



# Does sukuk market development spur economic growth?



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## ABSTRACT

We investigate the impact of sukuk market development on economic growth using a sample comprising all sukuk-issuing countries spanning the period 1995–2015. We use the system GMM estimator to tackle potential omitted variable bias, endogeneity, and simultaneity issues. We report a strong and robust evidence that sukuk market development is conducive to economic growth, even after controlling for various measures of financial market development, institutional quality, and classical determinants of economic growth. In addition, the evidence does not support the well-known positive association between financial development and economic growth. We conclude that the development of sukuk markets may have promoted financial inclusion by eliminating the negative effects of religious self-exclusion, which stimulates investment and economic growth.

## 1. Introduction

The last decade has witnessed an unprecedented growth in the Islamic financial services industry, reaching USD1.88 trillion by the end of 2015 (IFSI, 2016),<sup>1</sup> to the extent that Islamic finance has become part of G20 agenda. The recent success of the Islamic financial industry took place during a crisis period of the conventional finance industry. Many recent academic studies argue that the Islamic finance industry exhibited less risk, better performance, and more stability than its conventional counterpart during the recent global financial crisis of 2008 (Beck et al., 2013; Chapra, 2008; Hasan and Dridi, 2010). They attribute this better performance to the unique features of Islamic contracts and investment securities. Much of this expansion has been fueled by the extensive issuance of sukuk, investment certificates that comply with Sharia<sup>2</sup> principles, as an alternative to the issuance of fixed income securities or interest-based bonds. This is both as a mean of raising government funding through sovereign sukuk and as a way of companies obtaining external financing through the issuance of corporate sukuk. This tremendous growth is shown from the significant increase in the level of global sukuk issuance by nearly 250 times since 2001, from USD1.17 billion to USD290 billion by the end of 2015 (IFSI, 2016).

Although the finance-growth nexus remains heavily disputed in the academic literature, it is now well established that financial development is broadly conducive to economic growth (Levine, 1997; Wachtel, 2001; King and Levine, 1993a, 1993b). Indeed, financial markets foster economic growth by stimulating capital accumulation and promoting efficient allocation of resources and technological innovations (Thumrongvit et al., 2013). However, and despite more than two decades of sukuk issuances, the literature addressing the macroeconomic effects of sukuk financing and particularly its implications on growth is still sparse. Most available

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<sup>1</sup> Islamic Financial Services Industry Stability Report 2016.

<sup>2</sup> Islamic law.

evidence is descriptive and anecdotal. [Echchabi et al. \(2016\)](#) is the only existing empirical study that addresses this issue for a sample of 18 sukuk-issuing countries over the period 2005–2012 using the Granger Causality test. However, their results fail to identify a significant effect of sukuk issuance on GDP growth.

In this paper, we provide an empirical investigation of this particular issue. Precisely, we examine the impact of sukuk financing on economic growth using a sample comprising all sukuk-issuing countries for the period 1995–2015. Our analysis allows us to answer the following questions: (1) Did sukuk market development promote economic growth? If so, through which channels? (2) Does the effect of sukuk financing on economic growth depend on the type of sukuk (sovereign vs corporate)?

These issues are of particular importance not only for countries that are active in sukuk markets, but also for countries that are yet to make their debut in sukuk markets in the near future, as reported by the IFSI Stability Report 2016, in areas as diverse as Africa (Cote d'Ivoire, Kenya, Mauritania, Morocco, and Tunisia among others), Europe (Luxembourg), the Middle-East (Jordan and Oman), as well as Central Asia (Kazakhstan).

