amount the collecting bank releases the documents to the *importer*.

**Figure 4.5: Disbursement Procedure under Documentary Collection**



Source: International Islamic Trade Finance Corporation of Islamic Development Bank Group

<sup>97</sup> In (6. Payment) Paying Agent would reimburse the Remitting Bank at the date of maturity (i.e. 60 days from the date of invoice) in case of Delivery against Acceptance (D/A).

#### **4.10 LEGAL FRAMEWORK FOR 2-STEP MURABAHAH**

The Islamic *Fiqh* Academy in its fourth annual plenary session held in Jeddah in February 1988 noted that the *Shari'ah* encourages written contracts as stipulated in the Holy Qur'an (2: 282):

When ye deal with each other, in transactions involving future obligations in a fixed period of time, reduce them to writing. ...It is more just in the sight of God, more suitable as evidence and more convenient to prevent doubts among yourselves.

It is obvious that the cross-border nature of this transaction would be necessitating a solid legal framework to ensure the rights of all parties involved. Hence, the legal agreement between *Bank-B* and *Bank-C* for the above-mentioned disbursement, where *exporter* is from Egypt and *importer* is from the Gambia, is explained here below. The content of the 2-Step *Murabahah* Agreement in this case would look like as follows:

<u>Section-1</u>	Definitions
<u>Section-2</u>	Utilisation of the approved amount
<u>Section-3</u>	Procurement of the goods
<u>Section-4</u>	Takaful
<u>Section-5</u>	Delivery
<u>Section-6</u>	Payment of the purchase price by <i>BANK-B</i>
<u>Section-7</u>	Promise by <i>BANK-C</i> to purchase the goods from <i>BANK-B</i> and to resell the same
<u>Section-8</u>	Sale price payable to <i>BANK-B</i>
<u>Section-9</u>	Sale of the goods to <i>BANK-C</i> without responsibility of <i>BANK-B</i> for defects
<u>Section-10</u>	Denomination of the sale price
<u>Section-11</u>	Payment of the sale price
<u>Section-12</u>	Manner of payment of the sale price
<u>Section-13</u>	Delay in the exercise of rights
<u>Section-14</u>	Cancellation and suspension of the approved amount
<u>Section-15</u>	Representations and warranties
<u>Section-16</u>	Events of default
<u>Section-17</u>	Indemnity
<u>Section-18</u>	Effectiveness
<u>Section-19</u>	Conditions precedent to disbursement
<u>Section-20</u>	Documents-reports
<u>Section-21</u>	Governing law-settlement of disputes
<u>Section-22</u>	Notices- requests
<u>APPENDIX-I</u>	Form of opinion of counsel <i>BANK-C</i>

<u>APPENDIX-II</u>	Form of offer from <i>BANK-C</i> to purchase the goods from <i>BANK-B</i>
<u>APPENDIX-III</u>	Form of acceptance by <i>BANK-B</i>
<u>APPENDIX-IV</u>	Transaction intimation notice

The introduction of the agreement would indicate as:

**Table 4.4: Introduction of 2-Step *Murabahah* Agreement**

<p><b><u>THIS AGREEMENT</u></b> is made on ____/____/1430H corresponding to ____/____/2009G between Bank-B and Bank-C.</p> <p><b>WHEREAS,</b></p> <p>(A) BANK-C has requested BANK-B to purchase a quantity of the Goods (hereinafter defined) and to sell the same to BANK-C on <i>murabahah</i> basis, so that BANK-C may resell the same to Buyer(s)/Importer(s) (hereinafter defined).</p> <p>(B) IBANK-B has, on 21/10/2009, approved the purchase of the Goods in an amount not exceeding US\$ 100 million (United States Dollar Hundred Million) only, and the sale thereof to BANK-C for resale to the Buyers.</p> <p>(C) The terms and conditions referred to in paragraph (B) above have been accepted by BANK-C on 27/10/2009.</p> <p>(D) BANK-B has agreed, subject to the terms and conditions of this Agreement, to authorize BANK-C, as an agent of and for and on behalf of BANK-B and to the extent of the Approved Amount, to negotiate with the Supplier(s)/Exporter(s) (hereinafter defined) and to conclude a contract or contracts for the purchase of the Goods.</p> <p><b><u>NOW IT IS HEREBY AGREED AS FOLLOWS:</u></b></p>
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*Source:* Outlined by the author based on template provided by the Legal Department of Islamic of Islamic Development Bank

The first section of the agreement highlights the definition for the agreement as such “Except where the context otherwise requires, each of the following terms shall have the meaning assigned to it hereunder wherever used in this Agreement”. After definitions in the form of a table, section two of the agreement explains the utilization of the approved amount by *Bank-C* as indicated in Table 4.5.

**Table 4.5: Utilization of the Approved Amount**

<p>2.1 BANK-B shall, upon effectiveness of this Agreement in accordance with Section 18 hereof, make the Approved Amount available to BANK-C for the Operation.</p> <p>2.2 The availability of the Approved Amount is subject to, in the absolute opinion of BANK-B, the following events:</p> <p>(i) a Material Adverse Effect has occurred and is continuing;</p> <p>(ii) there being no adverse change in the international money, banking and/or capital markets which would have adverse impact on the domestic money, banking and/or capital markets;</p> <p>(iii) there being no adverse change in the socio-political, financial and/or economic conditions of the GAMBIA, which would have adverse impact on the domestic money, banking and/or capital markets;</p> <p>(iv) there being no adverse effect on BANK-B's access to the money and capital markets.</p> <p>2.3 Prior to each Transaction, BANK-C shall provide to BANK-B a Transaction Intimation Notice, which shall detail the type of the Goods, the name and contact details of the Buyer and the Supplier and the date of the Transaction.</p>
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2.4	BANK-C shall not proceed with the Transaction without obtaining the prior approval of BANK-B to the Transaction Intimation Notice.
2.5	BANK-C shall pay to BANK-B administrative fees amounting to US\$ 100,000 (US\$ Hundred Thousand) as a condition of effectiveness, prior to utilization of the Approved Amount.

*Source:* Outlined by the author based on template provided by the Legal Department of Islamic of Islamic Development Bank

After detailing the utilization matters, section three would explain the procurement transaction during utilization of the facility by *Bank-C*.

**Table 4.6: Procurement of the Goods**

3.1	It is agreed between the parties hereto that BANK-C's authority to purchase the Goods for and on behalf of BANK-B covers its procurement from the Supplier/Exporter and that the procurement shall be in accordance with the terms and conditions of this Agreement and shall be subject to the procedure to which the BANK-B may, in writing, agree or determine.
3.2	In acting as an agent of BANK-B, BANK-C shall endeavour to act as if acting for its own account and shall take all necessary measures to protect BANK-B's rights and interests and will not do or omit to do anything which will be inconsistent with its obligations and responsibilities under the Agreement.
3.3	BANK-C undertakes to select the Goods and to exercise as much care in satisfying itself as to matters of quality and quantity of the Goods and title thereto and of performance by the Supplier/Exporter as if it were purchasing the Goods for its own account directly from the Supplier/Exporter.
3.4	BANK-C shall be fully and solely responsible for the quality, condition, selection and specifications of the Goods and for deciding the need for, and the extent and the manner of, the transaction and storage thereof.
3.5	BANK-C shall ensure that all necessary permits, exchange control approvals, import licenses and all other consents required in connection with the purchase of the Goods are obtained.
3.6	BANK-C shall submit through the most expeditious mode of communication the terms and conditions of the draft Purchase Contract for the approval of BANK-B prior to the execution of the same. Any reference to the Purchase Contract, shall be taken as a reference to such contract after the approval of its terms and conditions by BANK-B and its conclusion by BANK-C on BANK-B's behalf. Once approved by BANK-B, no material amendment to or waiver or cancellation of, the Purchase Contract shall be made or agreed by BANK-C without the prior written consent of BANK-B.
3.7	BANK-C shall ensure that the purchase of the Goods will be done without the assistance or intervention, whether direct or indirect, of any middleman, commission agent or a similar person.
3.8	BANK-C shall, on behalf of BANK-B, do all things and observe and perform all obligations falling to be done or observed under the Purchase Contract as if the Goods are purchased by BANK-B directly from the Supplier.

*Source:* Outlined by the author based on template provided by the Legal Department of Islamic of Islamic Development Bank

Section four highlights the responsibility of *Bank-C* for arrangement of necessary *takaful* as:

“*BANK-C* shall insure, or procure *takaful* of, the Goods during transit and until the Sale Contract between *BANK-B* and *BANK-C* is concluded in accordance with Section-7 hereof. Such *takaful* shall be, to the full replacement cost of the Goods, with reputable insurers acceptable to *BANK-B* against such risks as are normally insured by persons transporting goods in the same manner and of the same kind as the Goods. *BANK-C* shall ensure that a term of such *takaful* will be that any proceeds payable by

the insurers under such policy will be paid in a freely convertible currency. *BANK-C* shall also make sure that, if any of the risks covered by the *takaful* shall have happened, the proceeds of such *takaful* shall be paid to *BANK-B*.

Where the draft Purchase Contract does not provide for the *takaful* of the Goods by the Supplier/*Exporter* in the manner specified in the above paragraph, *BANK-C* shall, at the time of submitting the terms and conditions of the draft Purchase Contract for the approval of *BANK-B*, advise *BANK-B* of the arrangements it has made, or will make, to insure the Goods in the aforesaid manner in order to obtain *BANK-B*'s approval for the same.”

In section five, *Bank-C* shall ensure that “the Purchase Contract provides for the delivery of the Goods to its order, and *Bank-C* shall be responsible for checking its quality, quantity, specifications and all other matters relating thereto”. The payment of purchase price by *Bank-B* is explained in section six as indicated in Table 4.7.

**Table 4.7: Clauses on Payment of Purchase Price by Bank-B**

6.1	Unless BANK-B otherwise agrees in writing, payment of the Purchase Price of all Goods shall be made by Documentary Letters of Credit.
6.2	For each Operation, the minimum drawdown shall be US\$ 100,000.00 (United States Dollar One Hundred Thousand) and the maximum drawdown shall be US\$3,000,000.00 (United States Dollar Three Million).
6.3	Subject to Sections 6.1 and 6.2 hereof, promptly after securing BANK-B’s approval, BANK-C shall open the Letter of Credit in favour of the Supplier/Exporter in accordance with the terms mentioned in Section 6.4 hereof, and arrange with the issuing bank to send a copy of the full text of the Letter of Credit to BANK-B by an authenticated message. Upon receipt of the authenticated message, BANK-B shall check the terms of the Letter of Credit against the terms of this Agreement.
6.4	Subject to Section 6.2 hereof, the BANK-C shall open a Letter of Credit in the manner required by the Purchase Contract in favour of the Supplier. Each and every Letter of Credit established under this Agreement shall contain, inter alia, the following particulars: <ul style="list-style-type: none"> <li>a) The number of the Documentary Letter of Credit.</li> <li>b) The name of the issuing bank.</li> <li>c) The name of the applicant for the Credit.</li> <li>d) The name of the beneficiary of the Credit.</li> <li>e) Description and quantity of the Goods.</li> <li>f) Origin of the Goods.</li> <li>g) The amount.</li> <li>h) <i>Takaful</i> cover</li> <li>i) The expiry date.</li> <li>j) The latest shipment date.</li> <li>k) The name of the paying bank or the negotiating bank.</li> <li>l) That the Credit will be available by sight/deferred payment.</li> <li>m) That the Letter of Credit is subject to the UCP.</li> <li>n) That the negotiating bank to inform BANK-B 3 (Three) days prior to the value date of the payment to the Supplier.</li> </ul>
6.5	The issuing bank shall communicate to BANK-B through authenticated SWIFT message the full text of the Letter of Credit. Provided that the terms and conditions of the Letter of Credit are acceptable to BANK-B, BANK-B will, on receipt of the said telex or message, issue an Irrevocable Commitment to Reimburse.
6.6	Amendments of any Letter of Credit relating to the matters specified in Section 6.4 hereof shall be



	subject to the approval of BANK-B. Any other amendment could be made by agreement of the parties to the Letter of Credit without reverting to BANK-B. However, any such amendment shall be notified to BANK-B.
6.7	The first Letter of Credit shall be opened within 2 (Two) months from the Effective Date or any other mutually agreed date. In the event that the first Letter of Credit is not opened or submitted to BANK-B for the first Disbursement to the Supplier within the period specified hereinabove, and BANK-B is not satisfied with the justification for such failure to open or submit the first Letter of Credit, BANK-B may, by notice to the BANK-C, terminate this Agreement and cancel the Approved Amount.
6.8	It is agreed by the parties hereto that the whole of the Approved Amount shall be disbursed within a period 12 (Twelve) months from the date of first Disbursement. Unless BANK-B otherwise agrees, such part of the Approved Amount as may remain un-disbursed after the expiry of the period specified herein, will be considered cancelled.
6.9	BANK-C shall bear the fees of issuance of any Letter of Credit hereunder or the confirmation thereof, if any.

*Source:* Outlined by the author based on template provided by the Legal Department of Islamic of Islamic Development Bank

Going through section 6.2 of the agreement in Table 4.7, the agreement sets maximum amount of drawdown to ensure that the facility to be availed for SMEs. After procurement of goods by *Bank-C*, the next section, shown in Table 4.8, of the agreement would govern promise by *Bank-C* to purchase the goods from *Bank-B* and to resell to the same.

**Table 4.8: Clauses on Promise by Bank-C to Purchase the Goods from Bank-B**

7.1	BANK-C undertakes to purchase the Goods from BANK-B after it has taken delivery thereof on behalf of BANK-B on the terms specified in Section 7.2 to Section 21 hereof.
7.2	The Sale Contract shall be concluded by an exchange of tested telexes, authenticated swift or fax messages as soon as BANK-C has taken delivery of the Goods on behalf of BANK-B. The said exchange will consist of an offer from BANK-C in the form provided in Appendix-IV, and an acceptance from BANK-B in the form provided in Appendix-V. If BANK-C fails, without excuse, to communicate with BANK-B for the finalization of the conclusion of the Sale Contract after BANK-C has taken delivery of the Goods on behalf of BANK-B, BANK-C shall be liable to BANK-B for any damage caused by the breach of BANK-C's undertaking to conclude the Sale Contract.
7.3	BANK-C shall, immediately upon purchase of the Goods from BANK-B hereunder, resell the Goods to the Buyer on such terms and conditions as may be agreed upon between BANK-C and the Buyer.

*Source:* Outlined by the author based on template provided by the Legal Department of Islamic of Islamic Development Bank

Sale price payable to *Bank-B* from *Bank-C* would be indicated in section eight. Though there exist a controversy, LIBOR usually is used as benchmark in *murabahah* agreements. However, use of LIBOR as a reference is an accepted practice among *Shari'ah* scholars by analogy of grape juice to wine. After the sale of goods from *Bank-B* to *Bank-C*, *Bank-B* avails itself from any responsibility for defect with goods by a paragraph in section nine as:

As *BANK-C* will select the Goods relying solely on its own skill and judgment, it is expressly agreed between *BANK-B* and *BANK-C* that *BANK-C* shall purchase the Goods from *BANK-B* “As Is” on delivery without responsibility on the part of *BANK-B* for any defect therein. When *BANK-C* takes delivery of the Goods and the Sale Contract is concluded in accordance with Section 7 hereof, or after 21 (Twenty-one) days from the date of delivery, *BANK-C* will be assumed to have examined the Goods and has satisfied itself as to its quality, quantity etc. However, if any defect appears in the Goods, *BANK-B* undertakes to assign to *BANK-C*, or to its nominee, the rights and warranties to which *BANK-B* may be entitled under the Purchase Contract, together with any other rights and warranties which may be implied by law or custom in favour of a purchaser.

In this case denomination of the sale price is defined in United States Dollar in section ten of the agreement. Based on this sale price, section eleven of the agreement governs the payment of sale price as indicated with Table 4.9.

