How Strategic is Islamic Finance and Stock Markets' Progression from Inception to date?

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Abstract

Islamic finance, specifically the Islamic stock market, is examined in this study from its beginnings to the present day as it remains a contemporary issue in academic field and the world at large. Islamic stock market performance, direction, and whether or not it has strayed too far from its basic ethical and moral underpinnings are all investigated. Analytical techniques employed in the study include a comprehensive review of the literature and trend analysis. In examining the development and functioning of the Islamic stock markets without regard to the broader Islamic finance industry, the task is nobly accomplished. The review examines the various changes that have occurred in the Islamic finance industry since its beginning; some of these changes have been perceived positively, while others have been viewed poorly. According to the findings of this study, the Islamic stock market is steadily shifting away from the ethico-moral orientation of the 1980s and 1990s. The race to emulate the conventional stock markets, championed mostly by market operators and policymakers, has engulfed Islamic markets. It is recommended in this study that the Islamic stock market come back to its original ethico-moral base and emphasis, while attempting to raise its overall market valuation.

Keywords**:** *Islamic Finance, Stock Markets', Islamic Stock market, Islamic Investors*

Introduction

Islamic and non-Islamic investors are increasingly turning to Islamic finance as a source of financing. Islamic finance has emerged as a rising star in the financial industry in recent years. There has been a growing interest in this business from the skyscrapers of Dubai and Kuala Lumpur to the XIX century palaces of Paris. Traditional Muslim prohibitions on interest payments and gambling are addressed by Islamic finance, which focuses on the design of financial instruments and transactions to comply with these prohibitions. Conservative Muslims, particularly those from Middle East and South-East Asia, are becoming increasingly concerned about the Western-style financial system and banking that involves explicit interest payments, particularly in nations with a big Muslim population.

Due to the lack of relevant data and the ongoing development of Islamic economic and financial systems, empirical study on Islamic finance is relatively new (approximately three and a half decades) (Abdullahi, 2018). Even the most recent empirical studies are still in their infancy and need to be appropriately positioned in relation to conventional finance because of the different axiomatic underpinnings of the various systems (Hasan, 2007). There has been a tremendous increase in empirical studies on Islamic finance since the beginning of the 21st century. Papers in this field are being accepted by a growing number of peer-reviewed academic publications. annual award for contributions to Islamic economics and finance for the first time since its inception in 1988 went to an economist whose contributions to empirical Islamic finance were the focus of his work in 2016. This shows that empirical research is becoming increasingly important in Islamic finance and economics. Initially, the early efforts on Islamic economics and finance focused on modifying existing models to fit some Islamic ethical criterion (Abdullahi, 2018). For example, instead of paying interest, a profit-sharing model might be used, and Zakah alms could be included. Other changes would include understanding the need of moderation in consumption, adhering to HalalHaram, and staying away from Maisir (gambling) and Gharar (excessive uncertainty).

General equilibrium analysis was first used in the 1980s to examine how a Sharia-compliant economy evolves over time. Khan and Mirakhor (1990), Sattar (1990) and Metwally (1990) are examples of these works. This breakthrough was made in part to assist Muslim countries in implementing the Islamic economic system at the economy-wide (macroeconomic) level. There were mixed outcomes in Sudan, Pakistan, and Iran when they tried this method. Islamic economics and finance literature has been strengthened by the success of countries such as Malaysia and some Gulf Emirate countries in introducing Islamic financial systems at micro level, facilitating the gradual dismantling of general equilibrium analysis in Islamic economics and finance literature for micro-analysis. As a result, partial equilibrium analysis is the subject of the majority of the current work on Islamic finance. Analyzing Islamic banking, Sukuk bond efficacy, monitoring Zakah collecting or Waqif institutions' efficiency, and measuring the success of Islamic stock indexes are all examples of this.

