FUNG GLOBAL INSTITUTE

GLOBAL ISLAMIC FINANCE FORUM

INTERNATIONALISATION OF ISLAMIC FINANCE

Revised 1 December 2012

Kuala Lumpur

Enhancing Islamic Finance:

Establishing an Islamic stock market that overcomes problems of the existing stock market regime

By

Andrew Sheng and Ajit Singh[1]

I. Introduction

This paper is a sequel to the 2012 Sheng and Singh article which identified and explained the significance of the two central tenets of Islamic Finance, namely its underpinning by a strong ethical system and the absolute prohibition of the use of interest rates. It was also argued in that paper that the cooperation between the conventional western system and the Islamic system is eminently sensible and will lead to a Pareto optimal increase in world welfare.

Our earlier paper concluded that Islamic Finance has been growing at a fast rate over the last two decades. It is a complete system that has the potential to satisfy the financing and banking needs not only of Muslims worldwide but also of non-Muslims in

[1]The authors are respectively President of the Fung Global Institute and Emeritus Professor of Economics at the University of Cambridge. They are grateful to the Perdana Foundation for funding this research, but all opinions and errors and omissions are personal to the authors.

various countries. It offers the world an additional financial system favouring profits derived from capital and labour working together, rather than interest, and with a rather different ethical basis than that under current Western capitalism.[2]

This paper looks at a much narrower, but current issue of establishing and operating Islamic stock markets within a global context. Islamic stock markets would compete against non-Islamic markets. If Islamic stock markets are successful, they will strengthen and enhance the international appeal and practice of Islamic finance. Leading Islamic scholars have long argued in favour of Islamic stock markets, even though they recognise that many practices in conventional stock markets may be incompatible with Islamic teaching. In 1984, Professor Metwally observed: *"In an Islamic economy where interest bearing loans are prohibited and where direct participation in business enterprise, with its attendant risks and profit sharing, is encouraged, the existence of a well-functioning Stock Exchange is very important. It would allow for the mobilization of savings for investment and provide means for liquidity to individual shareholders. However, existing Stock Exchanges in non-Islamic economies have many drawbacks. They generate practices such as speculation and fluctuations in share prices which are not related to the economic performance of enterprises. These practices are inconsistent with the teachings of Islam."*

Last year, one of the foremost scholars of Islamic economics and finance, Professor Abbas Mirakhor argued in this Forum for government intervention to develop truly vibrant and active Islamic stock markets. He notes that risk-sharing is central to Islamic finance and observes that *"…arguably, the stock market is the first-best instrument of risk-sharing. Developing an active and efficient stock market can promote international as well as domestic risk-sharing which render the economy and its financial system resilient to shocks."*

Coincidentally, Islamic scholars' positive interest in Islamic stock markets arose at the same time as a vigorous debate in economics on the non-Islamic stock market's negative consequences. The role of the stock market in propagating if not generating important dimensions of the current international financial crisis which began in 2008 has been a subject of many serious commentaries. As this paper intends to draw suggestions for an

[2] For a full discussion of the issue, see Sheng and Singh (2012).

Islamic stock market from the experience and analysis of the stock market in non-Islamic countries, we intend to explore what are the weaknesses of the current stock market model.

Most analysts agree that one of the significant causes of the 2007-2009 Great Recession was the US housing bubble. However, the ending of this bubble led to a fall in share prices not only in the US but also around the world due to the close integration of world stock markets that had occurred in the previous two decades. Oliver Blanchard (2010) estimated the bank losses due to the failure of the sub-prime mortgage market to be around US$250 billion. However, the consequent financial crisis led to 'contagion' and a sharp fall in aggregate world stock market capitalisation of the order of US$26 trillion – nearly 100 times larger than the losses associated with sub-prime mortgages. Similarly Robert Solow (2009) noted that the combined result of the housing and stock market shocks was a fall in US household wealth from US$64.4 trillion in mid-2007 (before the crisis) to US$51.5 trillion at the end of 2008. Thus US$13 trillion of household wealth disappeared in the space of about one year. Solow (2009) notes*:…."Nothing concrete had changed. Buildings still stood, factories were still capable of functioning; people had not lost their ability to work or their skills or their technology. But a population that thought in 2007 that they had 64.4 trillion dollars with which to plan their lives discovered in 2008 that they have lost 20 per cent of that."*

Thus, one important aspect of a stock market regime is that globalization may make an economy unstable through contagion, even though there is no intrinsic reason for the country to be subject to fluctuations. Such external shocks often end up with aprocyclical feedback loop between two volatile financial markets, namely, the stock market and the market for foreign exchange. These macroeconomic effects of the stock market are usually neglected in the economic literature and policy analysis. This is mainly because the corporate finance economists who specialise in this area tend to work with microeconomic models. This paper attempts to address this lacunae.

In 2011, the British Government invited a committee under LSE Professor John Kay to review the UK equity market and its impact on long-term decision-making. Its report[3] published in July 2012 identified two important principles that turn out to be relevant to the establishment of stock markets in Islamic countries :-

1. All participants in the equity investment chain should act according to the principles of stewardship, based on respect for those whose funds are invested or managed, and trust in those by whom the funds are invested or managed.
2. Relationships based on trust and respect are everywhere more effective than trading transactions between anonymous agents in promoting high performance of companies and securing good returns to savers taken as a whole.