**Table 4.9: Payment of Sale Price Clauses**

11.1	BANK-C shall pay to BANK-B the Sale Price 12 (Twelve) months from the date the corresponding Purchase Price is paid by BANK-B.
11.2	If any payment becomes due on a day on which the banks are not officially open for business in the place where payment is to be effected by BANK-C to BANK-B hereunder, such payment shall be made on the next following day on which such banks are open for business.
11.3	If the BANK-C fails to pay any amount payable hereunder when it is due in accordance with the terms of this Agreement, then in addition to paying such amount, the BANK-C shall pay BANK-B a late payment charge in respect of overdue amount and any such late payment charge shall be calculated and applied as follows: <ul style="list-style-type: none"> <li>(a) a sum determined by BANK-B after applying the formula indicated below: <math display="block">\frac{A \times B \times C}{360}</math> <p style="margin-left: 40px;">Where: “A” means the unpaid amount;  “B” a sum in aggregate equal to 1% per annum;  “C” means the number of days from and including such due date to, and, including the date of actual payment (whether before or after judgment).</p> </li> <li>(b) all reasonable costs and expenses (including, without limitation, any legal, or collecting agent’s costs and expenses) incurred by BANK-B as a result of delay in payment to BANK-B.</li> </ul>

*Source:* Outlined by the author based on template provided by the Legal Department of Islamic of Islamic Development Bank

In case of late payment by *Bank-C*, *Bank-B* charges late payment charges though it might be concern from the aspect of *Shari’ah* compliance. However, *Bank-B* shall, after deducting all costs and expenses incurred, pay any amount received pursuant to this Section-11.3 to a *Charity* Fund Account, details of which are stipulated in the same

section. In doing so, *Bank-B* would ensure that no late payment charges are incurred by it (except from cost incurred for recovery) but all late payment charges are directed to charity in order to comply with Islamic finance principles.

Section twelve of the agreement would clarify the manner of payment of the sale price as such:

*BANK-C* shall pay each Sale Price to *BANK-B* by telex or cable transfer to such bank account as *BANK-B* shall specify to *BANK-C*, or in such other manner as *BANK-B* may direct from time to time. All charges and expenses in connection with any payment by *BANK-C* to *BANK-B* hereunder, including legal fees, agent bank fees and taxes, shall be paid by and shall be for the account of *BANK-C*. All payments by *BANK-C* to *BANK-B* hereunder shall be made without any set-off or counterclaim and free and clear of all taxes, charges, deductions or withholdings of whatever nature, all of which shall be for the account of *BANK-C*.

After the clause on delay in the exercise of rights as such: “No delay, forbearance or other indulgence on the part of *BANK-B* or *BANK-C* in exercising any rights, which it may have against the other party, shall constitute a waiver thereof”, section fourteen governs cancellation and suspension as provided in Table 4.10.

**Table 4.10: Clauses on Cancellation and Suspension**

14.1	<p>Unless a commitment has been made with a third party by, or on behalf of, <i>BANK-B</i>:</p> <ul style="list-style-type: none"> <li>(i) <i>BANK-C</i> may request <i>BANK-B</i> to cancel the Approved Amount or any part thereof.</li> <li>(ii) <i>BANK-B</i> may, by notice to <i>BANK-C</i>, suspend the authority of <i>BANK-C</i> to purchase the Goods on behalf of <i>BANK-B</i> in any of the following cases: <ul style="list-style-type: none"> <li>(a) If the Agreement is not declared effective within 2 (Two) months of the date of the Agreement.</li> <li>(b) An Event of Default shall have occurred and be continuing.</li> <li>(c) A Material Adverse Effect shall have occurred and be continuing.</li> <li>(d) Any action shall have been taken or legal proceedings shall have been started for the winding up, dissolution or reorganization with effect on the capacity of <i>BANK-C</i> to implement the Operation or meet its obligations under the Agreement (otherwise than for the purposes of an amalgamation or reconstruction while solvent on terms approved by <i>BANK-B</i> in writing) or for the appointment of a receiver, trustee or similar officer of <i>BANK-C</i> or of any or all revenues and assets of <i>BANK-C</i>.</li> <li>(e) An extraordinary situation shall have arisen which (i) shall make it, in the opinion of <i>BANK-B</i>, improbable that the Operation can be carried out by <i>BANK-C</i>, or (ii) shall prevent the attainment of the purposes for which this Agreement is entered into.</li> </ul> </li> </ul>
14.2	<p>Suspension of the authority of <i>BANK-C</i> to purchase the Goods on behalf of <i>BANK-B</i> shall continue, in whole or in part, as the case may be, until the event or events which gave rise to such suspension shall have ceased to exist before the expiry of the time limit indicated in Section 6.3 hereof, or until <i>BANK-B</i> shall have notified <i>BANK-C</i> that the suspension has been lifted, whichever is earlier, provided, however, that in the case of any such notice, the lifting of the suspension shall only be to the extent and subject to the conditions specified in such notice, and no such notice shall affect or impair any right, power or remedy of <i>BANK-B</i> in respect of any other or subsequent event described in this</p>

	Section.
14.3	If (a) suspension under Section 14.2 hereof shall have continued with respect to any part of the Approved Amount for a continuous period of 30 (Thirty) days or (b) at any time BANK-B determines, after consultation with BANK-C, that any part of the Approved Amount will not be required to finance the purchase of the Goods hereunder, BANK-B may give notice to BANK-C cancelling such part of the Approved Amount. That part of the Approved Amount shall be considered cancelled as from the date specified in such notice.
14.4	BANK-C shall have no authority to make any commitment on behalf of BANK-B after the date indicated in Section 14.3 hereof.
14.5	Cancellation of the Approved Amount or any part thereof under Section 14.3 hereof shall not affect any commitment made, obligations incurred or rights accrued prior to date of cancellation.

*Source:* Outlined by the author based on template provided by the Legal Department of Islamic of Islamic Development Bank

Like any international agreement, 2-Step *murabahah* Agreement would have clauses on representations and warranties.

**Table 4.11: Representation and Warranties Clauses**

15.1	BANK-C represents and warrants to BANK-B and acknowledges that BANK-B has agreed to this Agreement in reliance on the following representations and warranties:
(a)	BANK-C is duly established and validly existing under the laws of Gambia and has the corporate power and has obtained all required Authorisations to own its assets, conduct its business as presently conducted and to enter into, and comply with its obligations under, this Agreement and the Transaction to which it is a party or will, in the case of any Transaction document not executed as at the date of this Agreement, when that Transaction document is executed, have the corporate power to enter into, and comply with its obligations under, that Transaction document.
(b)	Each Transaction document to which BANK-C is a party has been, or will be, duly authorised and executed by BANK-C and constitutes, or will when executed constitute, a valid and legally binding obligation of BANK-C, enforceable in accordance with its terms and BANK-C is not, nor will it be, a party to any agreement other than the Transaction documents, and none of the Transaction documents has been, or will be, amended or modified except as permitted under this Agreement.
(c)	Neither the making of any Transaction document to which BANK-C is a party nor the compliance with its terms will conflict with or result in a breach of any of the terms, conditions or provisions of, or constitute a default or require any consent under, any indenture, mortgage, agreement or other instrument or arrangement to which BANK-C is a party or which it is bound, or violate any of the terms or provisions of the BANK-C's constitutive documents or any Authorisation, judgment, decree or order or any statute, rule or regulation applicable to BANK-C.
(d)	To the best of BANK-C's knowledge, after due inquiry all the Authorisations (other than Authorisations that are of a routine nature and are obtained in the ordinary course of business) needed by BANK-C to conduct its business, carry out the Transactions and execute, and comply with its obligations under, this Agreement and each of the other Transaction documents to which it is a party; and (ii) except for rights that can reasonably be expected to be obtained on commercially reasonable terms at the time required, the Transaction documents contain all rights that are necessary for the conduct of the obligations of BANK-C as contemplated under this Agreement.
(e)	The BANK-C's constitutive documents have not been amended since 1 July 2009.
(f)	Neither BANK-C nor any of its property enjoys any right of immunity from set-off, suit or execution with respect to its assets or its obligations under any Transaction document.
(g)	Since 1 July 2009, BANK-C:
(i)	has not suffered any change that has a material adverse effect or incurred any substantial loss or liability; and

	(ii)	has not undertaken or agreed to undertake any substantial obligation.
(h)		The financial statements of BANK-C for the period ending on 1 July 2009:
	(i)	have been prepared in accordance with the accounting standards, and give a true and fair view of the financial condition of BANK-C as of the date as of which they were prepared and the results of BANK-C's operations during the period then ended; and
	(ii)	disclose all liabilities (contingent or otherwise) of BANK-C or and the reserves, if any, for such liabilities and all unrealized or anticipated liabilities and losses arising from commitments entered into by BANK-C (whether or not such commitments have been disclosed in such financial statements).
(i)		BANK-C has good and marketable title to all of the assets purported to be owned by it, in all cases free and clear of all liens, other than Permitted Liens and no contracts or arrangements, conditional or unconditional, exist for the creation by BANK-C of any lien;
(j)		All tax returns and reports of BANK-C required by law to be filed have been duly filed and all taxes, obligations, fees and other governmental charges upon BANK-C, or its properties, or its income or assets, which are due and payable or to be withheld, have been paid or withheld, other than those presently payable without penalty.
(k)		BANK-C is not engaged in nor, to the best of its knowledge, after due inquiry, threatened by, any litigation, arbitration or administrative proceedings, the outcome of which could reasonably be expected to have a material adverse effect.
(l)		No judgment or order has been issued which has or may reasonably be expected to have a material adverse effect.
(m)		To the best of its knowledge and belief after due inquiry, BANK-C is not in violation of any statute or regulation of any authority.
(n)		There are no ongoing or, to the best knowledge of BANK-C after due inquiry, threatened, strikes, slowdowns or work stoppages by employees of BANK-C or any contractor with respect to this Agreement.
(o)		None of the representations and warranties in this Section omits any matter the omission of which makes any of such representations and warranties untrue or misleading in any material respect.
15.2		Each representation and warranty is deemed to be repeated by BANK-C on the date of each Disbursement. It is deemed to be made by reference to the circumstances existing at the time of the representation or warranty.

*Source:* Outlined by the author based on template provided by the Legal Department of Islamic of Islamic Development Bank

As part of the process, afterwards, standard clauses governing events of default by *Bank-C*, indemnity for *Bank-B*, declaration of effectiveness conditions for the facility under 2-Step *murabahah* scheme as well as conditions precedent to disbursement, documentation, governing law for settlement of dispute for the agreement and notice by *Bank-C* would follow. This agreement with Islamic finance components would differ from conventional internal finance agreements in governing law for settlement of dispute as the clauses indicated in Table 4.12. Most of the Islamic Banks use English Common Law as governing law in their agreement but recent cases show that under English Law, *Shair'ah* principles might be disregarded by the courts. In this regard direct reference to *Shari'ah* Law as governing law would be instrumental.

**Table 4.12: Clauses on Governing Law/Dispute Settlement**

21.1	This Agreement shall be governed by and be construed in accordance with Islamic <i>Shari'ah</i> (as set out in <i>Shari'ah</i> Standards published by the Accounting and Auditing Organization of Islamic Financial Institutions and as interpreted by the Islamic <i>Fiqh</i> Academy of the Organization of Islamic Cooperation or BANK-B's <i>Shari'ah</i> Committee).
21.2	Any dispute between the parties to this Agreement and any claim by any party against the other party arising under this Agreement, which could not be determined by agreement of the parties within 60 (Sixty) days of notice by one party to the other, shall be submitted to an arbitration panel for final and binding decision in accordance with the rules and procedures of the International Islamic Centre for Reconciliation and Arbitration (IICRA), Dubai. The arbitration rules and procedures of IICRA shall be in lieu of any other procedure for the determination of disputes between the parties to this Agreement or any claim by any party against the other party arising thereunder. The English language shall be used throughout the arbitral proceedings and the resulting award shall be final, binding and enforceable on the parties.
21.3	If within 30 (Thirty) days after counterparts of the award shall have been delivered to the parties, the award is not complied with, any party may enter judgment upon, or institute a proceeding to enforce the award, in any court of competent jurisdiction against the other party, may enforce such judgment by execution or may pursue any other appropriate remedy against the other party for the enforcement of the award or the provisions of this Agreement.
21.4	BANK-C agrees that any judgment rendered under this Agreement against it may be executed against its funds (assets) in any jurisdiction. BANK-C hereby irrevocably waives any objection it may have to any suit, action or proceeding arising out of or relating to the enforcement of an arbitration judgment under this Agreement, whether brought in any jurisdiction in which it has funds (assets), and hereby further irrevocably waives any claim that any such suit, action or proceeding brought in any jurisdiction has been brought in any inconvenient forum.
21.5	To the extent that BANK-C may in any jurisdiction claim for itself or its assets immunity from suit, execution, attachment (whether in aid or execution, before award or judgment or otherwise) or other legal process or to the extent that in any such jurisdiction there may be attributed to itself or its assets such immunity (whether or not claimed), BANK-C hereby irrevocably agrees not to claim and hereby irrevocably waives such immunity.
21.6	Notwithstanding Section 21.2 above, before an arbitrator has been appointed to determine a dispute or a claim, BANK-B may, by notice in writing to BANK-C require that a specific dispute or claim to be heard by a court of law and commence proceedings accordingly in such court of law. This section is for the sole benefit of BANK-B.

*Source:* Outlined by the author based on template provided by the Legal Department of Islamic of Islamic Development Bank

The agreement would also provide formats for effecting the transaction during the implementation phase of the facility in the appendix. In any case, any disbursement request through SWIFT messages would suffice to fulfil the requirement stipulated in the formats in the appendix as authenticated SWIFT messages are legally binding.

#### **4.11 CONCLUSION: EVALUATION OF THE STRUCTURE**

The main purpose of this chapter is to demonstrate the mobilization of resources with (Reverse) 2-Step *murabahah* Agreements by which fund providers are expected to assume only the risk of another financial institution rather than small beneficiaries. Two

different frameworks namely, (Reverse) 2-Step *murabahah* and *mudarabah* for resource mobilization are provided.

In the first framework, called *Reverse* (from *Bank-B*'s point of view) 2-Step *murabahah* financing, *Bank-A* signs a *murabahah* agreement with *Bank-B* where *Bank-B* signs another *murabahah* agreement with its customers. In other words, *Bank-B* purchases goods and commodities from *Bank-A* and sells them to its customers. Under Reverse 2-Step *murabahah* financing *Bank-A* takes the direct risk of *Bank-B*. That is, unlike the resources mobilized by *mudarabah*, Reverse 2-Step *murabahah* would appear on *Bank-B*'s balance sheet and increase the leverage. Besides, based on real life experiences this structure may not be feasible for some banks in the position of *Bank-B* due to the banking regulations, which prohibits banks' involvement in commodity trade in some countries. To overcome these types of obstacles, an agency agreement between *Bank-A* and *Bank-B* can be signed where *Bank-A* authorizes *Bank-B* for identification of potential beneficiaries for *Bank-A*'s financing. Then *Bank-A* directly signs *murabahah* Agreements with these entities identified by *Bank-B*. In this structure *Bank-A* again can take the direct risk of *Bank-B* alone through a Letter of Guarantee from *Bank-B*. Reverse 2-Step *murabahah* structure is easier for implementation and gives more flexibility to *Bank-B* for its relation with customers since the role of *Bank-A* is not necessarily highlighted as opposed to an agency agreement.

The second framework for resource mobilization, *mudarabah*, creates some complexities, as it requires cumbersome money transfer processes. Transferring money to *Bank-B*'s (*mudarab*) account in the paying agent bank by syndication participants and then transfer of money forward by the *mudarab* decreases the efficiency. Besides, it lacks the attractiveness as syndication participants are expected to take direct credit risk of the *importer* possibly unknown to them. On the other hand, for *Bank-B*, the resources mobilized by *mudarabah* would be off-balance sheet items, the credit risk of the *importer* would be shared with other participants and *Bank-B* would receive *mudarab* fee out of profit realized by the participants.

Going through the disbursement mechanism under the 2-Step *murabahah* Agreement, one can discern the complexity created by ICR. As a matter of fact in any case *Bank-C*, supposedly local and not internationally recognized, would need an L/C confirmation from an international bank such as *Bank-B*. However, under the 2-Step *murabahah* transaction there is no harm for the *importer* to directly enjoy internationally recognized *Bank-B*'s L/C. Note that this might not be attractive for *Bank-C* as it loses fees charged to the *importer* for opening L/C and turn the 2-Step *murabahah* Agreement into a *de facto* agency agreement. Pros and cons of an agency would come across then as explained here above.