As a fundamental tenet of capitalism, self-interest and greed are revered in conventional economics since they are unique to it. Selfishness and materialism have overtaken morality in our society. The 2008 worldwide stock market crash was sparked by investors' greed, which culminated in the loss of trillions of dollars in assets. Derivatives are the financial market's most evocative symbol of greed. It is technically defined as a product or instrument derived from another product or instrument. As a result, derivatives like options, swaps, and futures have no intrinsic value and instead rely on the value they claim to have borrowed from another product. Islamic finance, in contrast to conventional financial practices, focuses on transactions that fall within the parameters set by Islamic law. Derivative financial products, at the core of the 2008 global financial crisis, were strictly prohibited in Islam. The introduction of an Islamic equities index was designed to remedy the moral bankruptcy that is evident in conventional stock trading. Islamic stock indexes are becoming more widely available throughout the world, following in the footsteps of Islamic banking's recent triumphs. Large exposure to real estate is found in Islamic stock indexes. Leverage impacts are further reduced by the use of Sharia-compliant screening in the Islamic stock market (Saiti, Bacha and Masih, 2014). Islamic index management, like Islamic banking, has a very small asset base compared to its conventional equivalents. An increase in Islamic economics and finance is expected to have a favorable impact on Islamic stock index diversity. The same may be said about Muslim countries throughout the world's economic growth and prosperity.

As commerce and financial transactions become increasingly global, stock markets throughout the world have reacted by becoming more interconnected. In addition to enhancing the efficiency of stock markets throughout the world and growing their capitalization, this link also facilitates financial contagion during a crisis. As a result, a stock market's interconnectedness with the rest of the globe grows stronger as efficiency increases. Due to the fact that the Islamic index is a subset of the broader conventional index traded on stock exchanges throughout the world, there is a strong possibility of correlation between the two indexes (Abdullahi, 2021).

This study examines the evolution of Islamic finance, specifically the Islamic stock market, from its beginning to the present time period. Islamic stock market performance since creation, the direction it is heading, and whether it has altered course from its initial ethical-moral basis of the '80s are the main objectives of this study. The study's primary approach of analysis is a thorough review of the literature and an analysis of trends. The study is broken into four sections: the introduction, the literature review, the trend analysis, and the conclusion and recommendations.

Review of Relevant Literature

It was a popular proposal among Islamic economists in the 1970s and 1980s to create an Islamic stock exchange. The long-held demand for separate Islamic stock exchanges (ISE) gave way to Islamic stock indices (ISI) inside conventional exchanges in the 1990s, with the development of Sharia funds and later Sharia indices such as the Islamic Dow Jones index and the Islamic FTSE. How this contributes to the Islamic stock index is a question of both theoretical and practical investigation. Islamic stock exchange pioneers such as Metwally (1984) and Tag El-Din (1985, 1996) concentrated on the ethics of market workings, notably the issue of speculating, which was considered as being against Islamic values. The equilibrating capital market in Islamic economies ensures that enterprises satisfy their capital requirements via the capital market and invest the same capital up to the point when marginal productivity of capital is equal to user cost of capital (Sattar, 1991). Metwally (1984) predicted that authorities would have to intervene in an Islamic stock market in order to control its activities.

The Islamic framework for stock trading prohibits transactions with Gharar (extreme uncertainty), according to its code of conduct (Tag El-Din and Hassan, 2007). Islamic financial assets have a unique aspect in that they are linked to real assets (Asutay, 2012). The Islamic economists, according to Siddiqi (2006), "advocated an asset-based system of money creation and credit extension in which money loans will play a marginal role." Because of this, current Islamic banks' financialization and adoption of Western banking products goes against the fundamental principles of Islamic economics and finance (Choudhry 2007; Asutay, 2012). For the current shift in Islamic finance toward replication of conventional financial structures, academics have attributed it to a lack in modern economic principles and a preference for codified Fiqh literature above the purposes of Maqasid al-Shariah, among other reasons (Siddiqi, 2006). Because of the importance of understanding the wider social and environmental impacts of the projects they fund, Islamic financial institutions may benefit much from conventional financial institutions' experience in this area (Asutay, 2012). Literature on volatility linkage has suggested this: markets linked together by increased trading, the sharing of investors, and capital movements move together during a crisis. And thus, we have to wonder if the same holds true for Islamic stock indices? From a theoretical standpoint, the answer might be either yes or no; but, from an empirical standpoint, further research may be necessary to get a clearer picture. Evidence of this phenomena (spread of contagion/herd behavior) occurring may be found in the global financial crisis of 2008. Covid 19 has offered new opportunity to test these riddles, as the epidemic continues. It has been shown that Islamic indexes tend to follow overall market patterns during times of crisis, such as during the COVID-19 pandemic of 2021(Abdullahi, 2021). The report found that Islamic indexes, like conventional indices, were impacted by the crisis.