These notions of stewardship, trust and respect are clearly aligned with the ethics and beliefs of participants in the Islamic stock markets than with those currently practiced in the non-Islamic ones.

In the following sections, we shall visit the problems of primary and secondary aspects of the non-Islamic stock markets and other critiques of corporate governance, and how Islamic stock markets should avoid these defects. We do this because the stock market is not only an important symbol of capitalism, but also has a wider role in the economy to promote investments and create employment. The case for and against the stock market inevitably involves a discussion of important related subjects of corporate finance, corporate governance and corporate law. The relationship between the legal system and the stock market and that between corporate finance and the stock market are salient to any assessment of the role of the stock market in economic development. This paper presents a nuanced and balanced view of the feasibility and desirability of the Islamic stock market. It suggests that the Islamic stock markets can compete effectively against non-Islamic stock markets by improving on corporate controls and serving the real sector by helping small and medium enterprises (SMEs) raise capital.

[3]The Kay Review of UK Equity Markets and Long-term Decision Making, July, 2012, available at www.bis.gov.uk/kayreview.

This requires the creation of a class of intermediaries that nurture SMEs before they access capital markets.

Specifically, the paper reflects on the following questions:

a) Do stock market economies grow faster than economies where stock markets are relatively little used?

b) Stock markets have an ability to finance technological developments and therefore have an important role in principle in supporting new technology. Are stock market economies more conducive to technical change and economic development than non-stock market economies?

c) To be compatible with *Shariah* laws, an Islamic stock market will need to eliminate amongst other things, short-termism, speculation and strategic pricing by stock-market participants. What kind of regulation, formal or informal, will be required to achieve this?

d) How well does the stock market perform its essential task of pooling together society's savings dispersed among individual savers, to channel these savings selectively to companies with the best investment prospects;

e) How does the stock market ensure the efficient use of assets embodying past savings?

f) What are the implications of stock market development for corporate governance?; and

g) What are the implications of the mode of financing of corporate growth for stock markets in emerging countries?

We will review the evidence on some of the more important of the above issues from the data on non-Islamic stock markets. The implications of this analysis for the potential development in Islamic stock markets will be examined.

II. Do Stock Markets help Economic Development?

The mainstream free market ideology that permeated financial market theory and development economics thinking recommended almost without reservation the establishment of stock markets in emerging markets as positive for growth. In the 1990s, the International Finance Corporation helped to establish stock markets in many emerging markets and led the wave of portfolio investment in emerging stocks as an asset class.

Their argument for stock markets is two-fold. First, the World Bank concluded that the bank-dominated financial systems of developing countries in the 1980s were failing. The debt-based system, together with policy-based allocation of government funds, particularly to big domestic corporations to promote industrialization, was unsatisfactory because of excessive leverage, crony capitalism and inefficient and inflationary finance.

The second argument was what may be called natural progression. The basic idea is that stock market development is a part of a natural progression of countries towards higher stages of development. As countries become richer, they also expand and modernise their capital markets, with the stock markets as the foundation of deep derivative markets. Stock market development became an emblem of economic development, just as airports were emblems in the 1960s.

These views were supported by advanced market fund managers and some emerging market intellectuals. The former wanted a wider range of assets to diversify their risks, with opportunities to improve their risk-return frontier. The latter group argued that long-term capital for developing countries should come from the huge accumulated savings of Western investment institutions such as pension funds and insurance companies. This would reduce emerging market debt overhang. Stock markets would also enable government assets to be privatized, foreign exchange to be obtained and emerging market companies would be able to raise capital to expand overseas.

The proponents of the conventional stock market model suggest that deep and liquid stock markets improve four key functions of capital markets: resource allocation; price discovery; risk management and corporate governance. Enhancing deep and liquid capital markets in emerging markets not only enable the channelling of long-term direct and portfolio investments from developed markets, but also raise long-term capital that create jobs and growth. Furthermore, price discovery is improved as stock markets "signal" the attractiveness of "undiscovered" emerging market firms, and with the arrival of advanced market investors and intermediaries, risk management and corporate governance is improved.

There is no question that primary and secondary stock markets enable emerging market entrepreneurs to raise capital and "double leverage" their assets, since they can not only raise capital in primary issues, but also use their (now) liquid holdings as collateral to raise more capital in the secondary market or through the banking system.

Whilst there have been substantial financial deepening in many emerging markets, the volatility of such markets, with boom-bust cycles and sharp gyrations in capital flows have resulted in a more nuanced re-examination of the costs and benefits of stock markets for economic development. In the following sections, we examine these more systematically in order to see what lessons can be drawn for Islamic stock markets.

First, the series of stock market debacles since the Asian financial crisis, tech stock bubble, the Gulf stock market crash and the Great Recession all suggest that short-termism, excessive market volatility, lack of corporate control, social inequities and weak risk management are endemic in the existing structure.