We argue that domestic sukuk market development contributes to the country's economic growth in many ways: **First**, sukuk markets, by mobilizing savings, make financing available to long-term debtors, thereby contributing to the efficient functioning of capital markets. Since long-term funding is crucial to the economy's productivity gains, this role of capital rationing is of major importance to the finance-growth link. **Second**, sukuk markets, along with bond and stock markets, contribute to the deepening of the financial market of an economy. For instance, in the absence of sukuk markets, banks tend to have reduced opportunities for investing deposits and that may lead them to make unsound or suboptimal loans. Furthermore, an underdeveloped sukuk market forces both insurance and pension funds companies to invest in short-term securities, which do not correspond to the liability side of their balance sheet, thereby exposing them to maturity mismatches. A well-functioning sukuk market allows banks to invest in sukuk certificates and hence mitigate information asymmetries, thereby fostering the efficient allocation of resources, essential for economic growth. **Third**, a well-developed sukuk market coupled with an advanced financial structure may stimulate economic growth through technological innovations and enhanced labor productivity in the private sector. **Fourth**, sukuk certificates are based on risk-sharing, meaning that the issuer and the investor share the risk of the investment and split the profits or losses between them on agreed terms. This risk-sharing feature of sukuk will lead borrowers and lenders to share business risks in return of a share of profits, which may spur investment, and hence economic growth. **Finally**, sukuk securities can drain the savings of devout Muslims who are not willing to invest in interest-based bonds, since they do not satisfy the needs of pious individuals as they carry “Riba” (interest) prohibited by Sharia principles. This could lead to higher financial inclusion and thereby stimulate investment and economic growth. In the absence of sukuk certificates, savings would not be used efficiently and therefore not channeled to the formal financial sector, which may hinder investment and economic growth.

By way of review, we find that the development of sukuk markets, both sovereign and corporate, plays an important role in stimulating long-run economic growth, after controlling for various measures of financial market development, the quality of institutions, and the classical growth determinants. Moreover, the results show that government spending and trade openness seem to exert a negative impact on economic growth, while the initial income level is positively and significantly correlated with economic growth. However, the evidence does not support the well-known positive association between financial development and economic growth.

The paper contributes to the existing literature in many ways. First, it contributes to a relatively unexplored area of research on the potential effect of Islamic finance on economic growth. Further, the findings contribute to our understanding of the channels through which sukuk markets stimulate economic growth. Moreover, we address the link between sukuk market development and economic growth using a dynamic panel model estimated with the system GMM estimator of [Blundell and Bond \(1998\)](#), which allows us to tackle the problems of joint endogeneity of the independent variables and country heterogeneity (i.e., unobserved country-specific effects), as well as potential omitted variable bias.

The reminder of the paper is organized as follows: Section 2 presents an overview of sukuk markets. Section 3 summarizes the literature review. Section 4 describes our data and variables, while Section 5 explains our methodology. Section 6 discusses the empirical results, and we conclude in Section 7.

## 2. Overview of sukuk markets

The Accounting and Auditing Organization for Islamic Financial Institutions (AAOIFI) defines sukuk as “certificates of equal value representing undivided shares in ownership of tangible assets, usufructs and services or (in the ownership of) the assets of particular projects or special investment activity, however, this is true after receipt of the value of the sukuk, the closing of the subscription and the employment of funds received for the purpose for which the sukuk were issued”. More simply, sukuk are asset-backed securities that provide the holders with an ownership in the underlying asset as well as any profits in accordance with this ownership. However, instead of paying a fixed interest payment as in the case of bonds, the periodic payments to the sukuk holders are in the form of either profit from a joint venture, lease payment, or profit from the sale of assets, depending on the structure of sukuk.

The development of the sukuk market has been spectacular in recent past years. Indeed, based on growth rates, sukuk market has surpassed the vibrant Islamic banking sector as the fastest-growing sector of the Islamic finance services industry, expanding at around 20% annual growth rate over the period 2008–2014 (see [Fig. 1](#)).

This tremendous growth has been spurred by a heightened interest among sovereign and corporate entities to tap the sukuk market for funding, especially in the aftermath of the global financial crisis. Furthermore, the issuer base of sukuk has expanded in recent years with debut issuances by the United Kingdom, Luxembourg, Senegal, Hong Kong, and South Africa, while several other countries remain in the pipeline for debut sukuk issuances in the near future, including, Mauritania, Morocco, Kenya and Tunisia

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