Many of the early pioneers in the development of Islamic economics and finance envisioned a future economy free of the periodic financial shocks that often destroyed the conventional economy. When it comes to asset holdings in an Islamic economy, for example, Mirakhor and Zaidi (1988) claim that capital inflows to the economy are less impacted by rapid and uniform fluctuations in the perception of the country's creditworthiness. Islamic economies do not use interest rates to calculate financial rates of return, unlike those based on interest. In comparison to the conventional financial system, in which interest rates are set by central banks, this gives the Islamic economy a larger market basis (Mirakhor and Zaidi, 1988). Because Islamic economics are linked to real assets and Gharar is prohibited, excessive volatility is prevented in an Islamic economy as has lately been seen in the main global economies. Interest rates are prohibited in Islamic finance in order to limit inflation and ensure that funds are used for the most productive purposes possible. A small number of conventional economists had also predicted this and cautioned against the destabilizing function of interest in an economy and its involvement in the occurrence of business cycles (Dar and Presley, 1999).

The absence of a debt market in an Islamic economic system left the system dominated by equity financing and partnership arrangements (Mirakhor and Zaidi, 1988). As a result, the Islamic financial system relies heavily on risk sharing. According to Fahim Khan (2019), when it comes to Islamic finance, risk sharing plays a significant role since it requires economic agents to accommodate the financial requirements of others without any economic rewards and discourages them from borrowing for any other purpose than to fulfill their own immediate needs. For Islamic joint ventures, the Shari'ah mandates the use of the Mudaraba and Musharaka concepts of participatory, cooperative, and coordinated enterprise (Choudhury, 2001). As a result, equities trading and other capital market operations follow the profit-and-loss sharing model, exactly like the rest of Islamic finance.

Other studies on Islamic stock markets include Mirza, Rizvi, Saba, Naqvi, and Yarovaya (2021) who compare the risk-adjusted performance of Islamic and conventional equities funds during the COVID-19 crisis. When compared to their conventional counterparts, Islamic equities funds outperformed their counterparts in terms of risk-adjusted performance, investing strategy, and volatility timing. During the peak months of the COVID19 crisis, Islamic equities funds outperformed non-Islamic rivals, according to their findings. Even if the spread narrows, the tendency remains. Islamic stock markets are examined by Abbes and Trichilli (2015) for their dynamic integration across a wide range of existing and developing markets. Among Islamic stock markets belonging to the same economic sector, they discovered a long-run equilibrium link.

However, the Islamic stock markets of different economic groups are separated to some extent. Over time, and particularly during instances of financial crisis, the degree of integration and causation links across Islamic stock markets changes. Shariah-compliant equities may give diversification benefits by considering diverse economic groups, such as those in developed and developing nations. The stability of Islamic finance was examined by Chiadmi and Abbahaddou (2021), who used stylized data from conventional financial markets, such as heteroscedasticity and financial contagion, to complete their study. Especially during times of crisis, Islamic stock indices show high volatility, according to this data. They found that Islamic finance operates in a high-risk environment despite its unique characteristics, including its inherent stability. As a result, they recommend that Islamic finance operators increase their ability to handle systemic risks in order to maintain the stability of the system. Based on cointegration and volatility spillover, Hasan (2019) examines the benefits of an Islamic stock index over a conventional index for diversification purposes. From January 20 to June 25, 2018, the Dhaka Stock Exchange's daily conventional (DS30) and Islamic (DSES) indexes were used in the study. The findings demonstrate the short- and long-run interdependence of the two markets. The long-run returns on both indices show signs of volatility clustering. In addition, the findings show that both markets are more susceptible to bad news than positive news when it comes to trading. They discover that there is considerable volatility transmission from Bangladesh's conventional stock market to its Islamic stock market. Investing in Bangladesh's conventional and Islamic stock markets, according to the findings, does not provide any benefits to investors who own both indexes.

Antar and Alahouel (2019) examine the potential benefits of a solely Dow Jones investment; Islamic indexes; they found that in spite of the long-term relationship between the Islamic indexes, diversification possibilities exist. An investigation investigating whether Chinese equities investors can profit from diversifying their portfolios into Shariah-compliant indexes was conducted by Saiti, Ma, Nagayev, and Yumusak (2019). Results show that Islamic indices are less volatile than conventional indices, making them ideal for portfolio diversification. Yahyaee, Mensi, UrRehman, Vo and Kang (2020) examine the pre- and post-crisis performance of 22 Islamic and conventional Dow Jones stock market indexes. In addition, they look at the time-frequency correlations between conventional and Islamic stock sectors and assess portfolio risk management. During the entire study period, Islamic equities returns outperformed conventional equity returns. However, before the financial crisis, conventional equities returns were far greater. Islamic stock returns outperform their conventional counterparts during and after moments of crisis.