Second, the case against speculative stock markets was powerfully argued by John Maynard Keynes in his General Theory: *...'Speculators may do no harm as bubbles on a steady stream of enterprises. But the position is serious when enterprise becomes the bubble on a whirlpool of speculation. When the capital development of a country becomes a by-product of the activities of a casino, the job is likely to be ill-done. The measure of success attained by Wall Street, regarded as an institution of which social purpose is to*

direct new investment into the most profitable channels in terms of future yield, cannot be claimed as one of the outstanding triumphs of laissez-faire capitalism' (Keynes 1936).

In the 1990s, a Blue Ribbon Committee of 25 leading US finance specialists chaired by Harvard Professor Michael Porter was appointed to investigate to what extent the American financial system and the stock market in particular was responsible for the poor American economic performance, particularly during the period 1980-1995 (when the US economy was stagnant – the trend rate of growth of US productivity was virtually zero). The Committee's conclusions argued…*'The change in nature of competition and the increasing pressure of globalisation make investment the most critical determinant of competitive advantage. Yet the US system of allocating investment capital both within and across companies is failing. This puts America at a serious disadvantage in global competition and ultimately threatens the long term growth of the US economy' (Porter, 1992).*

Third, the Kay Report uncovered serious deficiencies in the current model, arising from *"short-termism is a problem in UK equity markets, and that the principal causes are the decline of trust and the misalignment of incentives throughout the equity investment chain".* Indeed, the Kay Report found that UK companies were not investing as much as their competitors and that smaller companies are finding difficulty in accessing capital. Furthermore, successful companies are beginning to privatize themselves because of the regulatory burdens, whilst investors are complaining that the long-term returns on investing in listed companies have been disappointing.

III. Lessons for Islamic Stock Markets

Given these contrasting perspectives, what are the appropriate lessons to be drawn for the construction of Islamic stock markets? We start with the question of financing of corporate growth and ask what role the stock market plays in this task.

The text-book function of the stock market is to help increase savings by providing an additional investment instrument, (namely share purchase). It enables individuals to buy a fraction of a steel plant or a shipyard, thus spreading the risks across the board.

This also helps investment as without such fractional buying and risk-sharing of big projects, these may not have been undertaken at all.

However, the experience of non-Islamic countries in the real world does not quite square with this textbook account. In leading industrial countries, such as the UK and Germany, most of the large firms listed on the stock markets in these countries do not raise new equity capital at all. Instead, they rely on their retained profits for financing almost all of their investment needs. The few, usually small, companies that do go to the stock markets do not use the new capital for investment purposes. Rather, it is employed as a means of acquiring liquidity in the early stages of their development. The Kay Review concludes that the main role of equity markets is not to monitor allocation of capital between companies, but instead to oversee its allocation within companies. The Review goes on to suggest that "*promoting good governance and stewardship is….the central rather than an incidental function of the UK equity markets.*" We similarly find that there are relatively few IPOs (initial public offerings) in continental European countries such as Germany and Italy. This suggests that the role of public equity markets in these countries is also likely to be small (Pagano, Panetta and Zingales, 1998).

What has happened in advanced markets like the UK is that companies now raise more capital through private equity and debt, which leads to a closer relationship between providers and users of capital. Such a relationship is much more difficult for listed companies due to the fragmentation of share ownership, extensive restrictions on information which listed companies are allowed to share and operational difficulty of "managing good earnings" without huge listed share price shocks.

The experience of the US stock market is quite different from that of the UK or European countries. There are not only many more IPOs and more listed companies, but also a greater resort to the stock market by small companies. The US stock markets act more importantly as an "exit mechanism" for the public flotation of companies in the hi-tech sectors, for private equity and venture capital that play important roles as incubators of dynamic entrepreneurs and innovators.

In the case of fast-growing developing countries in Asia, the behaviour of the stock market in mobilising savings and financing corporate growth is also different from the US or the European experience. First, these countries enjoyed an enormous expansion of savings over the last thirty years, with savings as a proportion of national GDP growing from about five per cent GDP at the beginning of the period to thirty per cent or more now. In this huge increase in national savings, the stock market has played a relatively small role.

Second, as studies by Glen and Singh (2003, 2005) and Singh (1993) suggested, large firms in developing countries raise a much larger proportion of their capital from the stock market than large firms in advanced countries. This so-called Singh-paradox is counter-intuitive and defies most explanations offered for it. The closest reasonable interpretation is that the growth rate of a developing country's firms is greater than that of advanced country corporations, leading to a greater demand for funds by the former. But this explanation does not answer the question of why this "greater demand" should be met by equity issues rather than other sources. Indeed, the question of fairness in access to capital markets arises: why should large SOEs and large multinational and local firms have greater access than SMEs?