After evaluating the different dimensions, one may appreciate the superiority of 2-Step *murabahah* financing for the simplicity it brings to the disbursement mechanism. Besides, 2-Step *murabahah* financing is very likely to be preferred by syndication participants over *mudarabah* as participants would like to avoid the credit risk of a small *importer*. However, as mentioned above, in some jurisdictions 2-Step *murabahah* financing may create legal problems to be overcome by an agency agreement accompanied by a Letter of Guarantee (L/G) from the fund-raising Bank. In addition, the fund-raising bank, *Bank-B*, would prefer *mudarabah* as it would not affect the leverage and brings a *mudarab* fee. In any case, this chapter demonstrates the potential of 2-Step *murabahah* for resource mobilization/liquidity management in Islamic finance as an alternative to not only *mudarabah* but also *sukuk* and commodity *murabahah* by constructing and structuring a particular mechanism. It is expected that this might be utilized by IDB's agencies in facilitating trade financing between member countries and also between the Bank and the member countries.



## **Chapter 5**

# **CONTEXTUALISATION, DISCUSSION AND CONCLUSION**

### **5.1 SUMMARY OF THE RESULTS**

The first part of Chapter 2 on determinant of intra-OIC trade indicates that recent increase in intra-OIC trade ratio is not achieved through existing policies of OIC organs. Hence, several policy measures need to be implemented to turn the OIC-Ten Year Programme of Action on. The majority of the possible measures relates to customs. With reference to many OIC countries' worries on loss of valuable tax revenue from customs, second part of Chapter 2 examined the determinants of OIC countries' customs revenue to suggest that trade integration itself may not lead to loss of revenue from customs. Chapter 2 is structured by classifying the sample of OIC countries according to GDP sizes as OIC countries whose GDP is less than US\$40 billion are deemed small while others deemed as big country. The results of the econometric model indicates that tariff as well as policy measures such as implementation of WTO customs valuation agreement might not have impact on customs revenue for small OIC countries. It is argued that the lack of capacity in small countries to impose requirements of these policy measures is a possible cause of leakage in tax collection. Accordingly, the survey on trade facilitation, employing the same GDP size classification, under this research directed to senior government officials. The survey on "Trade Facilitation in OIC Member Countries *vis-à-vis* WTO Trade Facilitation Negotiations on GATT Articles V, VIII and X and Agreement on Implementation of Article VII (Customs Valuation) of GATT", as provided in Appendix IX, was conducted during the seminar on "Non-tariff Barrier Impact on Market Access" in Tunisia, 4-8 October 2009. The objective of this survey is (i) to assess the level of implementation of GATT articles V, VII, VIII and X in OIC countries so as to diagnose relevant needs and (ii) to identify important trade facilitation needs/remedies as a base for cooperation among OIC countries. The main motivation behind such a humble survey initiative was to have reflections of government officials on the issue as complement to results of econometric models. The results of the survey indicate differing stands of OIC countries based on their economic size. Small countries mainly suffer from supply side

constraint, including lack of trade finance, as well as lack of capacity for standard and conformity assessment testing. Besides, public authorities of small countries hold very strong concerns on customs revenue loss while big countries' main concern is the market access to other OIC countries especially market access to small OIC countries. The result of the survey is provided in Table 5.1. As per indication of second part of Chapter 2, OIC countries are classified as small and big based on their GDP size while designing the questionnaire.

**Table 5.1: Summary for the Results of the Survey<sup>98</sup>**

Small Countries (GDP less than US\$ 40 billion)	Big Countries (GDP more than US\$ 40 billion)
<p>1- Supply side constraints for trade (with reference WTO Aid-for-Trade Agenda):</p> <p>1.a. Insufficient transportation infrastructure;</p> <p>1.b. Low industrial production capacity;</p> <p>1.c. Inefficient customs;</p> <p>1.d. Low Port efficiency.</p>	<p>1- Market access to other OIC countries:</p> <p>1.a. Insufficient transportation infrastructure of small OIC countries;</p> <p>1.b. Low port efficiency of small OIC countries;</p> <p>1.c. Irregular payments in customs to expedite customs clearance;</p> <p>1.d. Technical barriers to trade in OIC countries;</p>
<p>2- Fear for loss of customs revenue and irregular payments in customs:</p> <p>2.a. Non-Harmonization of tariff nomenclature, customs valuation practices and rule of origin;</p> <p>2.b. Non-Harmonization of customs procedures as well as non-existence of well established Information and Communication Technology implications in the form of Single Window for customs administrations.</p>	<p>1.e. Custom Valuation problem in OIC countries;</p> <p>1.f. Various Non-Tariff Barriers in OIC countries.</p>
<p>3- Lack of capacity in testing bodies and labs to exercise standard testing for imports.</p>	

*Source:* Compiled by the author from the results

In parallel to the survey conducted under this research, SESRIC conducted a questionnaire on ‘Enhancing Economic and Commercial Cooperation among OIC

<sup>98</sup> The survey on trade facilitation in OIC member countries Vis-à-vis WTO trade facilitation negotiations on GATT Articles V, VIII and X and agreement on implementation of Article VII (Customs valuation) of GATT. The survey was conducted during the Seminar on “Non-tariff Barrier Impact on Market Access” in Tunisia, 4-8 October 2009. The survey is provided as in the Appendix IX.

Member Countries'. The questionnaire was directed to eminent persons and experts from international organizations, academia, private sector representatives, OIC bodies and government bodies. The fourth section of the questionnaire enquired benchmark regional integration for additional insight to OIC economic integration. Most of the respondents counted the Association of Southeast Asian Nations (ASEAN) as a good benchmark since it could successfully bring countries with very different socio-economic development levels together. Together with the implementation of ASEAN AFTA, ASEAN countries successfully introduced complementary trade facilitation measures. In addition to electronicization of customs (establishment of national Single Window) to be integrated in the next step, development of mutual recognition agreement for chemical products and electrical equipments, ASEAN very successfully harmonized customs procedures of very diverse member countries including Malaysia, Myanmar, Philippines, Singapore, Indonesia, *etc.* which tremendously vary in socio-economic and public management dimensions. Respondents also count European Integration as an excellent example of strong political will. However, they do not take European Integration as a good benchmark as it is highly institutionalized, costly and comprises of politically alike countries. The respondents very often stressed the removal of non-tariff barriers alongside the tariff reduction for a deeper economic integration. Also, for a deeper economic integration cooperation among customs authorities of OIC member countries, technological improvements in customs procedures and mutual recognition of standard and conformity assessment test were listed to be pursued. In an interview conducted for this research with Mr. El Hassane Hzaine from Islamic Center for Development of Trade, he warns the potential shortfalls with the harmonization course and proposes the mutual recognition principle as an alternative, practical, and cost-effective course. Another major recommendation from the SESRIC's questionnaire is establishment of Free Trade Zones for small countries to create tax incentives in order to build domestic production capacity to engage in international trade.

In Chapter 3, creative value chain financing for cotton sector development has been proposed to avail needed funds for addressing the supply side constraint which is also within WTO Aid for Trade initiative. However, trade finance alone would not suffice to achieve the aspiration of the OIC Five-Year Cotton Action plan. Particularly, policy

measures for enhancing agricultural efficiency, especially yield per hectare, in cotton-producing OIC member countries are needed.

Lack of trade finance is also indicated as an impediment to more trade for OIC countries. Indeed, the importance of trade finance is eminent even in the legal text of the Framework Agreement in TPS-OIC, which was drafted in the mid-1980s. As stated in Article 2, the agreement aims at the promotion of trade among OIC Member States through the exchange of trade preferences by “making use of the trade financing and export credit insurance facilities provided by OIC institutions, in conformity with their rules and regulations, for products exchanged under this Agreement”.<sup>99</sup> Accordingly in Chapter 4, 2-Step *murabahah* is proposed to direct more funds to support OIC countries’ trade. Nevertheless, the proposed structure needs to be placed under a market for mobilizing more resources in an efficient manner. In an interview with Mr. Hani Salem Sonbol, Deputy Chief Executive Officer of International Islamic Trade Finance Corporation of Islamic Development Bank Group, he listed the limitations to enhance intra-OIC trade by availing trade finance:

Even in a concessional form, trade finance might do very little to affect importers’ preference of supplier. Concessional trade financing alone to promote imports from OIC countries is likely to be curbed given the importance of quality and timely delivery of shipment commitment in trade business. As long as the private sector in OIC countries develops its capacity to supply quality on a timely basis, a couple of hundred basic point concessions in trade finance would not urge imports from OIC countries. Hence, he suggests mobilizing resource for availing trade finance to enable OIC countries to sustain their economy/industry by imports in a competitive global market where the private sector in OIC countries should survive. That is, trade financing activities should have trade-creation effects for all and urge a more competitive business environment for the private sector in OIC countries by availing more trade finance especially in favour of Least Developed OIC Countries.

Besides, he suggests that the greatest challenge for intra-OIC trade comes from supply side constraints in the form of production capacity and trade infrastructure. OIC countries still lack in production capacity for non-oil sectors especially in industry. Basically, if they are not able to produce enough even for the domestic market with reasonable prices,

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<sup>99</sup> The Framework Agreement for TPS-OIC legal text is available at [http://www.comcec.org/EN/belge/agreements/doc/TPS-OIC\(E\).doc](http://www.comcec.org/EN/belge/agreements/doc/TPS-OIC(E).doc) last accessed on 22 November 2009.

it is difficult to urge them to sell to other OIC countries. Although many OIC countries have comparative advantages in the agricultural sector, given the price suppression as a result of agricultural subsidies, most prominently in cotton, in developed countries it is not possible to capitalize this for enhancing trade among OIC countries. Paying over international prices for the sake of enhancing intra-OIC trade might not be expected from importers. Even after heavy investment to meet domestic consumption many OIC countries need to have enough transport infrastructures, *i.e.* efficient ports to handle heavy traffic, and human capacity in their countries and in partner OIC countries to handle international trade transactions. Even then existence of Non-Tariff-Barriers in partner OIC countries might turn out to be a hurdle. He counts lack of trade infrastructure and very existence of Non-Tariff-Barriers as serious challenges especially for small OIC countries. However, there might be some improvement opportunities by providing trade finance solutions in the form of capacity building of financial institutions, cooperation among stock exchanges and other financial institutions to develop a settlement system for payment of trade transactions. Besides, this cooperation can be expanded to mobilize more resources to be availed for entities in OIC countries in order to decrease trade financing costs.

## **5.2 POLICY IMPLICATIONS OF THE RESEARCH**

As evidenced from deliverables mentioned here above, there are many items proposed which do not seem to be in a well-designed framework. Since the effectiveness of PRETAS as of 25th COMCEC in November 2009, it would be a good gain to discuss a formal framework and continue activities on OIC trade integration within a formal framework for any future initiative. Based on the mentioned observations, this section proposes outward-looking, cost-effective, and informal policy options for a resilient OIC trade integration framework which avoids rigidly structured, highly institutionalized integration so the costs associated do not exceed the benefit generated out of integration.

Non-feasibility and unsuitability of the projects are major risks in the process of designing a trade integration framework. Hence, benchmarking is very important to identify implementable projects. European Integration for trade integration could have

been a good benchmark in many ways but ASEAN integration would be much more suitable for OIC, as per reasons provided above. The ASEAN Trade Integration Model can be benchmarked as summarized by Gundogdu (2007):

- (i) Harmonization of tariff nomenclature;
- (ii) Harmonization of custom valuation;
- (iii) Harmonization of custom procedure;
- (iv) National Single Windows to be integrated;
- (v) Mutual Recognition Agreements (MRAs).<sup>100</sup>

These projects require high involvement from the member countries, as it involves major risks in implementation. For example, introduction of Single Window often gets resistance from well-established Custom connections. The preference, therefore, is to maintain the *status quo*.

**Table 5.2: The Outline of the OIC Trade Integration**

Strategy:	Structure:
A. Capacity building in trade facilitation for small OIC countries	A.1. Harmonization of tariff nomenclature A.2. Harmonization of custom valuation A.3. Harmonization of custom procedure A.4. Improving port efficiency A.5. Capacity building for testing bodies and labs A.6. Establishment of National Single Windows
B. Improving market access among OIC countries	B.1. Mutual Recognition Agreements (MRAs)-based on HALAL Standards B.2. Trade Preferential System (PRETAS) for OIC Member Countries B.3. Unified Rule of Origin Cumulation System
C. Developing a scheme to encourage companies for cross border trade by relieving tax burdens	C.1. Inward Processing Regime
D. Develop a system based on Information and Communication Technology for collaboration among OIC countries in the area of customs valuation, inspection, etc.	D.1. Integrated Single Window
E. Divert funds from speculative instruments to trade finance needs of OIC countries	E.1. 2-Step <i>murabahah</i>
F. Cotton Sector Development	F.1. Enhancing productivity and production techniques; F.2. Strengthening member countries' structural capacities and organizations; F.3. Developing the fields of processing and marketing; F.4. Trade and international competitiveness; F.5. Arranging finances.

Source: Drawn by the author

<sup>100</sup> ASEAN Cosmetics MRA was signed in 2003 and electrical&electronic equipments MRA signed in 2002.

Based on the result of three essays and connected surveys an outline for OIC trade integration is developed in Table 5.2. The recommendations in the outline are explained hereafter.

### **5.2.1 Capacity Building in Trade Facilitation**

Although there is no clear definition of ‘trade facilitation’, based on the international organization’s definition, it implies improved efficiency in the administration, procedure, and logistics at ports and customs in order to decrease time and cost of cross border trade. Trade facilitation has been subject of many international initiatives but it was at the 1996 Singapore Ministerial Conference where ministers from WTO member-countries instructed the WTO Goods Council to look at possible ways of simplifying trade procedures, an issue referred as “trade facilitation”.<sup>101</sup>

Going through Table 5.1, the importance of trade facilitation especially for small OIC countries is eminent as it can mitigate some of the supply side constraints while assuring reasonable customs revenue. However, as evidenced from the definition above, scope of trade facilitation is up to customs and ports. Any supply side constraints afterwards such as transportation infrastructure development should not be in the framework as this can undermine cost-effective and informal policy options for a resilient OIC trade integration framework. Those supply side constraints such as transportation infrastructure or industrial capacity building might better be the subject of development banks and governments agencies.

On the other hand, capacity building in trade facilitation would boost cross-border trade for not only members of an economic integration but also non-members once implemented by a country as stated by Cernat (2001; Page-15) after puzzling results for trade-creating effect of African RTAs, who argued that

Unlike widespread opinions and standard theoretical prediction, a large number of African RTAs are not trade-diverting but trade-creating, both with regard to intra- and extra-RTA trade. Explanation for these apparently puzzling results is to be

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<sup>101</sup> The Singapore issues were cited in the 1 August 2004 decision which broke the Cancún deadlock. WTO Members agreed to start negotiations on trade facilitation, but not the three other Singapore issues.

found in the reduction of invisible trade barriers that hampered trade with both RTA members and third countries.

That is, trade facilitation itself is not trade diverting at all. However, since they boost economic development through more cross-border trade, they should not be ignored.

As indicated in Table 5.2, Items A.1. to A.3., very often, are implemented through the WTO / regional economic integration membership process and it is very likely that many OIC countries have gone through those. On the other hand, there exists huge trade facilitation gain through improving port efficiency of OIC countries. Without efficient ports, any improvement in custom clearance would mean very little as inefficient ports would neutralize the gains in custom clearance. Recent work at the World Bank (Wilson *et al.*, 2003) examines the relationship between trade facilitation and trade flows in the Asia-Pacific region. The study defines and measures trade facilitation using four broad indicators. Each one is constructed using country-specific data for 19 members of the Asia Pacific Economic Cooperation (APEC) to build the following measures:

- (i) Port efficiency;
- (ii) Customs environment;
- (iii) Regulatory environment; and
- (iv) E-business usage.

