Global Context for Islamic Finance: 
*Role of Equity Markets*

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Inaugural Annual Symposium on Islamic Economic and Finance, Istanbul
September 8th, 2015
Key Points

• Crucial juncture for development of global economy and finance after 2007/9 GFC
• Islamic Finance is risk-sharing and not risk-shifting
• For challenger to succeed, Islamic Finance must be conceptually and practically superior to mainstream finance in at least some key fields.
• Mainstream finance is debt-driven, which creates concentration, fragility and inequality – not sustainable.
• Islamic Finance is ethical-based, but must work on its foundations of resource allocation, price discovery, risk management, corporate governance and human resource issues in order to gain market share relative to mainstream finance.
• Paper points out some pathways to this vision.
Scope of Talk

1. Global Trends to 2030 and impact on Finance
2. International Monetary System (IMS) - a Debt-driven system
3. Technology and impact on financial system
4. Equity-based financing – role of stock markets
5. What Islamic Finance needs to do in areas of equity-financing
6. Preliminary conclusions
Key Functions of Finance failed in Run Up to Global Financial Crisis

1. Resource allocation
2. Price discovery
3. Risk management
4. Corporate governance

...but finance did not even discipline itself

1. Resources went to speculation – QE created US$10 trn without savings
2. What does DCF value mean with negative interest rates?
3. Uncertainty was assumed away
4. Finance was meant to exercise credit and corporate discipline on real sector
Six Transformative Trends:
Why We Need to Rethink Finance

1. Global Rebalancing – Multipolar Cold War 2.0
2. Demography – Youth benefit or Age burden?
3. Financialization and Debt Overhang – Who pays?
4. Disruptive Technology – Jobs and Creative Destruction
5. Climate Change – Water, Food & Energy Stress
6. Governance – Democracy, Market or State?

EMEs will bear burden of QE – those who reform fastest will be winners – building deeper equity and risk-sharing markets key to sustainability in more volatile world
McKinsey - Global Debt Increased by US$57 trn since 2007, Outpacing World Growth

Global stock of debt and equity outstanding by type, US$ trn, end-period, constant 2013 exchange rates

1 2Q14 data for advanced economies and China; 4Q13 data for other developing economies.
Sources: Haver Analytics; national sources; World economic outlook, IMF; BIS; McKinsey Global Institute analysis.
## Financial Assets Doubled in China and Asia 2002-2013

<table>
<thead>
<tr>
<th></th>
<th>GDP (US$ billion)</th>
<th>Stock Market Cap (1)</th>
<th>Public Debt (2)</th>
<th>Private Debt (3)</th>
<th>Total Debt (1+2+3)</th>
<th>Bank Assets (3)</th>
<th>Total (1+2+3)</th>
<th>% of GDP</th>
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<td><strong>China</strong></td>
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<th>Region</th>
<th>GDP</th>
<th>Stock Market Cap</th>
<th>Debt Market</th>
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<th>Crude Ratio (%)</th>
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Sources: IMF GFSR 2015, “Navigating Monetary Policy Challenges and Managing Risks.”; author’s calculations.
Financial Repression main cause of inequality

- Global central bank assets, including FX reserves, total US$22.6 trillion, larger than combined GDP of U.S. & Japan
- 83% of world’s equity market cap supported by ZIRP
- 50% of world government bonds yield 1% or less
- In 2014, government bond yields fell to all-time lows (Japan, Germany, France, Spain, Italy, Ireland, Portugal, Sweden, Switzerland, Korea, Czech Republic, Hungary and Poland)

Global Trends to 2030 US National Intelligence Council

• Slowing global growth, with EME still growing faster than AME,
• Climate change risks, including food and water security
• Multipolar world – no single hegemon, multiple financial nodes and divergent development models (unlikely for a comprehensive, unitary and comprehensive approach to global governance and regulation).
• Growing potential for conflict
→ All these call for higher levels of equity cushion against unknown risks and uncertainty
→ Potential for Islamic Finance to evolve its own model
Rebuilding Equity Markets

1. Resource Allocation –
   a. Primary market, IPOs and SME crowd funding
   b. Secondary – shifting to long-term institutional

2. Price Discovery
   a. Pricing of new SMEs and start-ups
   b. Re-look at short-selling, hedging and margin financing effects on market fundamentals

3. Risk Management
   a. Re-look at risk management model, big data and stress tests

4. Corporate Governance
   a. How to rein in excesses
   b. Use of social discipline – name and shame?

5. Human Learning and Adapting
   a. Markets are eco-systems that learn and adapt
   b. Education of investors, SMEs and regulators on complexity and risks of markets
Adapting Equity Markets to “Best Fit”

- Demographics – how to get equity markets to finance young SMEs, funded by pension, insurance and social security funds
- Technology – using new technology to raise crowd-funding and equity for SME and start-ups
- Infrastructure funding – use long-term sukuks to finance infrastructure
- Corporate governance – use social media to monitor 24x7x360° markets and “name and shame” those who violate ethics and law
Waves of Digital Disruption –
Islamic Finance must use technology to compete

1995+
- Music
- Photography
- Video Rental
...  

2010+
- Print Media
- TV
- Travel
- HR
...  

2015+
- Finance
- Healthcare
- Automotive
- Retail
- Education
- Telco

2020+
All Safe havens will be subject to digital disruption...
...

50 Billion Devices Connected to Internet by 2020

A share and Silicon Valley lessons

• Stock markets are not independent of local culture, institutional framework and demographic profile
• “IFC” model of EME stock markets under-estimated the difficulties of building up whole eco-system of strong SMEs and innovation start-ups that play a role in mature secondary market development (IPO is exit mechanism)
• Result is that NYSE model replicated in many EMEs, forgetting that you need supporting infrastructure of deep long-term institutional investors, angel investors and availability of SMEs that can grow into corporate leaders
• Instead, EME stock markets often overloaded with SOEs, oligopolistic private corporates, with speculative and immature retail investors – resulting in weak corporate governance, predatory behaviour in market manipulation etc, and high volatility, and lack of access by SME.
• In turn, under-developed stock market results in dominance in fragile financial system with overleveraged banks, corporates and governments.
Building Strong Equity Markets is a multi-year ecosystem project

- Ajit Singh (1972) has warned that for many EMEs, the stock market and M&A market alone do not guarantee corporate behaviour that produces market efficiency.
- Islamic equity markets can draw on significant experience in many EME markets to build a stronger system of equity markets that are innovative, inclusive and ethics-based.
- The strong sukuk base, with options for rewarding upside performance of investee sovereigns or corporates, is an example where Islamic Finance have a base of comparative advantage to build on.
Tentative Conclusions

• Debt-drive mainstream finance has run its course, because it is fragile, unequal, and often predatory, with regulatory capture.

• Islamic Finance is ethics-driven, risk-sharing and equity-based, producing a real alternative to mainstream finance.

• Restoring balance in financial markets therefore needs diversity and innovation, and Islamic Stock Markets can draw on many recent experiences in EME stock markets, including successes and failures, to build a viable, more resilient Islamic Finance system that serves the real sector.
Thank you

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