According both to traditional economics theory and its further development in the seminal paper by Myers and Majluf (1984), the financing of corporate growth should follow the pecking order outlined below: firms should in the first instance rely as far as possible on retained earnings for their investment needs; if that is not adequate, they should resort to debt and only as a last resort raise any funds from the stock market. Myers and Majluf show that this is mainly due to asymmetrical information between managers and outsiders. Glen and Singh (2005) confirm the earlier Singh (1995) and Singh and Hamid (1993) results for the 1980s. Their new results for the 1990s suggest that the pecking order theory is comprehensively rejected by the data for this decade. As Table 1 on the financing of corporate growth in 19 developing and 22 advanced countries for the period 1995-2000 shows that developing countries during this time span, on average, financed 39 per cent of their growth from equity issues, 27 per cent from retained earnings and 35 per cent from debt. In contrast, for advanced countries on average, the corresponding figures were 17 per cent, 53 per cent and 30 per cent

respectively. This clearly indicates a much greater resort to equity issues by developing country large firms compared with those of advanced countries.

Table 1. Financing of corporate growth in 19 developing countries and 22 advanced countries for the period 1995-2000*

Developed Markets	Liabilities	Ext F.	Int F.	Emerging Markets	Liabilities	Ext F.	Int F.
Australia	58%	32%	11%	Argentina	46%	16%	38%
Austria	52%	3%	45%	Brazil	74%	11%	15%
Belgium	56%	6%	38%	Chile	44%	33%	23%
Bermuda	41%	23%	36%	Colombia	73%	16%	11%
Canada	56%	32%	12%	Czech	33%	21%	46%
Cayman Islands	90%	8%	2%	Hong Kong	44%	20%	35%
Denmark	72%	6%	23%	Hungary	28%	1%	71%
Finland	53%	26%	22%	India	53%	5%	43%
France	61%	7%	31%	Indonesia	110%	12%	-23%
Germany	62%	5%	33%	Israel	54%	6%	40%
Greece	52%	34%	14%	Korea	27%	48%	25%
Ireland	76%	5%	18%	Malaysia	40%	18%	42%
Italy	68%	5%	27%	Mexico	61%	30%	10%
Japan	62%	6%	32%	Philippines	34%	17%	49%
Netherlands	65%	9%	26%	South Africa	49%	10%	41%
Norway	50%	23%	27%	Taiwan	59%	40%	1%
Singapore	66%	15%	19%	Thailand	74%	11%	15%
Spain	68%	-9%	40%	Turkey	61%	18%	21%
Sweden	57%	4%	39%	Venezuela	27%	54%	19%
Switzerland	54%	7%	39%				
United Kingdom	52%	21%	27%				
United States	47%	21%	32%				
Group Average	**53%**	**17%**	**30%**	**Group Average**	**35%**	**39%**	**27%**
Global Average	**49%**	**22%**	**29%**				

Source: Glen and Singh (2005).

*The basic accounting identity in this table is: the total finance for corporate growth consists of the growth of liabilities, growth of equity capital (Ext F) and the growth of internal finance.

It is not the purpose of this paper to explain this phenomenon as this has been done elsewhere[4] but rather to ask what lessons those who wish to establish an Islamic stock market should learn from the above experience of stock market financing in rich and poor countries.

It should be noted that in advanced as well as developing countries, the significance of public stock markets has declined while that of private equity has greatly increased. The question therefore is whether a strong Islamic stock market should attempt to create a thriving public market with perhaps a small role for private equity markets, or sequence

[4] For a fuller analysis of this issue, see further Glen and Singh (2003, 2005), Singh (2003) and Gügler, Mueller and Yurtoglu (2003).

development the other way round – develop SMEs first and then the stock market as an exit mechanism?

An important question raised by the above discussion is why don't more companies list on equity markets? What measures should a future Islamic equity market take to expand its role to meet the financing needs of households and corporations?

Several reasons have been put forward to explain this deficit of firms to list on the stock markets: fiscal discrimination against equity in favour of debt; the greater burden and expenses of listing on the public stock markets than before; and the poor performance of the public equity markets.

The Kay Review suggests a more fundamental and deeper reason in the nature of financial intermediation itself, since it regards equity markets as a means of financial intermediation between savers and corporations. The latter enables savers to achieve diversification and liquidity. A successful intermediary enables savers to derive the benefits of diversification and liquidity by minimising the disadvantages of control loss and information loss as the firms become bigger. The Review suggests that information asymmetry and principal-agent conflicts become more serious as the modern corporate economy evolves. The relationship between the investors and the corporations in large, impersonal, public equity markets is more distant and much less close (due to regulatory and information provision restrictions) than that between the management of a private equity-supported firm and its investors.

The more distant the human relationship, the easier the moral dimension gets lost.

The Kay Review sums up the evidence on the UK stock market in relation to savings and outlines an approach to resolving difficulties in this area in the following terms:-

"Equity markets today should primarily be seen as a means of <u>getting money out of companies rather than a means of putting it in.</u> This does not mean that equity markets are not relevant to investment in UK business. But the relevance is indirect. Equity markets are one of the means by which investors who support fledgling companies can hope to

realise value. Equity markets provide a means of oversight of the principal mechanism of capital allocation, which takes place within companies. Promoting stewardship and good corporate governance is not an incidental function of equity markets. The effectiveness of modern equity markets depends almost entirely on their effectiveness in promoting these goals of stewardship and governance." (Kay Review, paragraph 2.32, page 28).