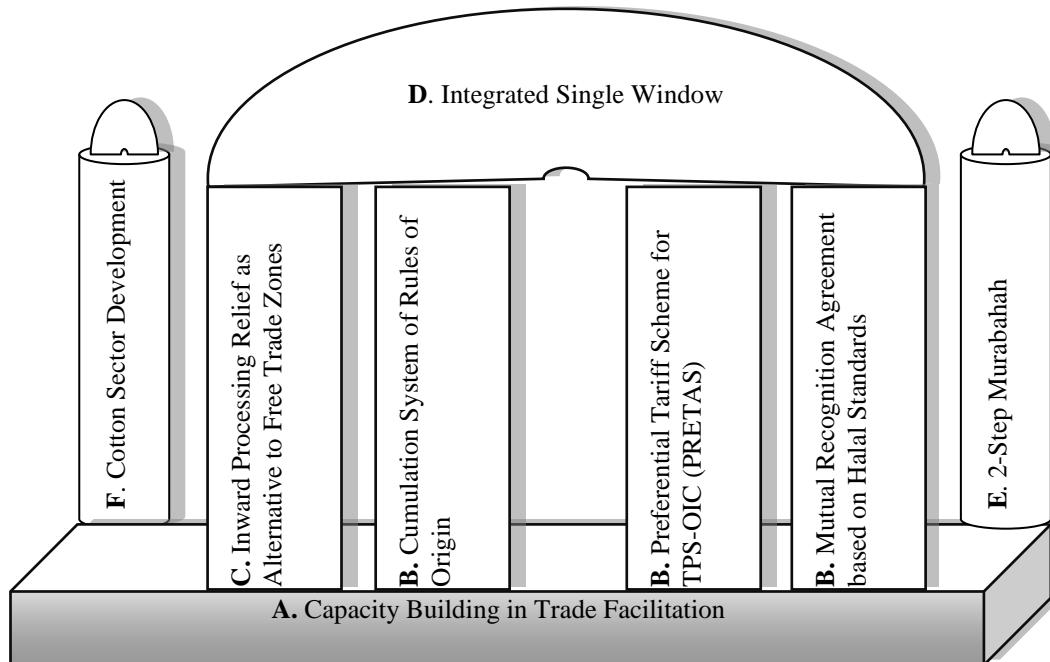
The findings suggest that enhanced port efficiency among these countries has a large and positive effect on trade and that regulatory barriers reduce trade prospects. Improvements in customs and greater e-business used significantly also improve trade, however, to a lesser degree than the effect of increased efficiency of ports. It is argued that a programme to raise capacity 'half-way' to the APEC average in all four areas among those countries below average would yield an increase in intra-APEC trade of about \$254 billion dollars. This is about a 21% rise in total intra-APEC manufactures trade. About \$117 billion of the gain (and 10% of the increase in trade) comes from the improvement in port efficiency.

With implementation of trade facilitation activities trade potential for private entities in small OIC countries should be expected to expand substantially. Given the strong base



after capacity building in trade facilitation, a resilient OIC trade integration framework can have strong base for any further initiative.

**Figure 5.1: The Framework for OIC Trade Integration**



Source: Designed by the author

In the next stage, further market access opportunities should be sought for OIC countries so they can have more trade opportunities with each other. The proposed framework, as depicted in Figure 5.1, requires strong foundations to be addressed with capacity building in trade facilitation. It is the sound capacity of OIC member countries in trade facilitation, which can substantiate other building blocks of B. for market access, C., D., E. and F. After elaboration of capacity building in trade facilitation, building pillars of the proposed trade integration framework:

- (i) B. Mutual Recognition Agreement
- (ii) B. PRETAS
- (iii) B. Cumulation System of Rule of Origin
- (iv) C. Inward Processing
- (v) D. Integrated Single Window

- (vi) E. Two-Step *Murabahah*
- (vii) F. Cotton Sector Development

are explained hereafter starting with Mutual Recognition concept.

### **5.2.2 Mutual Recognition Agreement for Market Access**

As stated by Pascal Lamy, the Director General of WTO, “while international standards are important, the procedures that are used to assess compliance with them are equally important, since they too can obstruct trade”.<sup>102</sup> Very often exporters, even if they have international as well as own countries’ certificates, might be required to obtain some national conformity assessment test for other countries. Obviously this would necessitate many standard tests for each country as per the national regulations of the country and gives rise to higher transaction cost and increases red tape, which may result in decreased probability of exports. On some occasions disturbance caused by standard and conformity even discourage exporters to do business with some countries (Gundogdu, 2007).

Any gain under OIC trade integration might be seriously curbed by technical barriers and cumbersome procedures of standard and conformity assessment tests for customs clearances. This issue was also in the agenda of ‘Transatlantic Economic Partnership’ between USA and EU to introduce a ‘Mutual Recognition Agreement’ (MRA) in order to mutually recognize each other’s conformity assessment test.<sup>103</sup> Besides, MRAs have been subject of much other regional integration such as NAFTA, MERCOSUR and APEC, ASEAN, *etc.*<sup>104</sup> It should also be noted that the concept of mutual recognition was also an important part of European integration since the *Cassis De Dijon* case in 1979 which changed the direction from harmonization of standards to mutual recognition principle for “Single European Market” (Stephenson 1998).

It can well be one of OIC trade integration strategy for a deeper OIC economic integration, as it can be a base for standard and conformity assessment tool for accepting

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<sup>102</sup> International Electrotechnical Commission IEC Council Centennial Session held on 26 September 2006, available at [http://www.wto.org/english/news\\_e/sppl\\_e/sppl41\\_e.htm](http://www.wto.org/english/news_e/sppl_e/sppl41_e.htm) last accessed on 10 November 2009.

<sup>103</sup> The London EU-US Summit of 18 May 1998.

<sup>104</sup> S. M. Stephenson, “Mutual recognition and its role in trade facilitation,” *Journal of World Trade* vol.33, No2 (1998).

the education and training standards of member countries which was also planned under ASEAN integration (Gundogdu 2007). In that regard, OIC MRA based on HALAL standard and conformity assessment would pave the way not only for easier cross-border trade but also for a deeper OIC economic integration. In its eleventh session, Islamic Summit Conference 2008 placed 'Halal food standards' within OIC economic integration, as it would be read from the final communiqué:

135. The Conference commended the major role undertaken by the Islamic Chamber of Commerce and Industry (ICCI) to reinforce Economic and Trade Cooperation among Member States. Furthermore, it welcomed the plans of the Chamber of Commerce and Industry and supported it as the principal representative of the private sector in OIC Member States with regards to values, Halal, and quality control. The Conference, likewise, expressed its appreciation for the pioneering leadership of the Chamber's Chairman. Furthermore, the Conference underlines the urgent need for the speedy implementation of the Chamber's Plan of Action to consolidate economic and trade cooperation among Member States. It urged all Muslim governments to facilitate the procedures in activating its mechanisms.<sup>105</sup>

In a similar fashion the 34<sup>th</sup> session of the Council of OIC Foreign Ministers in 2008 adopted the following resolution:

RESOLUTION NO. 7/35-E THE DEVELOPMENT OF INTERNATIONAL  
HALAL STANDARD

*(Extracts)*

3. Commends the ongoing efforts to develop an OIC Halal Standards, in particular regarding certification and accreditation among OIC Member States.

4. Welcomes the contribution of RM15 million by the Government of Malaysia over the next 3 years for the funding support of the operating cost of The International Halal Integrity Alliance, a non-profit organisation with the objective to promote and enhance international collaboration amongst national halal authorities...<sup>106</sup>

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<sup>105</sup> <http://www.ihialliance.org/oic.php> last accessed on 0 December 2011.

<sup>106</sup> <http://www.ihialliance.org/oic.php> last accessed on 0 December 2011.

This resolution was adopted during the session of prosperity and development.<sup>107</sup> For this purpose, projects for synchronization and capacity building of testing Labs/Bodies of OIC countries are needed as Director General of WTO drew the attention to the particularly acute problem in developing countries in stating “the fact that there are not enough internationally recognized conformity assessment institutions in these countries.”<sup>108</sup> Patent offices in OIC countries might also be included to MRA activities based on ongoing Halal standards initiatives.

Again going from Figure 5.1, PRETAS is recommended to be another pillar of the OIC trade integration framework.

### **5.2.3 Protocol on the Preferential Tariff Scheme for TPS-OIC (PRETAS) for Market Access<sup>109</sup>**

Became effective after ratified by 10 OIC member countries as of 25<sup>th</sup> COMCEC, the PRETAS is a milestone for OIC Trade integration. Indeed, it is an additional protocol to the more comprehensive TPS/OIC Agreement. PRETAS covers both industrial and agricultural products identified at HS level of the National Tariff Codes. The protocol operates based on the Most Favoured Nation (MFN) principle and the rules of origin for eligible products regulated according to the Annexed III of the Framework Agreement TPS/OIC until new TPS-OIC Rules of Origin Agreement become effective. The protocol includes special treatment for the Least Developed Countries by a three-year grace period for tariff reduction. The protocol introduces the following tariff reduction programme:

Each participating state covers 7% of its total HS lines but any state with 90% and above of its tariff lines less than 10% shall cover only 1% of the same total HS lines. Participating States are given option to products list to be liberalised. Besides, the 7% of total HS lines referred only includes the lines with tariff above 10%. Accordingly

- (i) Tariffs above 25% shall be reduced to 25%;

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<sup>107</sup> Obtained from Halal Alliance web page at <http://www.ihialliance.org/oic.php> last accessed on 03 June 2010.

<sup>108</sup> International Electrotechnical Commission IEC Council Centennial Session held on 26 September 2006, available at [http://www.wto.org/english/news\\_e/sppl\\_e/sppl41\\_e.htm](http://www.wto.org/english/news_e/sppl_e/sppl41_e.htm) last accessed on 10 November 2009.

<sup>109</sup> Available at [http://www.comcec.org/EN/belge/agreements/doc/PRETAS\(E\).doc](http://www.comcec.org/EN/belge/agreements/doc/PRETAS(E).doc) last accessed on 22 September 2009.

- (ii) Tariffs above 15% and up to 25%, shall be reduced to 15%;
- (iii) Tariffs above 10% and up to 15% shall be reduced to 10%.

These reductions are considered to take place in a gradual way. The implementation period is divided into six instalments for the Least Developed Countries and into four for others as of effectiveness date of PRETAS. The protocol also propose voluntary fast track tariff reduction schedule in the Article 4. Besides, it also necessitates abolishment of para-tariff and non-tariff barriers on the products subject to tariff reduction.

For a higher market access, percentage of tariff lines included might be extended in the future and more emphasis is to be given for non-oil products in tariff reduction to boost intra-OIC trade as evidence from “double dominance effect” mentioned before.

#### **5.2.4 Cumulation System of Rules of Origin for Market Access**

Cumulation system is a tool to allow imports from certain countries without undermining the origin of the final product to be exported.<sup>110</sup> Under a full cumulation system, products which have obtained originating status in one of the member countries may be added to products originating in any other member country without losing their originating status within the region. To enjoy preferential tariff rates in custom clearance, goods are required to obtain certificate of origin showing they have originated from (*i.e.* 40% of the content) a member country of preferential trade agreement. Under the full Cumulation system, even if the content is, let’s say, 20%, and if the trader proves that other 20% is from another member of the free trade agreement, these products can still enjoy preferential tariff rate.<sup>111</sup>

Pan-European Cumulation System, for example, was introduced in 1997, effectively created the Pan-European free trade zone for industrial goods. Turkey, which had been in customs union with the EU since 1996, joined the system in 1999. The system, with

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<sup>110</sup> There are three type so cumulation namely, bilateral, diagonal and full cumulation.

<sup>111</sup> For more detail please refer to “Rules of Origin, Trade and Customs” by Paul Brenton and Hiroshi Imagawa, Customs Modernization Handbook, p.183-212, published by World Bank available on line at [http://siteresources.worldbank.org/INTEXP/COMNET/Resources/Customs\\_Modernization\\_Handbook.pdf](http://siteresources.worldbank.org/INTEXP/COMNET/Resources/Customs_Modernization_Handbook.pdf) last accessed on 21 November 2009.

diagonal cumulation base, is being enlarged to the OIC member Mediterranean countries under the ‘Euro-Mediterranean Partnership Initiative’.<sup>112</sup>

PRETAS is a very important initiative and it should be further fortified by a Unified Rules of Origin Cumulation System. In this regard, TPS-OIC Rules of Origin Agreement is already being prepared by the Trade Negotiation Committee would come into force after necessary number of ratification of 10 states.<sup>113</sup> The Trade Negotiation Committee prepared a very comprehensive TPS-OIC Rule of Origin document which not only propose a full cumulation system under TPS-OIC Certificate Origin but also refers to customs valuation issues within the WTO Customs Valuation Agreement principles.<sup>114</sup> Besides, Chapter V of the agreement makes arrangements for administrative cooperation for mutual assistance and verification of certificate of origin.

There seems, however, to be a potential bottleneck for the verification of certificate origin issued by another member country. The cooperation among customs authorities, as in compliance with the Doha Ministerial Conference decision for identifying and assessing practical means for the exchange of information among customs authorities, might not be efficient. Establishment of Single Windows at national level to be integrated to other OIC countries’ Single Windows as planned by ASEAN countries, might more effectively address this bottleneck as well as undervaluation with customs valuation procedure and identification of tariff nomenclature during the customs clearance as proposed in Chapter 2 of this work.

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<sup>112</sup> [http://ec.europa.eu/taxation\\_customs/customs/customs\\_duties/rules\\_origin/preferential/article\\_783\\_en.htm](http://ec.europa.eu/taxation_customs/customs/customs_duties/rules_origin/preferential/article_783_en.htm) accessed on 30 October 2009.

<sup>113</sup> Available at [http://www.comcec.org/EN/belge/agreements/doc/TPS-OIC%20RULES%20OF%20ORIGIN\(E\).doc](http://www.comcec.org/EN/belge/agreements/doc/TPS-OIC%20RULES%20OF%20ORIGIN(E).doc) last accessed on 23 November 2009.

<sup>114</sup> According to the agreement, customs value for taxation should be determined by transaction value. In case of customs value can not be determined by transaction value it should be determined by either:

- Transaction value of identical goods;
- Transaction value of similar goods;
- Deductive value method;
- Computed value method;
- Fall-back method.

Not surprisingly, the process is a replica of the system introduced with “WTO Customs Valuation Agreement”.

### 5.2.5 Inward Processing Relief as an Alternative to Free Trade Zones

Inward Processing Relief (IPR) is a method of obtaining relief from customs duties, financial transaction taxes for imports and Value Added Tax (VAT) charges for imports processing against a specific export commitment. The relief applies to raw materials/goods imported from outside the country, processed and exported back to outside the country. IPR provides relief to promote industrial exports and enhance competitiveness of local industries in the world market.<sup>115</sup> In this regard, it can be a very effective tool for strategic product and export-oriented industry development for small OIC countries as an alternative to establishment of Free Trade Zones which are highly institutionalized and costly.

IPR has been employed by the European Union for a long time and proved to be a very effective tool. As a part of EU Custom Union, Turkey has a long tradition of implementing inward processing in alliance with EU practices based on EC-Turkey Association Council Resolution 1/95.<sup>116</sup>

To provide an idea about its widespread utilization, as stated in WTO Trade Policy Review of Turkey, recently more than half of the imports of Turkey has been cleared under IPR. There is a strong correlation between the number of IPR Licenses issued and the recent foreign trade increase of Turkey. Presently, IPRs are used even for local inputs to be processed for domestic and foreign markets. To give an idea about its instrumentality, Turkey issues IPR licenses for the Electrical Generator sector (identified as a strategic sector), which obtains its input from the domestic market and are exempted from VAT and some banking taxes related to purchase under IPR, for exports and even domestic sale.<sup>117</sup>

Similar to the cumulation system, this tool also has a bottleneck as tracking of an IPR license is very cumbersome and requires cooperation of many national agencies. As observed with the Free Trade Zone, ineffective controlling might lead to customs revenue

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<sup>115</sup> Accessed on 10 November 2009 at [http://customs.hmrc.gov.uk/channelsPortalWebApp/downloadFile?contentID=HMCE\\_CL\\_000229](http://customs.hmrc.gov.uk/channelsPortalWebApp/downloadFile?contentID=HMCE_CL_000229)

<sup>116</sup> Accessed on 10 November 2009 at [undp.un.org.tr/unido/documents/nationalprogtr-41.rtf](http://undp.un.org.tr/unido/documents/nationalprogtr-41.rtf)

<sup>117</sup> Refers to the author's own experience with Turkish Exporters Unions

loss and paper-base monitoring would create huge and discouraging red tape. In this regard, implementation of the Information and Communication Technology (ICT) system under national Single Window which allow effective cooperation among national agencies and preferably other OIC countries' public authorities might be essential.

### **5.2.6 Integrated Single Window**

The framework developed up to now indicates the importance of cooperation among public authorities within the country and cooperation of public authorities among OIC countries. Inefficient communication might seriously undermine the proposed framework as it might create huge red tape as an impediment to cross-border trade rather than encouragement for private sector in OIC countries to trade more among each other.

