TRUST, ETHICS, STOCK MARKET
and Economic Growth

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**This article is a summary of a chapter a book titled "Social Capital and Risk Sharing: An Islamic Finance Paradigm" (2015)*

By 2007, more than US$ 15 trillion was held by over 91 million individual investors in stocks and corporate bonds, either directly or through mutual and pension funds. These massive investments and financial markets could not have conceivably reached such a size had it not been for most people having trust in their investments and the common belief in others' trustworthiness. However, scandals associated with the 2007/2008 financial crisis have eroded trust in the financial system. As a result, the need to understand forces contributing to financial market development and instability has been placed at the center stage of global policy and academic discussions. A sound and stable financial system underpinned by strong institutional quality and social capital has become an object of search.

At the most basic level, a market exchange takes place when there is trust between two agents in a transaction. This forms an exchange of trust—an important asset that greases the wheels of exchange in the society—rendering the market more efficient and connected. On the other side of the coin, ethics underpin trustworthy relations and reinforce trust. Ethics is particularly relevant when the social function of the stock exchange and ethical investor relations are taken into consideration. A successful and vibrant stock market requires that information, enforcement, and governance costs be minimized for the full participation in the market to take place (Allen and Gale, 2009). Reinforcing this participation is the existence of strong informal relations of trust and ethical behavior that can reduce such costs. More broadly, the implementation of Islamic rules of market behavior in a society, such as faithfulness to the terms and conditions of contracts and trustworthiness, can address informational problems and reduce the costs of market entry.

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Stock markets have developed rapidly in parallel with the banking sector in many parts of the world especially in emerging markets to serve as a direct conduit for efficient resource allocation and an engine of economic development. Despite this progress, there is a relatively smaller set of theoretical and empirical evidence on factors that contribute to stock market development compared to the literature on the determinants of growth and banking sector development. An important advance in the last two decades in research on stock market development has been the significance of the role of social capital as a determinant of the level of stock market transactions. This article addresses these developments focusing on the role of social capital in relation to the growth of stock market and the economy.

Our previous research (Ng et al., 2016) demonstrates that trust is a robust and positive determinant of stock market depth and liquidity having considered more than 30 potential determinants. Using Bayesian model averaging, trust is found to exhibit high posterior inclusion probability (0.64–0.99), which indicates that trust is highly likely to belong in the correct model of stock market development. Among the components of social capital, trust is the most relevant in the context of market development.

The relevance of trust is then examined in selected Muslim countries (Bangladesh, Egypt, Indonesia, Iran, Jordan, Kyrgyz Republic, Malaysia, Morocco, Nigeria, Pakistan, Saudi Arabia, Turkey, and Uganda). Stock markets in the Middle East and North Africa region and emerging Asian countries are generally smaller with less liquidity, higher risk premium, and cost

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of funds and lower quality of legal infrastructure. The dynamics in OIC countries are also distinctive as some are rich in resources yet characterized by weak institutions and widespread poverty. Several OIC countries (Indonesia, Saudi Arabia, and Turkey) are also gaining prominence as emerging markets among the G20 economies. Of the Next 11 (N-11) largest populations after Brazil, Russia, India, and China (BRICs) that are expected to greatly impact the global economy, seven countries (Bangladesh, Egypt, Indonesia, Iran, Nigeria, Pakistan, and Turkey) are part of the OIC. Such diverse heterogeneity is also apparent in the level of trust and market development in the sample OIC countries. Malaysia, for example, has one of the lowest levels of generalized trust (8.80%) despite having the largest market capitalization (132.55% of GDP). While generalized trust in Indonesia is the highest (47.05%), the market size of Indonesia (21.97% of GDP) is on average less than one fifth of the Malaysia's market capitalization over the 2000–2006 period. The Bayesian model averaging result buttresses the importance of generalized trust in the development of stock market in countries with relatively lower formal institutional quality.

Having established the importance of social capital, particularly trust, in stock market development, this article highlights how trustworthiness would influence the impact of stock market on economic growths. Given the importance of ethics and its relation with trustworthiness, the role of ethical behavior in the stock market development-economic growth nexus is also assessed (Ng et al., 2015a). Using threshold regression to encapsulate the rich dynamics in stock market development and macroeconomic performance, stock market liquidity is found to be significant and positive in influencing GDP and total factor productivity (TFP) growth respectively when firms' ethical behavior is above 3.61 in the scale of 0–7 based on the Global Competitiveness Index. Market liquidity is also significant and positive in promoting GDP and TFP growth when trustworthiness and confidence is above the threshold of 4.42 in the scaleof 0–7. When compared to the significance of regulation and supervision of securities exchanges, ethical behavior and trustworthiness are more impactful in shaping the stock market-growth nexus. This finding echoes the search for alternatives to more regulation that foster trust and ethics in institutions and between members of communities to restore public confidence and further promote economic efficiency.

Following the empirical evidence above, several initiatives can be recommended for implementation as discussed in Ng et al. (2015b):

- Develop regular and reliable trust indices of stock exchanges, firms and reputational intermediaries to serve as a self-monitoring measure.
- Create a multiple reputational intermediaries system through the strengthening of voluntary and mandatory self-regulatory organizations.
- Create industry social capital and ethics board.

The issue of developing and fostering social capital to promote a trustworthy stock market is of central importance to policy makers, industry players, investors, academia, and households. In addition to effective means of mobilizing financial capital, strategic enhancement of social capital remains a crucial building block for the development of the financial industry. In this context, the design of policies to facilitate emergence of an efficient and trustworthy stock market becomes crucial to the further development of Islamic financial industry. The analysis and findings in this chapter support the notion of "better finance, more growth" and provide empirical evidence for policy makers to formulate initiatives to enhance social capital in order to promote stock market development.

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*****Notes:***
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