There are other weaknesses of non-Islamic stock markets that deserve attention. These include notably the short-termism of the stock markets. It is important to note that short-termism takes many different forms. Apart from not being concerned with the long-term value of the company, it connotes lack of investment in the company's infrastructure, in its standing and reducing expenditure on research and development. It also refers to making quick profits on the stock market rather than staying the course with long-term investment in particular companies. In view of its many manifestations, the phenomenon of short-termism is commented upon at more than one place in this text. In Chapter 12 of the General Theory, Keynes (1936) adopted a straightforward definition of short-termism in terms of share turnover and observed as follows…*"The spectacle of modern investment markets has sometimes moved me towards the conclusion that to make the purchase of an investment permanent and indissoluble, like marriage, except by reason of death or other grave cause, might be a useful remedy for our contemporary evils. For this would force the investor to direct his mind to the long-term prospects and to those only."* However, Keynes abandoned this idea because if individual purchases of investments were rendered illiquid, they might adversely affect the propensity to invest.

The Porter Commission regarded short-termism as a major fault of the US capital markets. It proposed a tax on those who dispose of their shares quickly. Under their scheme, if an investor held the shares in a corporation for five or more years, he or she would be subject to a much lower level of taxation. Porter and his colleagues thought that such a change in the taxation of stock market returns would, over time, change the culture and ethos of the market and shift it towards long-termism.

The Kay Review proposed a third, radically different approach to short-termism and stock market reform. Kay's remedy is original and a major contribution to the theory of

finance. It suggests that the answer lies in having long-term relationship, between all the players: asset managers; asset holders; and corporate directors. It attributes short–termism to the decline of trust and misalignment of incentives. The Review suggests that a culture based on principles of stewardship, founded on respect for those whose funds are invested, is required as a long-term remedy for the problems of the stock market.

This approach fits in well with the basic ethos and culture of Islamic stock markets. It is therefore likely to be easier to implement Kay Review's vision in an Islamic stock market than in the existing non-Islamic markets. Most commentators feel that it will not be easy to change existing stock markets due to resistance from those who would stand to lose from a major reform.

IV. Stock Markets and Economic Efficiency: Further Lessons for Islamic Stock Markets

The Islamic stock market has the great advantage of being late on the scene and can therefore achieve fast growth and structural development much more speedily than would otherwise be the case. Moreover, the history of stock markets in non-Islamic countries and their analyses provide rich and varied narratives about the progress of the stock market as well as its difficulties in these countries. The Islamic stock market must examine these narratives closely and learn the lessons which they provide. With that in mind, we shall consider some controversial issues in non-Islamic stock market economics and examine their implications for Islamic markets. The two main issues we shall focus on are: (i) the efficiency of the stock market prices; and (ii) the takeover mechanism, together with means such as bankruptcy, de-listing from the stock market as the disciplinary devices to increase economic efficiency.

IV.i. Stock Markets and Efficiency of Share Prices

Opinions differ on how 'efficient' stock market prices are in theory and in practice.

The orthodox paradigm of share price determination postulates that share prices are efficient because they emanate from perfect markets involving large numbers of well-informed buyers and sellers in which no one buyer or seller can influence the price and where there is a homogeneous product, namely corporate shares. There is, however, an alternative paradigm indicated by the passage from Keynes cited earlier that characterizes stock markets essentially as gambling casinos dominated by speculators. Allen and Gale (2000); Shiller (2000); Shleifer (2000); Singh et al (2005), Baker and Wurgler (2007); and Hong and Stein (2007) among others have formalized the various elements of this paradigm[5]. In brief, this literature suggests that, in the face of a highly uncertain future, share prices are likely to be influenced by the so-called 'noise-traders', and by whims, fads and contagion. For similar reasons of psychology, investors may attribute much greater weight to near-term price forecasts rather than historical long-term performance, thus suggesting another reason for short-termism. Nevertheless, many economists believe that overall the best theory of share price determination is the one suggested by Keynes' famous 'beauty contest' analogy. This points towards strategies adopted by probably a large number of investors on the stock market:-

> *"Or, to change the metaphor slightly, professional investment may be likened to those newspaper competitions in which the competitors have to pick out the six prettiest faces from a hundred photographs, the prize being awarded to the competitor whose choice most nearly corresponds to the average preferences of the competitors as a whole; so that each competitor has to pick, not those faces which he himself finds prettiest, but those of which he thinks likeliest to catch the fancy of the other competitors, all of whom are looking at the problem from the same point of view. It is not just a case of choosing those which, to the best of one's judgement, are really the prettiest, nor even those which average opinion genuinely thinks the prettiest. We have reached the third degree where we devote our intelligences to anticipating what average opinion expects the average opinion to be.*

[5]See also studies of behavioural finance, for example, contributions by Barberis and Thaler (2003); Hong et al (2007) and Baker et al (2007).

And there are some, I believe, who practice the fourth, fifth and higher degrees." (Keynes 1936, p. 156).