As a result implementation of information and communication technology solutions is an utmost important issue for successful OIC trade integration. In brief, a Single Window system refers to single submission of data and information, single and synchronous procession of data and information, single decision-making for custom release and clearance by information and communication technology applications. For example, in the ASEAN region, Singapore developed a very reputable single window called TradeNET by which traders can submit export/import documentations electronically to the various government agencies for processing and electronically receiving approval notification. TradeNET entertains about 30,000 transactions per day, and decreased customs declaration approval time to 5 minutes.<sup>118</sup> In this regard, single window applications can decrease time and cost of cross-border trade, hence, stimulates trade of a country. Some OIC countries have already implemented national single window systems such as Malaysia's DagangNET and Turkey's Bilge System.<sup>119</sup> Tunisia benchmarked Singapore's TradeNET. Also, some OIC countries adopted ASYCUDA system developed by UNCTAD.<sup>120</sup>

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<sup>118</sup> R. Jayanta, B. Shweta, "Key issues in trade facilitation, summary of World Bank/EU workshops in Dhaka and Shanghai in 2004," World Bank Policy Research Paper 3703(2005).

<sup>119</sup> For more information on Bilge see [http://en.gumruk.gov.tr/e-customs/projeweb\\_eu.pdf](http://en.gumruk.gov.tr/e-customs/projeweb_eu.pdf); for more information on DagangNET see [http://www.unescap.org/tid/projects/da6\\_symposium\\_s2mah.pdf](http://www.unescap.org/tid/projects/da6_symposium_s2mah.pdf) last accessed on 23 November 2009.

<sup>120</sup> Iran, Jordan, Yemen, Burkina Faso, Mali, Gambia, Benin, Cote d'Ivoire, Guinea, Mauritania, Uganda, Chad, Sudan, Comoros, Gabon, Niger, Cameroon, Nigeria Bangladesh, Maldives, Lebanon, Palestine and Syria. Accessed on 10 August 2009 at <http://www.asycuda.org/countrydb.asp>.



The integration of single window within the OIC trade integration framework should be two-fold. First of all, given the very complicating and crucial taxation issues expected to be caused by inward processing, rules of origin cumulation system and mutual recognition agreement, national single windows for customs might be integrated to local government agencies involved with inward processing relief and TPS-OIC Certificate of Origin issuing agencies as well as testing bodies. In the second stage, national windows of OIC countries can be integrated to allow an efficient cooperation among OIC countries' customs authorities for identification of tariff nomenclature for customs taxation, preventing undervaluation during customs clearance as well as verification of TPS-OIC Certificates of Origin. Such cooperation can serve to prevent valuable customs revenue loss especially for small OIC countries.

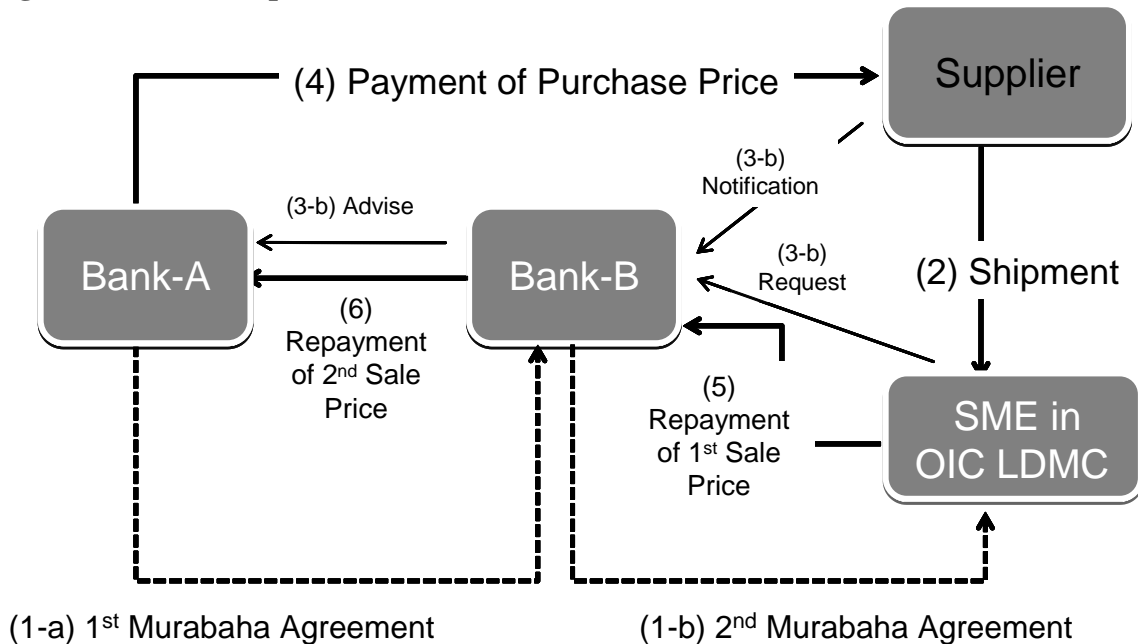
### **5.2.7 Two-Step *Murabahah***

Lack of trade finance is identified as one of the impediments for enhancing OIC countries' trade as evidenced from the legal text of Framework Agreement in TPS-OIC. As mentioned before, Article 2 of the agreement proposes the use of trade finance for promoting trade between OIC countries. Based on the findings, the lack of trade finance seems to be a much more severe problem for least developed OIC countries. Even after a successful implementation of the above-mentioned framework, there needs to be a trigger for those countries so they can ignite the production cycle by trade.

Most of the time, international banks are not willing to take the risk of importers in a market unknown to them. However, they might be expected to assume only the risk of another financial institution rather than small beneficiaries in different countries (Gundogdu 2009). '2-Step *Murabahah* Financing Mechanism' can be used to mobilize resources from financial institutions to serve least developed OIC member countries. Under this mechanism, international banks avail funds to a local bank in least developed OIC member countries which then provides it to the traders/SMEs. In this scheme, international banks would take the risk of a local bank, which lacks in necessary foreign exchange loan capacity to support traders/SMEs.

Going through the example in Figure 5.2, the system would work such that ‘*Bank-A*’ purchases the goods and sells it to ‘*Bank-B*’ for a mark-up on a predetermined maturity date. Then, ‘*Bank-B*’ sells the goods to the importer/SME according to a *murabahah* agreement between them.

**Figure 5.2: Two-Step *Murabahah* in the Context of International Trade**



*Source:* International Islamic Trade Finance Corporation of IDB Group

This mechanism transfers the direct credit risk of the importer SME to *Bank-B* which would be considered for exposure by *Bank-A*. It can be discerned that this mechanism can be used to boost SMEs in least developed OIC countries to turn on the engine of growth. 2-Step *murabahah* mechanism can also be used for mobilizing resources for the cotton sector under the supply chain financing introduced in Chapter 3.

In order to divert more funds from speculative financial instruments to trade finance, cooperation among OIC Stock Exchanges is essential. 2-Step *murabahah* scheme can be embedded into stock exchanges as an alternative to Bonds, *sukuk*, and commodity *murabahah* so as to support real economic transactions and decrease the cost of trade finance for least developed OIC member countries by creating competitive 2-Step *murabahah* market under stock exchanges.

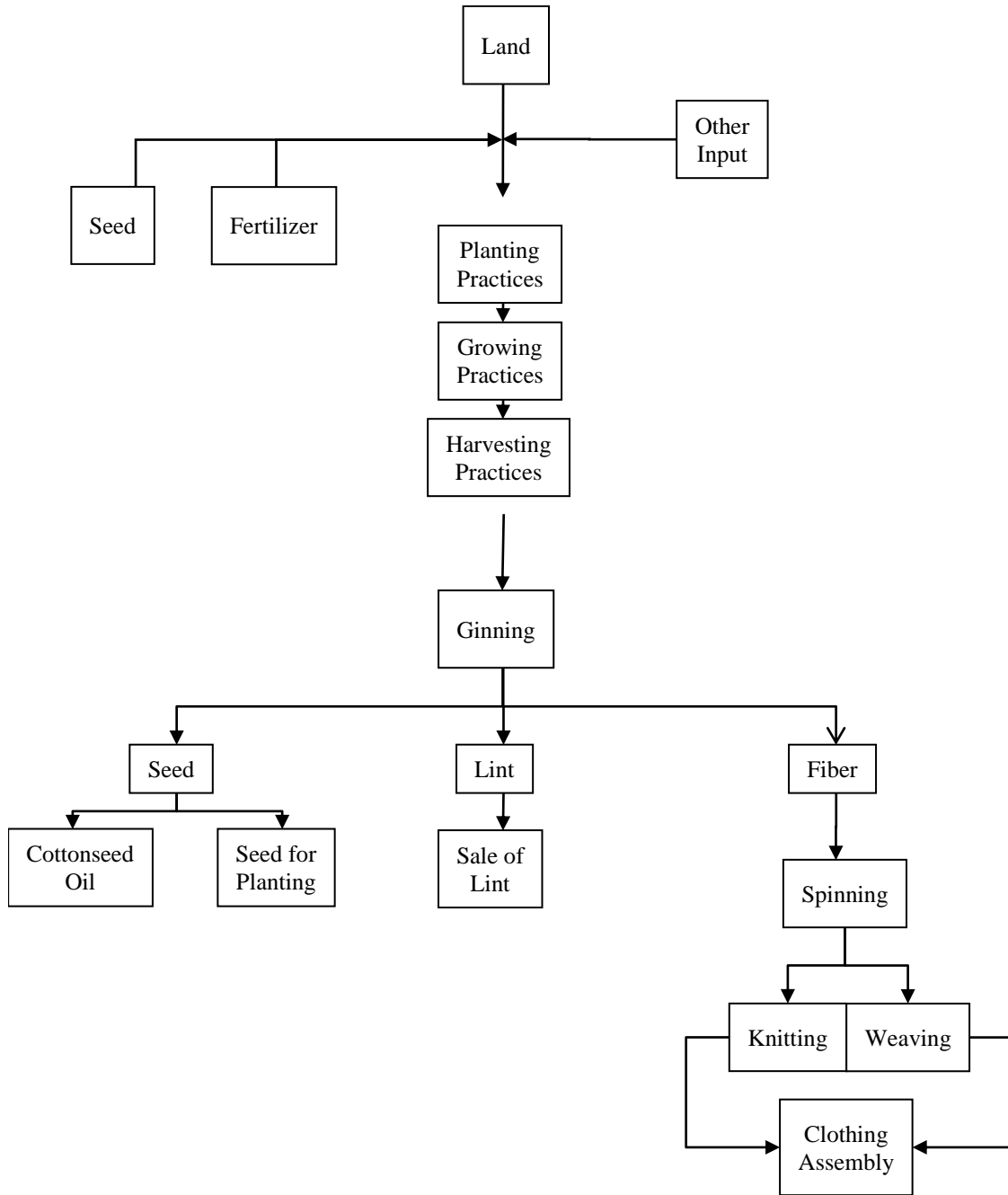
### 5.2.8 Cotton Sector Development

Development of cotton sector is an important element of OIC trade integration as this commodity itself is the only exportable items of many least developed OIC countries. Going through the deliverables of the OIC Five-Year Programme of Action and insight provided in the second essay in Chapter 3, the following items are identified as major issues throughout the action plan for OIC cotton-sector development:

- (i) Countries with insufficient yield suffer the decrease of both international market share and prices;
- (ii) The large variation in cotton yield among the OIC members and the need for improving the productivity create a wide margin for cooperation in this sector;
- (iii) High levels of production and/or export subsidies provided by developed countries to their domestic producers lead to serious distortions in international cotton markets;
- (iv) As a result, the increase in world cotton production (supply) reduces its price and this, in turn, reduces the revenues that could be obtained by the cotton exporting countries in the developing regions, including the OIC members;
- (v) Demand for cotton is highly affected by its quality and consistency. So, to maximize revenue, producers must properly classify their product. USA cotton is promoted by claims that it is less contaminated and better classified. Manual classification in most African countries reduces the value of their cotton;
- (vi) The lack of skilled labour and capital and high cost of energy and transportation are among the factors that still impeding the development of sustainable textile industry (processing the raw cotton) in most OIC West African cotton producing countries where these factors raise the cost of textile production;
- (vii) The OIC cotton producing countries, combined together, are net exporters of cotton, but many of them, particularly those in West Africa, are among the poorest in the world lacking the capacities for developing textile industries;
- (viii) Yet, sustainable and modern textile sectors have already been developed by some of the OIC countries who are also among the major importers of cotton in the world;

- (ix) Cotton producers, exporters and industrialists in the OIC countries should, therefore, lead the way of cooperation in the cotton sector. They can facilitate cooperation among themselves.

**Figure 5.3: Cotton Sector Development**



Source: The author

Going through the above Figure 5.3., one can easily see the importance of cotton-sector development in developing textiles and subsequent higher value added industries. Without developing an efficient cotton sector, it would be of a hurdle to streamline many Least Developed OIC countries into OIC trade integration. Obviously sustainable cotton production depends on four components: price, quantity, quality and cost. The issue of international price has been subject of WTO negotiation and very little can be done. However, there is opportunity especially in quality and quantity of cotton produced to increase economic value of the endeavour. As the figure indicates improvement shall come from planting, growing and harvesting practices. Hence, complete supply chain financing is to be complemented with quality, quantity and value increasing initiatives in order to make cotton production business profitable/sustainable as:

- (i) Improving the productivity and yield levels (introducing better seeds, irrigation, mechanization of seeding);
- (ii) Decrease the contamination (use of special bags for harvesting, establishing basic warehouses in villages);
- (iii) Improving testing and classification of cotton (grant for HVI testing machines and training);
- (iv) Promoting investment opportunities in cotton sector (Ginning machines) for processing and marketing of cotton in order to enhance international competitiveness;
- (v) Eliminating intermediaries between net cotton exporting and net cotton importing OIC countries (trade bridges, bringing West African cotton to warehouses in the net cotton importing OIC countries).

With reference to agricultural financing toward poverty alleviation, it is obvious that supply chain financing to the cotton sector in the form of discounted formal credit would help alleviating poverty subject to:

- (i) The discounted funds with formal credit should be assured to reach farmers but not informal credit providers which may include local banks, landlords, and unscrupulous managers of agricultural cooperatives who may apply local market interest rate to poor farmers while enjoying discounted funds mobilized through formal credits;
- (ii) The funds should focus on procurement of inputs for agricultural production but not purchase of consumption items giving rise to impoverishment of farmers. In this regard, availed funds should be monitored to assured that they are used for procurement of input to boost agricultural production;

- (iii) Formal discounted credit should be accompanied by several infrastructure development projects in the form of transportation, irrigation, *etc.* which targets to increase agricultural productivity to make agricultural input financing sustainable by assuring reasonable level of yield for harvest and market access for sale of yield.

Any formal credit targeted to the cotton sector should observe these concerns in order to develop a financially but also socially optimal solution.

### **5.3 LIMITATIONS OF THE RESEACH AND FUTURE RESEARCHES**

An important strength of this research is its relation to real-life cases, in which the researcher was involved in developing. However, similar to any other research, this research also has certain limitations, as discussed below.

In this research, while analysing the determinants of intra-OIC trade and OIC countries' customs revenue in Chapter 2, an econometric model is employed. However, the data set for the model includes 1995-2007 time periods which exclude data after the global financial crisis. Data for 2008 and 2009 became available by the end of the completion of this research. In this regard, future research on determinants of intra-OIC trade and OIC countries' customs revenue would be useful for data set including aftermath of the global financial crisis to validate findings.

In Chapter 3, focus is on financing part of cotton sector development. However, there needs to be further studies which should propose to-the-point intervention for other aspects of cotton sector development in OIC countries to address policy guidance of the OIC Five-Year Cotton Action Plan. The prospective research might be conducted on:

- (i) Seeding selection;
- (ii) Land preparation;
- (iii) Sowing activities;
- (iv) Weeding: mechanical and chemical;
- (v) Plant trimming;
- (vi) Defoliation (by chemicals);
- (vii) Harvesting;
- (viii) Collection of plant stems activities;
- (ix) Logistics of transporting seed cotton to collection centre;
- (x) Storage (examining contamination);
- (xi) Grading of seed cotton;
- (xii) Ginning activities;

- (xiii) Quality and weight control;
- (xiv) Lot allocation;
- (xv) Logistics of storing of bales at warehouse;
- (xvi) Commercial enhancement review-sale.

