

**The Causality between Islamic Banking Profit Rate and Conventional Banking  
Interest Rate on Deposits and Loans.**  
(Evidence from Pakistan's Dual Banking system)



By

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## ABSTRACT

This study is an attempt to investigate the relationship between Conventional Bank's Interest Rate (CBIR) and Islamic Bank's Profit Rate (IBPR) on Deposits and Loans. The study also shed lights on the impact of SBP Policy rate (SBP-PR) on both of the said rate of returns. The study uses VECM & ARDL as main econometric techniques including Johansen cointegration and Granger Causality tests applied on Bi-annual data of Pakistan's banking industry from 2003 to 2018. All private conventional banks (20) and all private Islamic banks including Islamic divisions of Conventional banks (21) used as sample for the study. Johansen cointegration test confirmed the causal link between profit rate of Islamic Banks and interest rate of the conventional banks on deposits. Granger causality test results endorsed the causality between the two rates of returns on deposits. The direction of causality is uni-directional and it is running from Islamic Bank's profit rate on deposits to Conventional bank's interest rate on deposits. ARDL-bond test and ARDL cointegration test traced out that long run cointegration between Islamic Bank's Profit rate on loans and interest rate of conventional banks on loans. SBP Policy rate granger cause the both: Conventional and Islamic bank's rate of return on deposits but on loan side it doesn't granger cause Islamic Bank's Profit Rate. The findings of the study have policy implication for Bank's product pricing mechanism, SBP monetary policy and financial stability.

**Key words:** Conventional Bank's Interest Rate, profit rate of Islamic Bank's, SBP discount rate, cointegration, Granger Causality, Pakistan, Dual banking.

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