However, until recently, the empirical literature on the determination of share prices has been dominated by the so-called 'efficient markets hypothesis (EMH)', which argues that real world share prices are efficient in the sense that they incorporate all available information (Fama, 1970). In the 1980s, 1990s, and 2000s with (a) the 1987 US stock market crash, (b) the meltdown in the Asian stock markets in the 1990s, (c) the bursting of the technology stock bubble in 2000, and (d) the demise of the housing and subprime mortgages' bubble in 2007-2009, the EMH has suffered fundamental setbacks. None of these events are compatible with the fundamental valuation efficiency of the stock market. Alan Greenspan (1998) has commented as follows on the reasons for (a) and (b): "At one point, the economic system appears stable, the next it behaves as though a dam has reached a breaking point, and water (read 'confidence') evacuates the reservoir. The United States experienced such a sudden change with the decline in stock prices of more than 20 per cent on October 19, 1987. There is no credible scenario that can readily explain so abrupt a change in the fundamentals of long-term valuations on that one day." Kindleberger (1989) similarly documented about thirty cases of unwarranted euphoria and excessive pessimism on the stock markets since the South-Sea bubble of 1720. He termed these episodes as manias, panics and crashes.

James Tobin (1984) made an analytically useful distinction between two kinds of efficiency of stock markets: (a) the information arbitrage efficiency that ensures that all information concerning a firm's shares immediately percolates to all stock market participants, ensuring that no participant can make a profit on such public information; and (b) fundamental valuation efficiency, that is, share prices accurately reflect a firm's fundamentals, namely the long-term expected profitability. The growing consensus view is that, in these terms, stock markets may at best be regarded as being efficient in the sense of (a) above, but are far from being efficient in the economically more important sense (b). Thus EMH, as identified in (a), is compatible with share prices not reflecting fundamental values. In his presidential address to the American Finance Association, Fischer Black, a prominent supporter of EMH observed this as follows. He said that the efficient market theory of the stock market 'seems reasonable' if we adopt

the right definition of 'efficient'. He defined 'efficient' to mean that individual company stock prices are between half true value and twice true value almost all the time and he defined 'almost all' to mean at least 90%.[6] This illustrates at a very conservative level the difference between theory and empirical reality in relation to the orthodox hypothesis. A more detailed discussion as well as other examples of share prices evidently departing from their fundamentals for prolonged periods is provided in Singh et al (2005).

Apart from the day-to-day mispricing of share prices on the stock market, which is particularly likely to be severe in developing countries as their firms do not have a long track record, share prices in developing countries are more volatile than in advanced countries [see further Singh (1997); El-Erian and Kumar (1995)]. Share price volatility is, however, a negative feature of stock markets for several reasons. First, it reduces the efficiency of the price signals in allocating investment resources. Secondly, it increases the riskiness of investments and may discourage risk-averse corporations from financing their growth by equity issues and indeed from seeking a stock market listing at all. Thirdly, at the macroeconomic level, a highly volatile stock market may lead to financial fragility for the whole economy (Singh 1997).

IV.ii. Takeovers and Bankruptcy as Disciplinary Mechanisms

It is important in this context for Islamic scholars favouring the establishment of stock markets to also bear in mind that the stock market often "spontaneously" leads to the development of a market for corporate control. Such a market exists in countries like the US and the UK and plays an active role in these economies. In developing countries, this market exists so far only in a rudimentary form. This is because in most of these countries, there are immature stock markets without sufficient separation of ownership from control. Nevertheless, developing country governments come under pressure from big players in the system to establish a free market for corporate control. Parenthetically this market is regarded by traditional economics as the evolutionary end point of stock market development. Empirical evidence, however, is all to the contrary. Research shows that the takeover mechanism as it works in the real world is

[6] See further Shiller (2012).

highly flawed. Selection in the market for corporate control takes place not on the basis of performance alone, but both on performance as well as size. Thus, a large, relatively unprofitable firm has a greater chance of survival than a small profitable firm. This has adverse consequences for economic efficiency. See further Tichy (2002), Scherer (2006), and Singh (2008). The market for corporate control instead of being a vehicle for economic efficiency, exacerbates the shortcomings of stock markets by encouraging speculative takeovers of whole companies rather than just buying and selling of a few shares of individual companies. Thus, in the non-Islamic world, in conventional economic terms, neither the pricing mechanism nor the takeover mechanism in the real world, are helpful to economic efficiency and development.

The third issue is the effectiveness of the exit mechanism for failed companies, such as de-listing from the stock market or actual bankruptcy. The important disciplinarian role of the exit mechanism is that failed institutions should exit and that there are consequences for failure. Many emerging market stock markets do not work well because of the lack of enforcement of rules or not allowing more de-listing and bankruptcy of failed companies. Indeed, in a number of cases, governments have been known to intervene in stock markets to bail out companies in trouble. However, it may be observed that not all interventions to save the closure of large firms in developed or developing economies is necessarily wrong. The orthodox view is that such action only engenders more moral hazard problems, eroding the disciplinary role of financial markets. However, a full cost-benefits analysis of the proposed intervention is required before it can be concluded that the cost of intervention is too high in terms of erosion of financial market discipline. It is also worth noting that one way in which takeovers may be helpful is the case of a declining company which may be acquired by someone before it fails.

