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# What factors explain stock market retardation in Islamic Countries<sup>☆</sup>

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### ABSTRACT

Stock markets have been recognized in literature as a source of financial development and economic growth. Notwithstanding the recent trend of the stock market development in emerging countries, some argue that Islamic countries' stock exchanges are still infantile. The central aim of this research, therefore, is to investigate factors impeding stock market development (SMD) in Islamic countries. We explore a panel annual data of 11 main Islamic countries vis-à-vis the developed countries for the period of 1996–2011. The findings show that all of our concerned macroeconomic determinants play a major role in the developed countries. On the other hand, financial openness has substantially less contribution in Islamic countries, while the financial intermediary development plays a major role. The results are also indicative of the need for the Islamic countries to improve their legal environment and economic freedom. Lastly, we also attempt to measure the integration level, where the findings tend to indicate a relatively lower and unstable pattern of integration for the Islamic countries, suggesting the impact of volatile inflows.

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## 1. Introduction

Stock markets have been theoretically and empirically recognized as a source of financial development and economic growth. Many studies show that a well-functioning stock market can promote economic growth by providing much needed capital and liquidity for fuelling faster capital accumulation, productivity improvement, and by improving economic efficiency through effective resource allocation (Atje and Jovanovic, 1993; Beck and Levine, 2005; Caporale et al., 2004; Levine and Zervos, 1993, 1998b; Rousseau and Wachtel, 2000; Toda and Yamamoto, 1995; and others). Some argue that the stock markets may drive the economic growth through various channels (Enisan and Olufisayo, 2009). Firstly, they assist in mobilization of domestic savings by enhancing the set of financial instruments available for savers to diversify their portfolios. They also provide opportunities for individuals to have partial ownership in businesses, thereby providing a relatively liquid means of sharing risks. Lastly, they promote efficient allocation of capital to productive investments along with providing investment outlets for both domestic and foreign investments.

The important role played by the stock market in addition to the substantial growth of capital markets around the world in the last two decades, and the trend of integration, have set forth the necessity for governments to prioritize the development of domestic stock markets. This issue is very relevant for the emerging markets, which have shouldered an increasing share of world growth in the past few decades.

Many researches in recent times have been undertaken in emerging countries that include Latin America, India, China, and so on. However, relatively less work has been done in the context of Islamic countries. Islamic countries comprise some of the richest countries with the largest oil and gas reserves as well as some of the poorest nations. The region has seen some rapid growth countries, with immense potential owing to the human capital and cost efficiency. Notwithstanding the recent trend of the stock market development in emerging countries, some argue that Islamic countries' stock exchanges are still infantile. Literature show that these stock markets, both in MENA and emerging Asian countries, are smaller, less efficient, less liquid, more volatile, prone to higher risk premium, higher cost of funds, and poorer quality of legal environment and governance (e.g. Abraham et al., 2002; Butler and Malaikah, 1992; Click and Plummer, 2005; Darat and Hakim, 1997; Domowitz et al., 1998; El-Erian and Kumar, 1995; Kim and Shamsuddin, 2008; Selçuk, 2004; Sharma and Wongbangpo, 2002; and others). This could be attributed to poor-quality of information flow, high trading costs, disintermediation, and less competition due to international investment barriers (less integrated with other markets). In the less developed countries, even though the financial system is developing and becoming more sophisticated and credit availability has increased, the allocation of resources is still inefficient (misallocation of resources), and the economy struggles to obtain the funds necessary to respond to an increase in the demand for output, thus hampering the growth of the economies (Chaiechi, 2012; Deidda and Fattouh, 2008; and others). The system also cannot fully benefit from foreign capital inflows that may provide additional capital to local savings and promote capital accumulation, increasing growth through knowledge spillover (Borensztein et al., 1998).

The central aim of this research is to investigate factors impeding stock market development in Islamic countries. What is lacking in the existing literature is any rigorous empirical study focused on the critical factors impeding the stock market development in Islamic countries, in comparison to the developed markets. Therefore, we explore a panel data of 11 main Islamic countries, taking into account the availability of complete dataset for the determinants of stock market development in these countries. This is studied in comparison with a panel data of 11 stock markets in the developed countries. The annual observations are taken with the sample range from the year 1996 till 2011. The main contributions of this paper are: (1) Analyzing the determinants of stock market development in Muslim countries, such as financial openness, financial intermediary development, legal framework, governance, economic freedom, and so on; (2) Comparative examination of the extent of underdevelopment of stock markets in Muslim countries vis-à-vis more developed stock markets; and (3) Measurement of the integration level with the world for both group of countries and, at the same time, exploring its key determinants. A comparative study of the determinants would hopefully result in a better understanding of the factors hampering the stock market development in Muslim countries in order to improve the contribution of their stock markets to the economic growth of the countries. To the best of our knowledge, our study is the first comparative study in analyzing Muslim countries' stock markets with a major focus on deriving some policy implications to boost the stock market development in those countries.

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