In Chapter 4, the concept of 2-Step *murabahah* is introduced and this structure is proposed to be embedded in exchanges. Another study to develop a system to divert the funds of Islamic Banks from questionable liquidity management instruments to real economy via L/C financing would be complementary to this research. Accordingly, prospective research should show in detail how to embed the 2-Step *murabahah* concept into stock exchanges based on the case provided in this research.

## **5.4 EPILOGUE**

This thesis aimed to develop a resilient framework for outward-looking and cost-effective OIC trade integration in order to constitute a base for future direction to avoid rigidly structured and highly institutionalized discourse. Given the strategic consideration a special section is devoted to the cotton sector as per OIC mandate.

The empirical chapters evidence that the aim and objectives of the research set at the beginning of this journey have been achieved. However, by no means does it put a halt on the discussion but rather aims to initiate further discussions for enrichment of the OIC trade integration agenda by attracting more appeal within the OIC community. Therefore, a special emphasis is given to propose feasible and concrete building blocks by evidencing from other regional integration and national best practices to discourage vague ideas for OIC trade integration. In line of such expectation, further details might be embedded to the proposed framework in future studies.

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# APPENDICES



## APPENDIX I

### DRAFT ROAD-MAP FOR ACHIEVING INTRA-OIC TRADE VOLUMES TARGETS

Area	Recommended Action	Desired Result	Partners	Timeline
<b>1.Trade Financing</b>	1.1 Develop and introduce new mechanisms/tools aimed at increasing financing for SMEs and LDMCs	Enable SMEs to access financing better and more easily	ITFC, ICIEC	
	1.2 Enhance ITFC field presence	Increase awareness and bring the ITFC closer to the MCs	ITFC	
	1.3 Introduce new trade finance products	Meet needs of the clients for requirements such as LC confirmations, <i>etc.</i>	ITFC, ICIEC	
<b>2.Trade Facilitation</b>	2.1 Expedite the ratification of PRETAS by the MCs	Achieve greater liberalization of trade	OIC, MCs, COMCEC	
	2.2 Conduct annual meetings on specific infrastructure issues which will have a direct impact on trade facilitation	Facilitate the implementation of specialized projects	COMCEC, ICD	
	2.3 Enhance partnership with TPOs in MCs	Enable the exchange of trade related information	ITFC, ICDT, ICCI	
	2.4 Continue to conduct annual meetings for TPOs in MCs		ITFC, ICDT, ICCI	
	2.5 MCs to ease visa processes for member country businessmen	Facilitate easier business travel	MCs, COMCEC	
	2.6 Mutual Recognition Agreements (MRAs) for certification and testing bodies		MCs, COMCEC, ICCI	

Area	Recommended Action	Desired Result	Partners	Timeline
<b>3.Capacity Building</b>	3.1 Organize more training programs for MCs/enterprises in trade related areas	Respond to the demand for Islamic financial products	IDB, ITFC, ICDT, SESRIC, UNCTAD, ITC	
	3.2 Organize seminars on 'best practices' for MCs	Migration of best practice	ITFC, ICCL, TPOs, ITC	
	3.3. Cost sharing schemes for marketing and enhancing of exports		MCs, TPOs	
<b>4.Trade Promotion</b>	4.1 Strengthen brand awareness and promote products made in OIC MCs	Increase exports of MCs	MCs, ICCL, ICDT	
	4.2 Encourage MCs to utilize the existing platform within the OIC organs such as ICDT's trade network (TINIC)	Increase awareness and broaden opportunities	MCs, ICDT	
	4.3 TPOs to encourage and facilitate annual buyers-sellers meetings (business matching, trade bridging)	Expand trade opportunities	ITFC, ICCL, TPOs, ITC	
	4.4 Encourage MCs to increase participation in trade fairs and activities organized by ICDT		COMCEC, ICDT,ITFC	
<b>5. Development of Strategic Commodities</b>	5.1 Create funds for investment in agriculture and other strategic commodities	To increase food self sufficiency	MCs, IDB, Financial Intuitions and Specialized Funds	
	5.2 Expedite the implementation of Action Plan in cotton development and develop new action plans for development of other strategic commodities	Increase marketable the quality/quantity and benefits for MCs	OIC, MCs, COMCEC, IDB, ITC, UNIDO	

Source: COMCEC

## EXECUTIVE PROGRAMME OF THE ROAD-MAP FOR ACHIEVING INTRA-OIC TRADE VOLUMES TARGETS

Area	Recommended Action	Projects/ Programs/Activities
<b>1. Trade Financing Coordinator: ITFC</b>	1.1 Develop and introduce new mechanisms/ tools aimed at increasing financing for SMEs and LDMCs	Introduce new lines of financing in addition to the existing ones in 1430H (2009)
	1.2 Enhance ITFC field presence	a. Opening of Dubai Branch and then others
		b. "ITFC Focal Points" will be nominated in existing IDB Regional Offices
		c. "ITFC Customer Days" will be organized in some MC's
	1.3 Introduce new trade finance products	a. Meeting of Financial Institutions on Resources Mobilization
		b. Meeting/Brainstorming to discuss creation of Specialized Funds
		c. Workshop on ITFC's Lines of Finance: Challenges and Opportunities
		d. Meeting for Trade Finance and Insurance of Credit Institutions.
		e. Workshop on LC Confirmations and Possible Role of IDB Group in this regard for enhancing intra-OIC Trade
		f. Training Programme for Central Banks and Financial Institutions to enhance the awareness of export credit insurance and its benefit in facilitating trade finance
g. Promotion of DCIP (Documentary Credit Insurance Policy) among the OIC Financial Institutions to enable them to increase their exposure in relatively high risk countries		
2.1 Strengthen brand awareness and promote products made in OIC MCs	a. Showroom of OIC products and Services	
	b. Prepare a study on establishing an e-marketplace	
	2.2 Encourage MCs to utilize the existing platform within the	a. Enhancement of virtual exhibition
		b. OIC Tijari Exchange (with a view to complement TINIC)

<b>2. Trade Promotion Coordinator: ICDT</b>	2.3 TPOs to encourage and facilitate annual buyers-sellers meetings (business matching, trade bridging)	a. Specialized exhibition and supply/demand workshop on agribusiness products
		b. Cotton
		c. Agro-industry
		d. Building and construction services
		e. Pharmaceuticals, medical equipment and services
		f. Clothing industry
		g. Furniture
		h. Logistics and transportation
		i. World Halal Forum
		j. Turkey, Africa, Foreign Trade Bridge
		k. Intra-Trade Malaysia
	2.4. Promotion of Trade in services	<b>Study to identify Potential services to traded among OIC Countries Specialized Exhibitions and Partnership forum on High trading potential services on:</b>
		a. Architecture /Construction/Engineering
		b. E-commerce, IT and related services
		c. Distribution services: franchising
		d. Health related services
		e. Education and training
	2.5 Encourage MCs to increase participation in trade fairs and activities organized by ICDT	a. 12 <sup>th</sup> Islamic Trade Fair
		b. Trade Fairs of OIC Countries (OIC EXPO)
		c. Tourism Fair of Islamic Countries
d. Tourism Fair of Islamic Countries (OIC TOURISM)		

<b>3. Trade Facilitation Coordinator: ICDT</b>	3.1 Expedite the ratification of PRETAS by the MCs	a. Implementation of PRETAS
		b. Training Seminar on PRETAS for North Africa (CENCAD, AMU and Middle East)
		c. Training Seminar on PRETAS for Central Asia and ECO Countries
		d. Training Seminar on PRETAS for WAEMU Countries
		e. Training Seminar on PRETAS for ECOWAS Countries
		f. Training Seminar on PRETAS for South East and South Asia Countries
		g. Training Seminar on PRETAS for COMESA Countries
	3.2 Conduct meetings on specific infrastructure issues which will have a direct impact on trade facilitation	a. Forum on “Trade Efficiency and the Role of the Customs in the Context of International Trade
		b. Seminar on “Transport Facilitation and Intra-OIC Trade”
		c. Expand the relationship between Bakkah Shipping Company (OISA Project); IDB Group and ITFC
		d. Opening new branch of Islamic Protection and Indemnity Club “IPIC” (OISA Project) in Jakarta Indonesia
		e. Signing the Statute of OISA by the member states which have not done so
		f. Registration of member states maritime companies’ suitable tonnage with Islamic P&I Club Branches in Tehran, Dubai and Jakarta
	3.3 Enhance partnership with TPOs in MCs	a. Meeting of the TPO’s for evaluation of export performance and competitiveness of OIC Member Countries
		b. 1 <sup>st</sup> Annual Meeting of the Export Promotion Centers of French Speaking OIC Member Countries
		c. Establishment of Trade Information Facilitation System
		d. Meeting on Aid-for-Trade for ESCWA Region
		e. Expert Meeting on Aid-for-Trade Road Map for SPECA Region
		f. Ministerial Meeting on Aid-for-Trade Road Map for SPECA Region
		g. Meeting of Investment Promotion Agencies for the Evaluation of Investment Performance and improvement of doing business in OIC Member Countries
		h. Development of a database in order to facilitate commercial exchanges as well as cooperation and coordination
		i. preparation of a framework for statistical activities coordination among OIC Institutions
		j. Launching of a trade facilitation Programme (Needs Further Details)
3.4 Continue to conduct annual meetings for TPOs in MCs	k. Setting up of an observatory on procedures of Intra-OIC trade (Needs Further Details)	
	OIC TPO’s Meeting	
3.5 MCs to ease visa processes for member country businessmen	Establishment of Business Owners Union	

<p><b>3. Trade Facilitation</b> Coordinator: ICDT</p>	<p>3.6 Mutual Recognition Agreements (MRAs) for certification and testing bodies</p>	<p>a. Development of OIC Halal Food Standards b. 10<sup>th</sup> OIC Standardization Expert Group Meeting c. Operationalization of SMIIC (Islamic Countries Metrology and Standards Institute) d. Establishment of Islamic Rating and Certification Agency (Needs Further Details)</p>
<p><b>4. Development of Strategic Commodities</b> Coordinator: ITFC</p>	<p>4.1 Create funds for investment in agriculture and other strategic commodities</p>	<p>a. Gulf Cooperation Council Food Security Initiative (Promoting Intra Investment by private sector and the role of IDB Group) b. Summit on International Food Crisis</p>
	<p>4.2 Expedite the implementation of Action Plan in cotton development and develop new action plans for development of other strategic commodities</p>	<p>a. Trade and Investment Cooperation Opportunities among the OIC Member Countries in Cotton industry b. Forum on development of investment and trade in the field of basic food commodities c. Revitalization of the groundnut sector in selected sub-Saharan countries (Senegal, Gambia, Guinea-Bissau)  d. Forum on ways and means to enhance Trade and investment in food in Africa</p>
<p><b>5. Capacity Building</b> Coordinator: SESRIC with in collaboration of ICDT and ITFC</p>	<p>5.1 Organize more training programs for MCs/enterprises in trade related areas</p>	<p>a. Training Course on Export Strategies and International Marketing b. Training Workshop on SME Cluster Development for OIC Member Countries c. Workshop on “Promotion of Export Processing of Value Added Fishery Products” d. Training Program on Micro Finance Sector Development e. Workshop on “Small-scale Food Processing” with COMSTECH f. Workshop on “Oilseed Processing for Small-Scale Producers” with COMSTECH g. 13<sup>th</sup> Private Sector Meeting for Promotion of trade and joint venture investment among the OIC h. Workshop on Coffee Processing i. Regional training program for the staff of the chambers of Arab Member Countries j. Regional training program for the staff of the chambers of African Member Countries k. Fifth Forum for Businesswomen in Islamic Countries l. 3<sup>rd</sup> International Islamic, Economic and Cultural Conference m. Workshop for “Incubator Management training in Islamic Countries n. Workshop on export competitiveness o. Logistics and its role in developing intra-OIC trade p. Agreement of the Doha Round and intra-OIC trade negotiations q. Competition Policy and regulations in Islamic Countries r. Competition trade intelligence and export decision making s. Training course on enterprises strategy and international marketing t. Export Auditing and capacity building of the SMEs for Arab States.</p>

		u. Seminar on “The Project on the Intra-OIC Free Trade Area
		v. Launching of feasibility study on “the project of intra-OIC Free Trade Area”
		w. Seminar on Regional economic grouping within the OIC: Current status and prospects
		x. Training courses and forum on e-commerce and technical assistance (Needs Further Details)
		y. Follow up of the Multilateral Trade Negotiation in this sector and coordination of Member States’ positions with a view to setting up of a common negotiations platform
	5.2 Organize seminars on 'best practices' for MCs	a. OJT for staff of TPOs of MC’s on Foreign Trade Bridges
		b. OJT for Officials and staff of Chamber of Commerce of the AMCs
		c. OJT for Trade Mapping
	5.3. Cost sharing schemes for marketing and enhancing of exports	a. Develop High Trade School of Tunisia
		b. Training Seminar on Doha Development Round
	c. Help to develop the training Department of IGEME	
	d. Help to develop the training department of MATRADE	

Source: COMCEC

## APPENDIX II

### OIC FIVE YEAR COTTON ACTION PLAN COOPERATION AREAS

#### - COOPERATION AREA : 1- ENHANCED PRODUCTIVITY AND PRODUCTION TECHNIQUES

#### - STRATEGIC GOALS :

- Increasing the productivity and decreasing the costs;
- Solving the basic problems faced in production by bilateral or multilateral cooperation;
- Encouraging and supporting the usage, production, and trade of quality input, enhanced technologic machines and devices in the countries;
- Improving the product quality and leading production towards variety, standard and quality demanded by the member countries;
- Selecting three cotton research institutes as centers of excellence one in Africa, one for Arab countries and one for Asian countries with a view of harmonizing and strengthening research for the development of the cotton sector and cotton related activities.

No	Actions/Activities	Timeframe	Implementation Instruments (*)	Expected Outcomes / Impacts
1.1.	<p>Cooperation in the area of Research and Development:</p> <ul style="list-style-type: none"> <li>- Developing the collective working capacity of research centers of willing countries under the coordination of three designated cotton research institutes on regional basis among member states,</li> <li>- Conducting research on combating diseases and insects and increasing production efficiency and creating a gene bank within designated institutes for use of participating countries.</li> </ul>	<p>Preparation: Medium term</p> <p>Putting into service: Long term</p>	Cooperation Agreements (in progress).	<ul style="list-style-type: none"> <li>- Providing countries with R &amp; D services,</li> <li>- Improving quality seed and production techniques for demanding countries,</li> <li>- Seminars/workshops for awareness and education.</li> <li>- Establishment of Gene Bank at three identified regional R &amp; D centers,</li> <li>- Availability of clean cotton.</li> </ul>



No	Actions/Activities	Timeframe	Implementation Instruments (*)	Expected Outcomes / Impacts
1.2.	<p>Generalizing the use of new, productive, efficient inputs and techniques, as well as extending a wide spread education programs for producers.</p>	<p>Preparation: Short term</p> <p>Putting into service: Long term</p>	-do-	<p>-Extending the usage and promotion of new technologies; producing seed varieties, and other inputs,</p> <p>- Efficient usage of limited water supplies,</p> <p>- Increasing productivity and decreasing cost of production,</p> <p>- Creating the consumers awareness,</p> <p>- Producing quality in accordance with the international standards.</p>
1.3.	<p>Transfer of technology among member states and acquiring latest technology from developed world.</p> <p>In this context;</p> <ul style="list-style-type: none"> <li>- determining the sharing and exchange opportunities of technology, devices and equipment among member states,</li> <li>- Supporting projects that have immediate, short-term and practical consequences,</li> <li>- Encouraging preparation and implementation of joint projects among countries,</li> <li>- Preparation of a guide relating to projects for support.</li> </ul>	<p>Long term</p> <p>Short-term and long term</p>	-do-	<ul style="list-style-type: none"> <li>- Development of latest technology,</li> <li>- Successful transfer of technology,</li> <li>- Preventing the wasting of resources,</li> <li>- Shifting Project support to those which have or will have practical consequences,</li> </ul>

No	Actions/Activities	Timeframe	Implementation	Expected Outcomes / Impacts
1.4	<ul style="list-style-type: none"> <li>- Preparing a catalogue on variety, standard and quality of cotton by member states.</li> <li>- Reviewing the cotton classification systems of member states and developing international level of OIC standards of cotton.</li> </ul>	Preparation: Short – Medium Term	-do-	<ul style="list-style-type: none"> <li>- Opportunity to know the market and to produce in accordance with market expectations,</li> <li>- Development of Data Bank.</li> <li>- Easy marketing of cotton,</li> <li>- Setting up of OIC standards of cotton.</li> </ul>
1.5.	- Development and application of education and combating programs for the countries which have contamination problems.	Preparation: Short term  Putting into Service: Long Term	-do-	<ul style="list-style-type: none"> <li>- Increasing cotton quality,</li> <li>- Increasing marketing opportunities,</li> <li>- Decreasing the loss in value,</li> <li>- Providing clean and quality raw material for cotton processing industry.</li> </ul>
1.6.	- Improving quality and appropriate input systems.	Medium and Long Term	-do-	<ul style="list-style-type: none"> <li>- Providing producer with quality and appropriate input.</li> <li>- Decreasing input costs,</li> <li>- Developing the capacity of organizations/institutions acting in this field.</li> </ul>

Source: OIC Secretariat

**- COOPERATION AREA : 2- STRENGTHENING MEMBER COUNTRIES OF STRUCTURAL CAPACITIES AND ORGANISATIONS.**

**- STRATEGIC GOALS :**

- By strengthening institutions and associations taking part in production-marketing-processing chain, streamlining and making them more competitive, effective and active;
- Taking appropriate measures to develop the liberalization of market in national and intra OIC-CPCs levels, and increasing the role of private sector;
- Strengthening the communication channels among countries and institutions, enhancing the knowledge sharing, formation of an experts bank and achieving the knowledge and technology transfer through expert exchange;
- Constituting facilitator and developer agreements and regulations at the national and intra OIC CPCs level.