IV.iii. Stock Market Efficiency in Non-Islamic Markets: Further Lessons forIslamic Markets

The main lesson which the architects of Islamic stock markets should draw from the complex literature on share price determination and the takeover mechanism is that there are broadly two kinds of agents who participate in the stock market. One of these

is interested in maximising the long-term value of the company he or she is investing in. The second is a trader who is interested only in the share prices and whether he or she can make an immediate profit on the basis of the analysis of these prices and their movements over time. The second category of people is not at all interested in the long-term value. They try to forecast the psychology of the market and how they can profit from it. The main implication for the Islamic stock market is that in a normal market both these kinds of individuals or economic agents will be present. The Islamic stock market in order to achieve its long-term goals must encourage the former and attempt to discourage the latter type of activity. Short-termism will be against Shariah laws but it is difficult to provide proof of this behaviour because no one will admit that they were playing the market rather than seeking long-term maximisation of the value of the firm they had invested in. As suggested by the Kay Report the ideas of trust, stewardship and straightforward honesty will need to be brought to bear on this fundamental issue.

To avoid the difficulties of immature markets, which are bound to arise in developing countries from the operations of a market for corporate control, an alternative way to regulate it is to be much more cautious in allowing the takeover market to emerge. The simple point is that research shows that the takeovers represent a very costly mechanism for changing managements, especially when takeover bids are contested. Even when they are not contested the transaction costs tend to be high. See further Peacock and Bannock (1991). The takeovers and mergers also greatly increase the dangers of short termism, encourage speculation and financial engineering rather than the pursuit of normal capitalist goals of reducing costs and producing new products. It is important to note that neither Germany nor Japan nor any of the successful East Asian newly industrialised countries had a market for corporate control during their development. Research also shows that such a market is arbitrary and uncertain in its effects. There is no perfect solution to the need for change in management and ownership. Proponents of the US/UK system argue that the Darwinian process of creative destruction requires takeovers as a means of accelerating change. Opponents argue that such bidding wars are costly and the change has not necessarily benefited investors, due to the asset-stripping behaviour that regulators cannot always prevent. Developing countries must find a cheaper way of changing managements than the takeover mechanism that works in countries like the US and the UK.

V. Issues of Globalization and of Long-Term Growth for Islamic Stock Markets

We will consider briefly the growth question first as it is in some ways easier to answer. This is what was called - earlier in this essay - the natural progression theory which asserts that as economies grow, so does the stock market which is therefore an emblem of development. It will take us too far afield to discuss this theory in depth. However, we find that even broad brush evidence on this issue is telling. For example, it is useful to note that the economic miracles which have occurred in the second half of the twentieth century can hardly be ascribed to the stock market and its development. Thus in Europe, the Italian miracle (very fast growth), the German miracle, the Austrian miracle and in Asia, the justly famous miracles of Korea or Taiwan, did not depend conspicuously on the equity or bond markets in these countries. Similarly. an examination of comparative growth rates over a long hundred year timespan indicates that the bank-based countries (for example, Germany and Japan) have as good if not better, a long term record than the US and the UK. Pagano (1993) noted that the Italian stock market was bigger a hundred years ago than it was in 1990. The Italian economy evidently grew during these hundred years without any expansion of the stock market. There are wide inter-country differences in the size of the stock market relative to GDP in various European countries. In the UK the ratio of stock market value to GDP is five times larger than in Germany, France, Denmark and Finland, and six times larger than in Italy and Norway. Pagano reports that in Italy not only has the number of listed companies stagnated for nearly a century, the total worth of companies trading has not kept pace with the economy as a whole. At the turn of the century (1906), total market capitalisation of Italian firms was 26.3 per cent compared with 12.1 per cent in 1991. Explaining inter-country differences in the incidence of stock market capitalisation, the number of companies listed on the stock market and related questions are subjects for research which cannot be pursued here because these lie outside the scope of this paper.

We now come to the impact of globalization on Islamic stock markets. Islamic stock markets cannot operate independently from non-Islamic financial markets.

First, contagion will always occur, due to arbitrage activities between markets, even though such arbitrage may not be either legal or permissible under Sharia rules.

Second, the fact that current global markets are highly distorted in terms of interest rates, exchange rates, different tax rates and policy regimes, mean that there will be impact on Islamic stock markets.

Thirdly, the regulatory rules regarding Islamic stock markets and non-Islamic stock markets will be different, primarily because Islamic finance has Shariah rules that govern the moral foundations of Islamic markets. In the final analysis, the Islamic stock market is only as strong as its technical and legal infrastructure, the quality of listed companies, intermediaries and the way that Islamic regulators, courts and interpretation of *Shariah* laws reinforces trust in the Islamic Financial System and avoids the moral hazard and egregious behaviour that non-Islamic markets currently suffer from.

Fourthly, if non-Islamic financial markets suffer from short-termism and lack of trust, can Islamic markets protect themselves from "infection"?

The bottom line is that currently, non-Islamic stock markets suffer from the curse that modern finance appears to be serving itself rather than serving the real sector. Being built on moral foundations, Islamic stock markets must demonstrate that they serve the real sector more effectively, more equitably and more sustainably.