Studies by Erdogan, Gedikli, and evik (2020) examine whether or not there are any volatility spillover effects between forex markets and Islamic stock markets in Turkey, India, and Malaysia. Evidence suggests that the Turkish foreign exchange market is affected by volatility from the Islamic stock market. There is at least one route in which volatility spillover occurs between exchange rates and Islamic stock markets, according to test data. During the worldwide COVID-19 crisis, Bahloul, Mroua, Naifar, and Naifar, (2021) examines whether Islamic indexes, Bitcoin, and gold are safe-haven investments. The results suggest that the Islamic index is not a safe haven asset for the world's conventional stock market during the crisis. Studies by Adediran, Salawudeen, and Ashraf Sabzwari (2021) investigate the transmission of COVID-19-induced shocks to Islamic stock market indexes in the context of a macroeconomic climate and cross-country trade ties.

It was found that financial crises caused by a pandemic had immediate negative effects on Islamic stock markets in the United States and China, but not so much in the Middle Eastern markets. When it comes to foreign portfolio diversification for investors with different stock holding periods, kryel, Aslan, and zdemir, (2021), investigate the co-movement dynamics of Islamic equities returns. They found that there is a strong link between the UK Islamic stock index return and the Canadian, US, Malaysian and Indian indexes, indicating that diversification advantages for investors are reduced. In Bangladesh, India, Pakistan, and Sri Lanka, researchers Rahman, Khudri, Kamran, and Butt (2021) examine how stock markets responded to the COVID-19 issue. The study examines the correlation between verified COVID-19 cases and stock market returns. The findings show that COVID-19 exerts a strong short-term effect on stock market performance through unidirectional causation.

Trend Analysis

It's been a long journey from 2008's financial crisis to today's COVID-19 epidemic, where a number of studies have revealed that Islamic stock indexes too exhibit herd behavior and are impacted by the market just like their conventional counterparts. As a result, there is a pressing need for researchers to investigate why Islamic stock indices are losing their distinctness to conventional indexes as the Islamic stock market grows and spreads over the world. Empirical evidence shows that Islamic stock indexes are progressively mimicking their conventional counterparts in terms of herd mentality, risk, and return. According to Abdullahi (2021), the Islamic stock indexes are generally adopting a herd mentality during the COVID-19 crisis because, unlike the previous 2008 crisis, which was mostly focused on the banking sector, the present crisis is all encompassing (comprising both real and financial sectors). Since Islamic indexes are more closely linked to the real economy, their bad performance this time around can be explained by this fact. Only a few studies have looked at how Islamic indices may really help countries' economies flourish, with the majority focusing on how they can help investors diversify their portfolios. Modern econometrics methodologies dominate today's Islamic stock market study, which places less attention on Islamic ethical precepts and how they influence stock market behavior.

Conclusion and Recommendations

Since their inception in the 1990s, Islamic stock indexes have expanded at a phenomenal rate. There are now Islamic indexes in all major continents of the globe, often beating out their conventional equivalents in terms of performance. Total Islamic index value has risen from a few million Dollars to several billion Dollars during the past decade. As with Islamic banking, Islamic stock indexes have grown in size and value. However, this rapid expansion has not been without its drawbacks. There has been a shift in Islamic indices from their original ethico-moral roots, since they are increasingly mimicking the conventional indexes. As envisioned by early Islamic economists, both the Islamic stock markets and the Islamic banks have not had the influence they were expected to. It's time to go back and focus on Islamic ethical principles and how they influence Islamic stock behavior moving forth. A true Islamic alternative to the speculative, interest-based, and highly leveraged conventional stock market was the driving force behind the creation of the Islamic stock market. Priority must be given to fulfilling this one goal because it has yet to be accomplished. In the future, any further growth of Islamic stock markets must take into account local idiosyncrasies and the needs of the Muslim population before any profit concerns. The Islamic stock market has many excellent ideas, but the most important thing is to put these concepts into action and to enhance and reinforce their application. Islamic financing falls short in this area. Islamic finance is expected to be worth $3.5 trillion by 2024, according to the State of the Global Islamic Economy Report (2020), providing a solid chance to ensure the industry's continued ethical growth.

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