**- COOPERATION AREA : 3- DEVELOPING THE FIELD OF PROCESSING**

**- STRATEGIC GOALS :**

- Development of cotton classification laboratory and processing industry and facilities; shift of the inactive capacity to the other;
- Supporting the cotton development programs, especially the projects related to vertical integration.

**- COOPERATION AREA : 4- MARKETING, TRADE AND INTERNATIONAL COMPETITIVENESS**

**- STRATEGIC GOALS :**

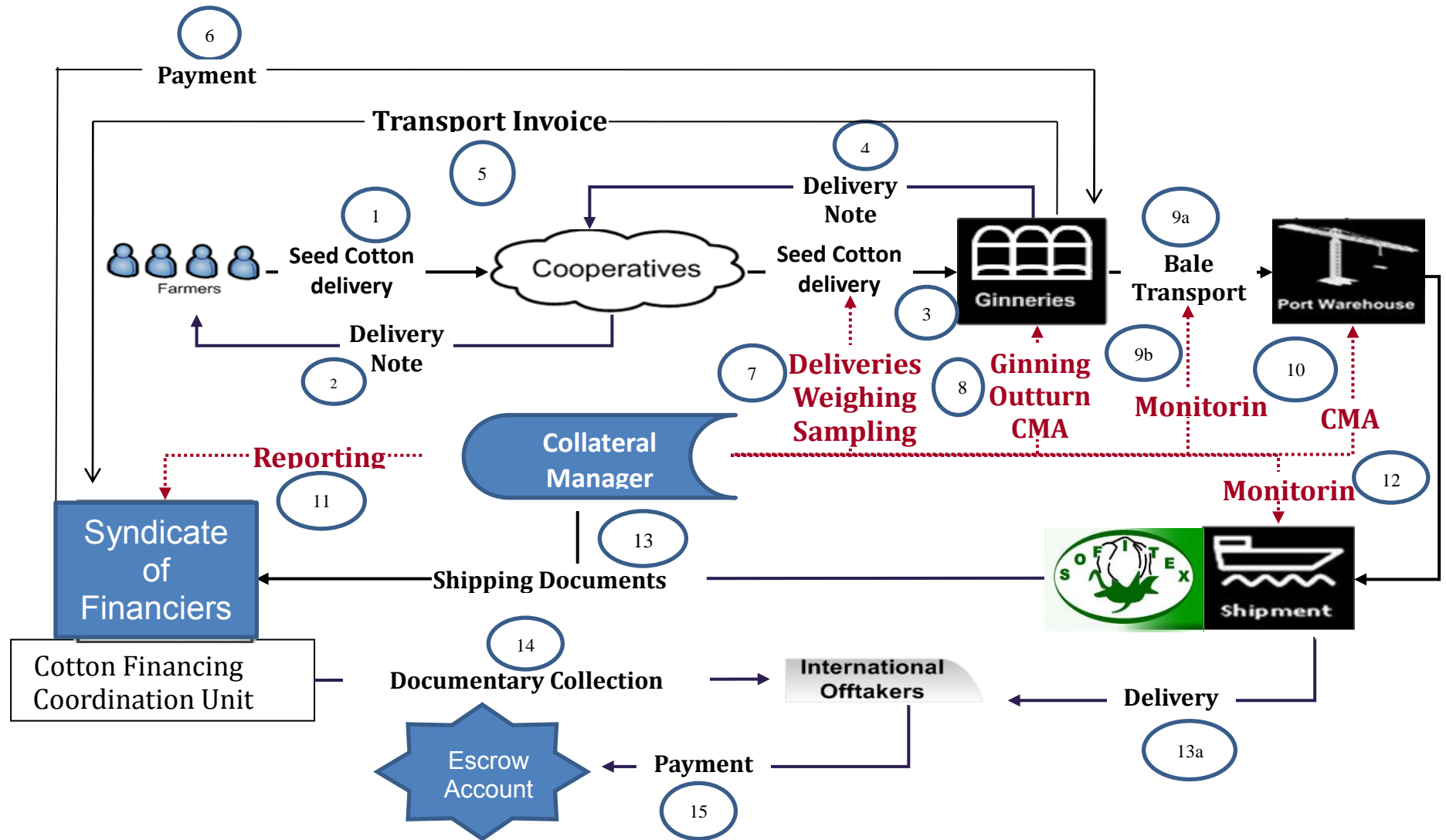
- For the marketing of cotton over developed stock exchange/exchanges of the member states to a large segment of buyers,
- Increasing the cooperation and the capacity among the countries in this field;
- Educate OIC member countries about WTO laws;
- Develop their own hedge market;
- Increase per unit value of cotton by value addition.

**- COOPERATION AREA : 5- ARRANGING FINANCES FOR THE ACTIVITIES**

**- STRATEGIC GOALS :**

- Developing the financing and guarantee mechanisms like export credits and insurances to generalize the cotton trade among the OIC- CPCs;
- Constituting facilitator and developer agreements and regulations at the national and intra OIC CPCs level;
- Knocking financial institutions ( IDB, ADB, UNDP, UNIDO, etc.) for funding the program.

**APPENDIX III**  
**EXPORT CASH FLOW FOR COTTON FINANCING**



Source: International Islamic Trade Finance Corporation of Islamic Development Bank Group

## **APPENDIX IV FORM OF OFFER FROM THE IMPORTER**

To:

### **Bank-B**

P.O. Box:

City/ Zip Code:

Country:

Facsimile:

We, the importer, in conformity with the *Murabaha* Agreement (the Agreement) concluded by us with Bank-B on \_\_\_\_/\_\_\_\_/\_\_\_\_\_, and in accordance with the related section of the Agreement thereof, offers to buy the Goods of which we have bought and inspected or procured the inspection thereof to its satisfaction and taken delivery on behalf of Bank-B, on the terms and conditions provided in the related section of the said Agreement:

- (i) Quantity and general description: \_\_\_\_\_
- (ii) Name and address of Supplier: \_\_\_\_\_
- (iii) L/C No. (if any): \_\_\_\_\_
- (iv) Country of origin: \_\_\_\_\_
- (v) Delivery Date: \_\_\_\_\_
- (vi) Purchase Price: \_\_\_\_\_

### **THE IMPORTER**

\*\*\*\*\*

*Source:* International Islamic Trade Finance Corporation of Islamic Development Bank Group

## **APPENDIX V FORM OF ACCEPTANCE BY BANK-B**

**To:** The importer

Bank-B, in response to your, the importer's, offer communicated through your telex/ fax number \_\_\_\_\_ dated \_\_\_\_/\_\_\_\_/\_\_\_\_\_, accepts the offer and hereby sells to you, on the terms and conditions provided in the related section of the Agreement concluded between us, Bank-B, and you, the importer, on \_\_\_\_/\_\_\_\_/\_\_\_\_\_, the following the Goods (which the importer has bought and taken delivery of, on behalf of Bank-B):

- (i) Quantity and general description: \_\_\_\_\_
- (ii) Name and address of Supplier: \_\_\_\_\_
- (iii) L/C No. (if any): \_\_\_\_\_
- (iv) Country of origin: \_\_\_\_\_
- (v) Delivery Date: \_\_\_\_\_
- (vi) Purchase Price: \_\_\_\_\_
- (vii) Sale Price: \_\_\_\_\_
- (viii) Due Date of Sale Price: \_\_\_\_\_

**BANK-B**

\*\*\*\*\*

*Source:* International Islamic Trade Finance Corporation of Islamic Development Bank Group



## APPENDIX VI KEYS TO READ THE BUSINESS PROCESS MAPS

For brevity, two commonly sequential processes, "Prepare" & "Submit" process steps, are combined as just a "Submit" process step (implying preparation and submission of the documents).

### Workflow

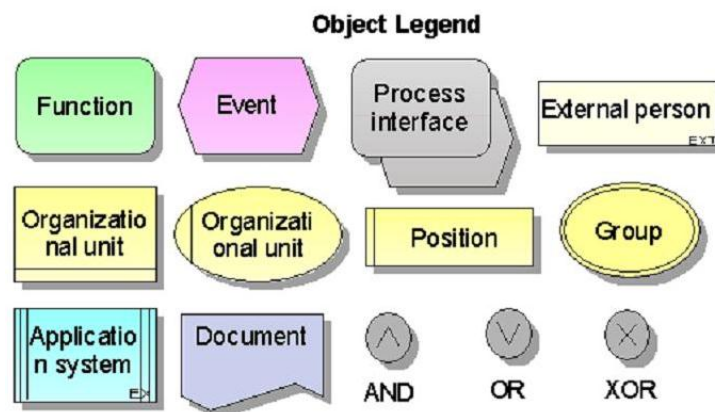
It is assumed that any clearance by several successive Fora or Managers/Senior Executive Officers implies that their respective comments will be taken into account before submitting the document to the next level or resubmitting it to the same level).

### RACI Charting

ACI is a standard for responsibility charting. The letters R, A, C & I are used to signify the following:

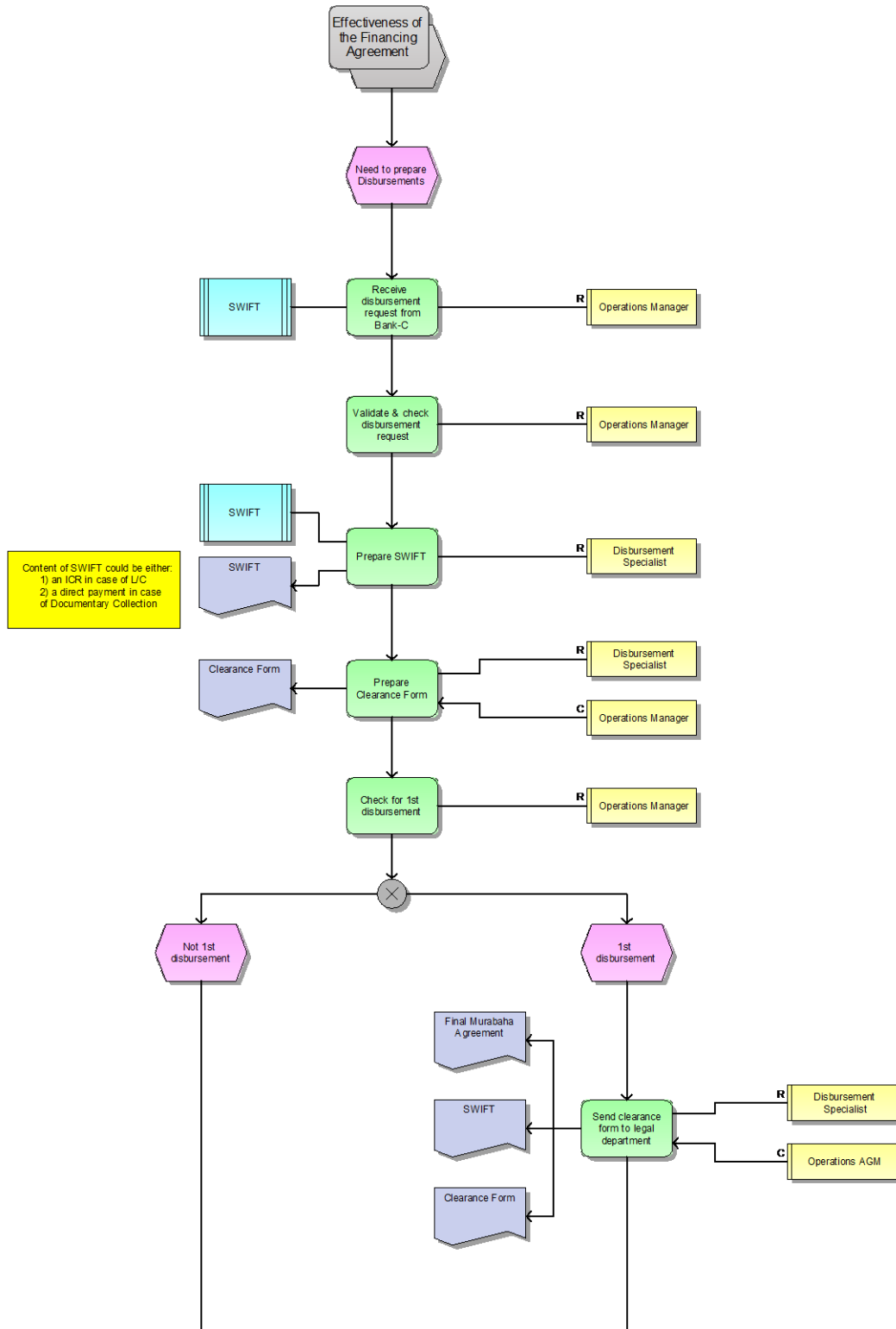
- R – Responsible: Does the Job. Execute.
- A – Accountable: Take Ultimate Ownership.
- C – Consult: Individuals who must be consulted prior to a final decision or action. “Consult” implies two-way communication.
- I – Inform: Need To Know. Do Not Change The Decision.

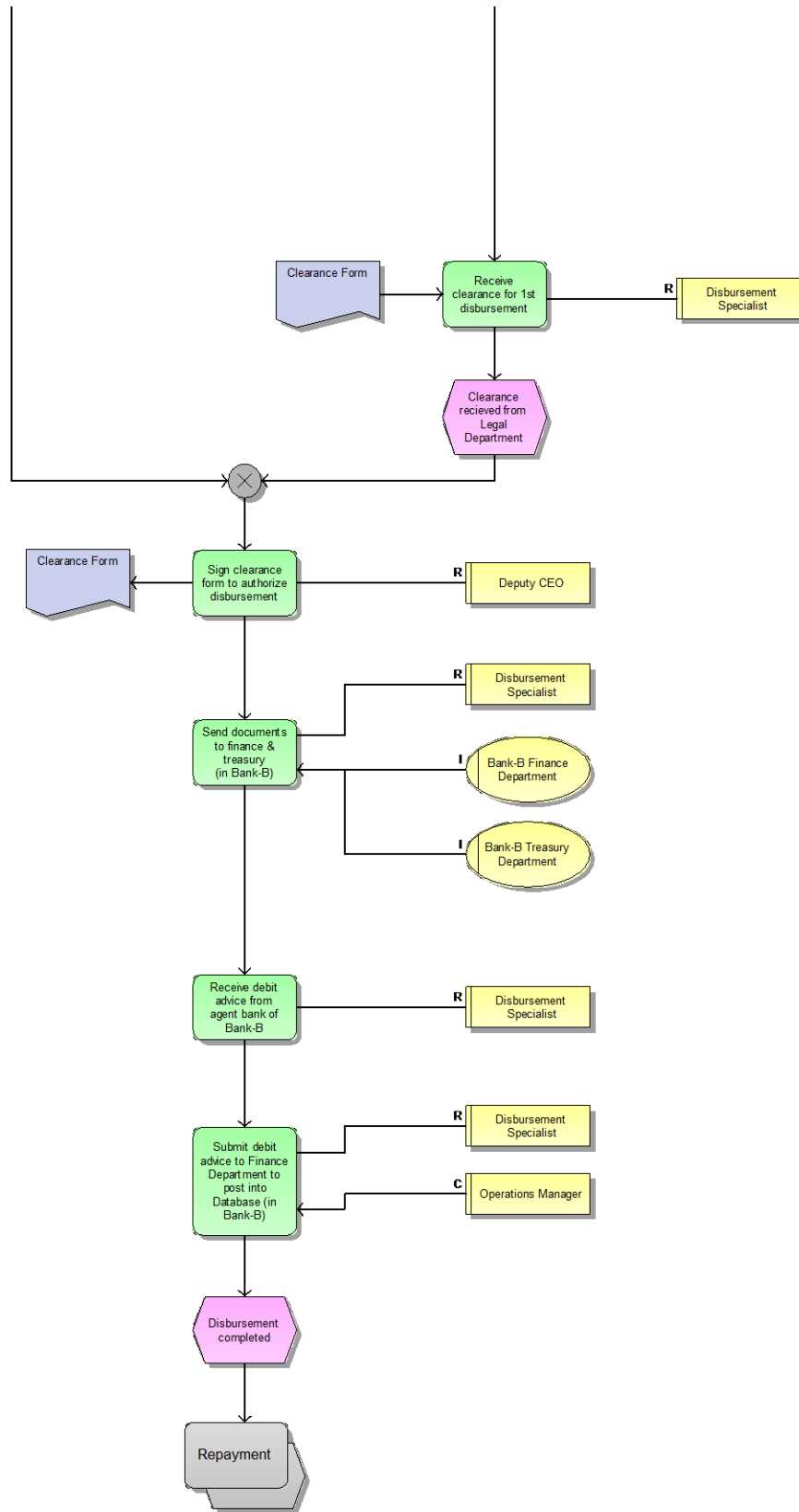
### Modeling Legend



*Special Note:* AGM Stands for Assistant General Manager; Deputy DEO stands for Deputy Chief Executive Officer in Bank-B.