How can we induce the financial system to serve the real sector? The answer is that if the financial system makes money, whilst the real sector is losing money, finance is not symbiotic or aligned with the real sector. Finance as a service industry can only prosper when its principal, the real sector prospers. Therefore the incentives that drive finance must be aligned with the real sector, not just in the short-term, but in the long-term as well. To do so, the marginal revenue from serving the real sector must be equal to the marginal cost of doing so. In other words, profits from toxic excess leverage should be taxed or regulated and if needs be, incentives are provided for lending to the real sector. The current global regulatory reforms do not address this basic distortion in incentives.

In that regard, we are convinced that conventional finance theory and its practice has forgotten its institutional history. Finance grew out of serving the real sector, with moral ethics and acting as the credit disciplinarian and corporate governance steward for borrowers and listed companies. For example, at the beginning of the 20th Century in England, there were 19 provincial stock exchanges in cities like Birmingham and Manchester. Economic historians tell us that they performed very useful functions, including raising substantial amounts of equity capital for local firms and worked on the basis of trust rather than formal legal rules. However, none of these provincial exchanges function today. Economies of scale enjoyed by the London stock market have overwhelmed all the small stock exchanges.

Indeed, with the arrival of modern finance theory and derivative financing, the game has become global, impersonal and a celebration of private greed at public expense. When financial markets become impersonal and too large and too complex to manage, they can lose their moral bearings, because personal accountability becomes lost in impersonal "public responsibility". Everybody's money is nobody's money, so liberal monetary creation for all loses all sense of responsibility. It is as if inflation is good for all. It may be good for those with a huge debt overhang, but the poor and those with holdings of paper assets will suffer.

This analogy of provincial stock exchanges with the Islamic stock market will be valid only if the latter remains small. It does mean that the role of financial intermediaries in safeguarding the moral bearings of Islamic finance is critical. They have to start small in helping SMEs raise funds for trade, investments and risk-taking. This calls for a very different approach from the "mega-markets" of centralizing liquidity through sheer scale. The Islamic stock market will also have to discourage any strategic pricing which is not concerned with enhancing the long-term value of corporations; be on guard against the threat of contagion and try to avoid any negative feedback loops which may arise from the interaction between the stock market and the foreign exchange market in a crisis situation.

VI. Conclusion

There is today widespread dissatisfaction with the stock markets in advanced countries including the US and the UK where such markets have been historically important. The UK Equity Market (Kay) Report is most illuminating. It recommends a root and branch change in the conduct of the stock markets. It calls for long-term relationships between all participants in the equity chain, relationships which are based on respect and trust and involve notions of stewardship and mutual respect. Kay also suggests that the whole ethos of the stock market should change to permit the exercise of appropriate values.

In essence, since stock markets are systems, the long-term viability and sustainability of systems depend on the trade-off between three overlapping but often conflicting objectives – efficiency in resource allocation, stability and resilience to internal and external shocks, and also fairness and equity, enabling all to access the market in a competitive manner. The fact that stock markets like all systems require regulation and policy intervention, particularly during crises, means that government intervention is inevitable. The current crisis has amply demonstrated that the Efficient Market Hypothesis assumed that efficiency would take care of stability and social equity.

It is the central contention of this paper that the proponents of the Islamic stock markets will find it easier to implement Kay's reform programme for the stock market than their UK counterparts. The strong ethical basis of the Islamic stock market gives it a decisive edge in meeting the requirements of the Kay Review. Indeed it may reach the position where the tutor and the pupil reverse their roles. The UK stock market may well learn from the experience of the Islamic stock market with its strong ethical underpinnings.

The advocates of Islamic stock markets should regard it as a long term commitment a kind of project that may take two to three decades to complete. They should begin by concentrating on the financing needs of the excluded, particularly the SMEs and by implementing the spirit of the Kay Report which as our earlier analysis indicated is very much in accord with Islamic ethics. It may also be useful to start the actual

establishment of Islamic stock markets in a small number of Muslim countries on a national basis in the first instance. However, as people come to know each other and as the knowledge base and experience expand, the national stock markets may integrate into regional or international Islamic stock markets. Developing markets is in a learning and adapting process.

The second major lesson is that they should not permit a market for corporate control to arise either "spontaneously" or by design. This is because as detailed in previous pages, such a market leads to short-termism, speculation, rapid turnover of shares, strategic pricing – all things which go against the grain of an Islamic stock market.

This raises an important question: If takeovers are not to be used to discipline errant or low performing firms, how should these firms be controlled? The answer is simple but extremely important. All firms should in the first instance be subject to the discipline of competition in the product markets. The exit mechanism in terms of bankruptcy laws and the court mechanisms should have higher priority in the policy agenda, rather than takeover mechanisms.

Through its ethical and moral base, Islamic stock markets will have to devote more attention to the stability and equitable aspects of market systems. Since Islamic finance investors and market participants are relatively new and inexperienced, it will take time to nurture the development of Islamic stock markets to balance the three objectives of stability, robustness and fairness in a transparent and sustainable manner.

To put all the above into practice will not be easy, but this is a worthy exercise and challenge for Islamic finance practitioners. It is also a historic opportunity to enter the global market at a time when there is widespread dissatisfaction with the conduct of the stock market and related financial institutions in advanced countries.

1 December 2012,
Kuala Lumpur and Cambridge.

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