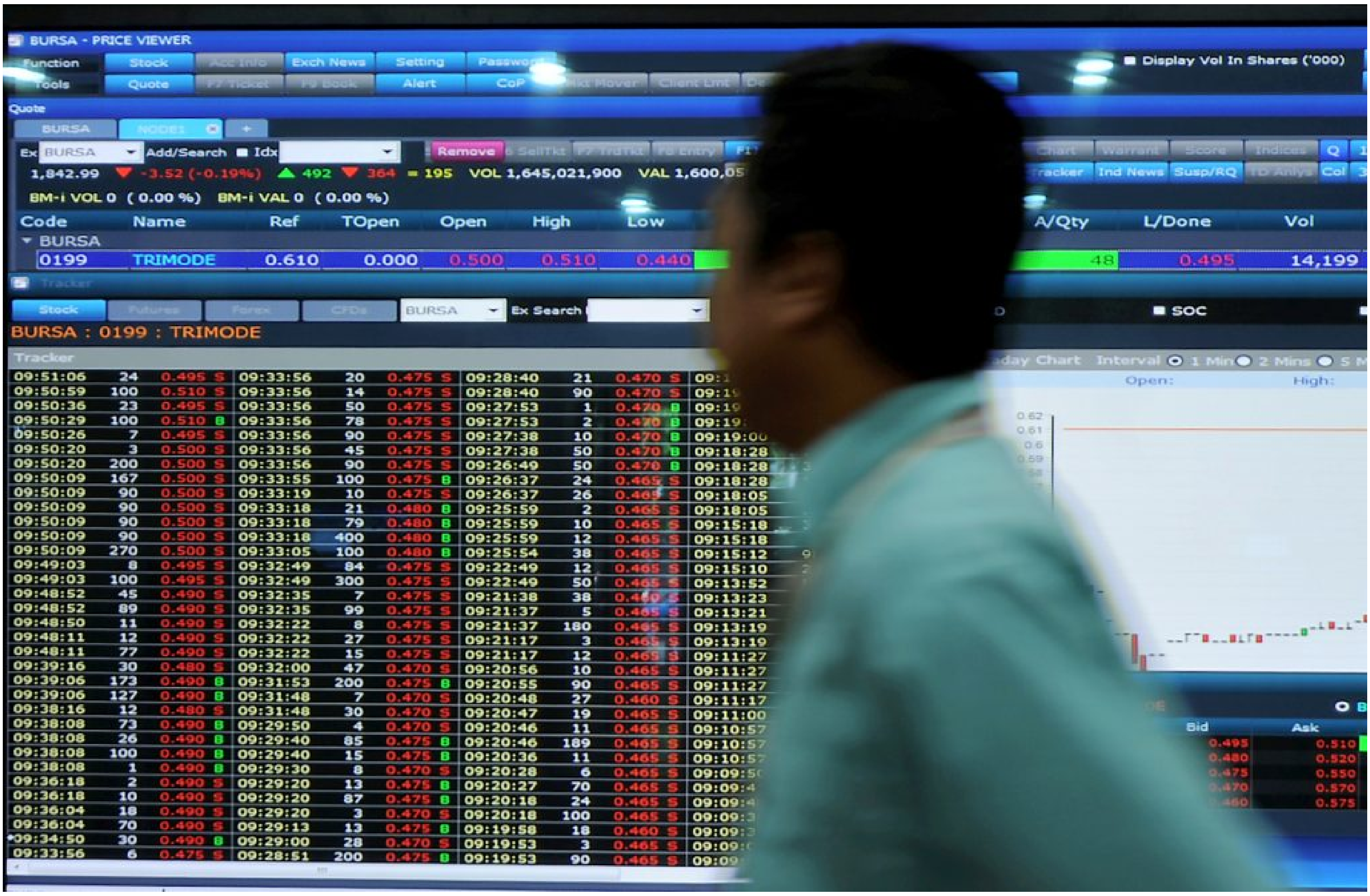
Infantile equity markets are a drag on development



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pic by MUHD AMIN NAHARUL

IF WELL-developed equity markets can contribute hugely to national growth, underdeveloped ones impose a huge cost on national competitiveness through higher required risk premiums and higher equity costs to firms.

The high cost of equity has the added disadvantage of incentivising firms to leverage their capital structure with debt.

Thus, the common phenomenon of developing countries with infantile stock markets and highly leveraged economies. Retarded stock markets offer perverse incentives, both to managers of firms and shareholders.

So, how do the equity markets of the Islamic world stack up? To address this, we examined the performance of the Muslim world's top eight stock markets against two global benchmark indices, the MSCI World and the S&P 500.

The annual performances of the main stock indexes of the eight stock markets were compared to that of the two benchmarks.

The percentage annual returns and volatility over the 16-year period 20012016 was studied. With the exception of Malaysia, which had returns and volatility (standard deviation) very much in line with the benchmarks, the other markets showed interesting results.

First, all the other seven Muslim world markets, Indonesia, Turkey, Pakistan, Egypt, Saudi Arabia, Kuwait and Oman had higher average annual returns than the global benchmarks.

In the case of the first five countries, their average annual returns were three to four times higher than the benchmarks. However, the good news of higher returns is offset by the higher relative volatility in all these markets.

Standard deviation which measures volatility is two to three times higher. Granular analysis shows year-to-year variance in excess of 50% to be fairly common. Egypt, for example, had several years of triple digit variation in returns.

The very high returns volatility seen in these markets are a symptom of their underdevelopment. These are markets that are very small by any measure.

Total market capitalisation in anyone of the eight Muslim markets is lower than that of a single stock like Amazon.com Inc, Microsoft Corp or Apple Inc. This is nothing but a reflection of both the inattention and the benign neglect of policymakers to equity market development.

Unlike the broken bridge that delays traffic and increases transport costs with very visible damage, governments often do not see the damage to their economies from infantile markets. The resulting inefficiency and deadweight loss is massive though unseen.

Markets and trading systems have evolved, thus developing equity markets require much more than the enabling infrastructure.

A key ingredient is the availability of risk management tools, particularly for the markets with massive volatility. Yet, equity derivatives though available in some Muslim markets have not been popular.

Perhaps there is a Shariah-compliant element to it. Until today, there are no Shariah-compliant hedging tools for equity exposure.

This is unlike foreign exchange exposure, where a number of Shariah-compliant instruments that mimic currency derivatives, futures/ options have been developed.

Like currency, equity exposure can have direct losses but there is also be an externality. When equity investors are unable to manage their risk, disintermediation happens. Equity markets not only cannot grow but would shrink. The resulting externality is that the cost of equity capital rises for all domestic firms blunting whatever competitive edge they may have.

Industries are becoming increasingly capital intensive; economies of scale are necessary for survival. Often this implies producing for markets beyond one's own borders, but export competitiveness, as argued above is not possible with inefficient domestic capital markets.

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