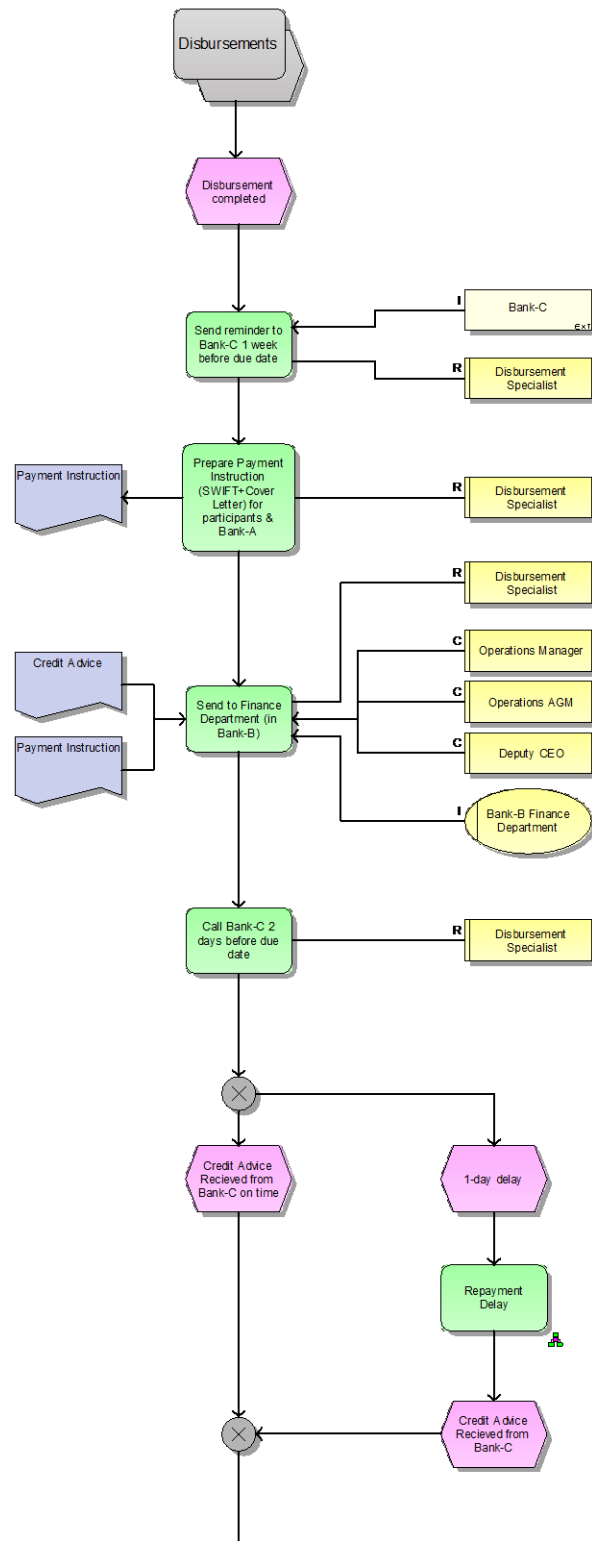
# APPENDIX VII DISBURSEMENT

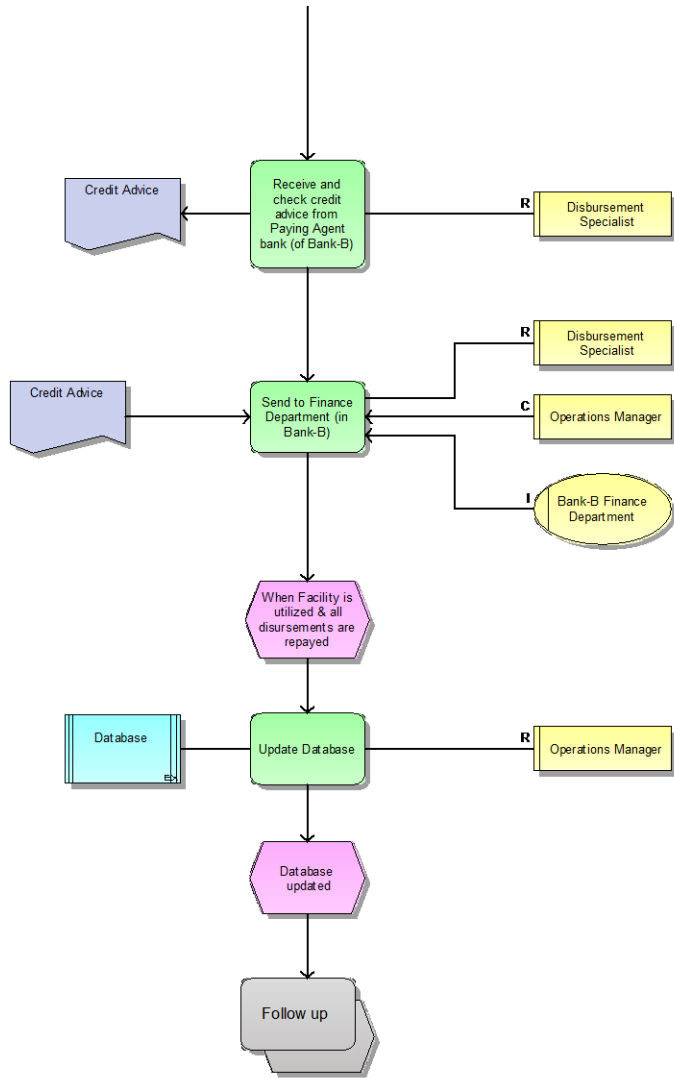




# APPENDIX VIII

## REPAYMENT





## APPENDIX IX

### THE SURVEY ON TRADE FACILITATION in OIC MEMBER COUNTRIES

Vis-a-Vis WTO trade facilitation  
negotiations on GATT articles V, VIII  
and X and Agreement on Implementation  
of Article VII (Custom Valuation) of  
GATT

**The objective of this survey is (i) to assess the level of implementation of GATT articles V, VII, VIII and X in your country so as to diagnose relevant needs and (ii) to identify important trade facilitation needs/remedies as a base for cooperation among OIC countries. Please be assured that your responses shall be maintained as confidential and in any deliverables aggregate results will be used.**

**Who shall be completing this survey?** This survey should be completed by a senior staff of the customs administration who is familiar with the above mentioned subject. In case you have any questions on the survey, please do not hesitate to contact Mr.Ahmet Suayb Gundogdu at [agundogdu@isdb.org](mailto:agundogdu@isdb.org).

**Please return the completed questionnaire to:** Ahmet Suayb Gundogdu, via email [agundogdu@isdb.org](mailto:agundogdu@isdb.org) or submit the hard copy.

## I. What is Your Perception of GATT Articles V, VII, VIII, and X in Regards to Level of Their Implementation in Your Country?

Your Country: (\_\_\_\_\_)

**Please mark the relevant boxes below to show your perception of the statements:**

1.1 International trade and customs legal framework as well as procedure open to the public and easily accessible.

Strongly Disagree	Disagree	Slightly Disagree	No Opinion	Slightly Agree	Agree	Strongly Agree
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1.2 Traders can get update on changes in regulations and procedures promptly and without any inconvenience.

Strongly Disagree	Disagree	Slightly Disagree	No Opinion	Slightly Agree	Agree	Strongly Agree
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1.3 Legal frame work is applied uniformly and impartially.

Strongly Disagree	Disagree	Slightly Disagree	No Opinion	Slightly Agree	Agree	Strongly Agree
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1.3 There is an independent appeal system for traders for customs authorities' decisions and this system efficiently operates.

Strongly Disagree	Disagree	Slightly Disagree	No Opinion	Slightly Agree	Agree	Strongly Agree
----------------------	----------	----------------------	------------	-------------------	-------	-------------------

1.4 Traders, with an effective mechanism, are allowed to comment on change proposal from public authorities on regulations and procedures before their implementation.

Strongly Disagree	Disagree	Slightly Disagree	No Opinion	Slightly Agree	Agree	Strongly Agree
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1.6 Importers can obtain advance ruling on tariff classification, customs valuation, rule of origin, etc. with an effective system in place.

Strongly Disagree	Disagree	Slightly Disagree	No Opinion	Slightly Agree	Agree	Strongly Agree
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1.7 Import and Export clearance requires excessive documentation and consumes substantial time.

Strongly Disagree	Disagree	Slightly Disagree	No Opinion	Slightly Agree	Agree	Strongly Agree
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1.8 Transaction charges levied on import and export clearance are limited the cost of services rendered by the authorities.

Strongly Disagree	Disagree	Slightly Disagree	No Opinion	Slightly Agree	Agree	Strongly Agree
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1.9 Penalties for minor breaches such as typing mistakes in customs transaction are reasonable.

Strongly Disagree	Disagree	Slightly Disagree	No Opinion	Slightly Agree	Agree	Strongly Agree
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1.10 Irregular payments are not often needed to release goods from customs quickly.

Strongly Disagree	Disagree	Slightly Disagree	No Opinion	Slightly Agree	Agree	Strongly Agree
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1.11 Document submission to trade related public authorities for approval is not difficult.

Strongly Disagree	Disagree	Slightly Disagree	No Opinion	Slightly Agree	Agree	Strongly Agree
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1.12 Implantation of Information and Communication Technologies (ICT) has substantially decrease the average time of customs clearance.

Strongly Disagree	Disagree	Slightly Disagree	No Opinion	Slightly Agree	Agree	Strongly Agree
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1.13 There is no discrimination against goods and vehicles in transit.

Strongly Disagree	Disagree	Slightly Disagree	No Opinion	Slightly Agree	Agree	Strongly Agree
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1.14 Goods and vehicles in transit are not subject to unreasonable charges higher than the cost of service rendered.

Strongly Disagree	Disagree	Slightly Disagree	No Opinion	Slightly Agree	Agree	Strongly Agree
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1.15 Transit procedure and regulations are clearly spelled out and easily available to public.

Strongly Disagree	Disagree	Slightly Disagree	No Opinion	Slightly Agree	Agree	Strongly Agree
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1.16 Transit vehicles are not forced to use less convenient routes within the country while heading to their destination.

Strongly Disagree	Disagree	Slightly Disagree	No Opinion	Slightly Agree	Agree	Strongly Agree
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1.17 Overall, in which of the following areas in your opinion is the most problematic (*please select the 4 most problematic areas and then rank them from 1 to 4 [1 = most problematic; 4= least problematic]*):

- a) \_\_\_ Customs valuation
- b) \_\_\_ Rule of origin of the goods
- c) \_\_\_ Inspection and release of goods
- d) \_\_\_ Import licenses
- e) \_\_\_ Tariff classification
- f) \_\_\_ Technical or sanitary requirements
- g) \_\_\_ Payment of fees and penalties

1.18 What is the status of your country regarding to WTO Custom Valuation Agreement:

	Implementation Year	Provisions to the Agreement	Your Notes
Agreement on Custom Valuation			

## II. Priority Level for Trade Facilitation in Your Country

Please imply the level of priority needed to be bestowed by your Government for each of the following trade facilitation areas in order to reduce cost and time of cross border trade (Please go through the whole list of measures prior to your decision, for each: 1 = lowest priority; 2 = medium priority; 3 = high priority; 4 = highest priority).

- |  |        |   |   |   |   |         |
|--|--------|---|---|---|---|---------|
| 2.1 Immediate and comprehensive publication as well as dissemination of existing/new trade rules and regulations.  | Lowest | 1 | 2 | 3 | 4 | Highest |
| 2.2 Formation or improvement of inquiry points for traders to keep up with the procedures.   | Lowest | 1 | 2 | 3 | 4 | Highest |
| 2.3 Formation or improvement of consultation mechanism for traders to comment on regulations and procedures before their implementation.   | Lowest | 1 | 2 | 3 | 4 | Highest |
| 2.4 Formation or improvement of an independent and efficient appeal system for traders to dispute customs authorities' decisions.  | Lowest | 1 | 2 | 3 | 4 | Highest |
| 2.5 Formation or improvement of an advance ruling mechanism for traders to obtain advance ruling on tariff classification, customs valuation, rule of origin, etc.   | Lowest | 1 | 2 | 3 | 4 | Highest |
| 2.6 Formation of an advance submission mechanism for traders to submit customs clearance documentation prior to arrival of commodities to customs area.  | Lowest | 1 | 2 | 3 | 4 | Highest |
| 2.7 Availability of post-clearance audit for trusted traders to clear goods before completing all customs procedures.  | Lowest | 1 | 2 | 3 | 4 | Highest |
| 2.8 Simplification and elimination of some documents needed for import and export clearance in customs.  | Lowest | 1 | 2 | 3 | 4 | Highest |
| 2.9 Adoption of international standards for harmonization and standardization of customs documents.  | Lowest | 1 | 2 | 3 | 4 | Highest |
| 2.10 Facilitating coordination and document collection among various domestic and foreign regulatory authorities by introducing Single Window.   | Lowest | 1 | 2 | 3 | 4 | Highest |
| 2.11 Availing online services such as submission and approval of customs declaration, payment of customs duties electronically, etc.   | Lowest | 1 | 2 | 3 | 4 | Highest |
| 2.12 Formation of special clearance channels (e.g. green, blue, red) for authorized traders in customs for express clearance.  | Lowest | 1 | 2 | 3 | 4 | Highest |
| 2.13 Capacity building for customs related testing bodies in order to decrease time needed for standard and conformity assessment tests.   | Lowest | 1 | 2 | 3 | 4 | Highest |
| 2.14 Port Efficiency   | Lowest | 1 | 2 | 3 | 4 | Highest |
| 2.15 Overall, in which of the following areas in your opinion would be <u>the most</u> effective for trade integration among OIC countries (please rank them from 1 to 4 [1 = most effective; 4= least effective]):        |        |   |   |   |   |         |
| a) _____Capacity building in Trade Facilitation (e.g. establishment of national single window, capacity building for testing bodies, enhancing port efficiency, etc.)  |        |   |   |   |   |         |
| b) _____Integrated Single Window among OIC countries   |        |   |   |   |   |         |
| c) _____Mutual Recognition Agreement for standard and conformity assessment among OIC countries  |        |   |   |   |   |         |
| d) _____Full Cumulation System for Rule of Origin among OIC countries  |        |   |   |   |   |         |
| e) _____Other (Please indicate)  |        |   |   |   |   |         |
| 2.16 Please use the space below to highlight any trade facilitation measure you think would be particularly effective in reducing your cost of doing business or in increasing/maintaining your country's competitiveness. |        |   |   |   |   |         |