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The Role of the Stock Exchange in an Islamic Economy

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Dr. Metwally has made an attempt in his paper to show how stability could be brought in share prices in an Islamic economy. His main proposals are essentially two:

1. The Management Committee of the Stock Exchange (MC) should determine the maximum share price (MSP) for each company at intervals of no more than three months. The MSP should be equal to the company's average net worth per share. Shares would not be allowed to be traded at a higher price than the MSP, but they may be traded at a lower price. The complexities of determining the average net worth have not been discussed.

2. Shares should be allowed to be traded only within specified trading periods with a view to reduce the frequency of trading in the shares of a given company. Who will prescribe the trading periods has not been indicated; it may be assumed that this task will also be performed by the MC.

It has been assumed that dealings only during the prescribed trading periods at prices lower than or equal to the MSP will eliminate speculation and bring about stability in the stock market. It has been presumed that there will be no black market and that, in the event that underlying economic conditions tend to raise share prices above the MSP, no black market will develop because docile Muslim sellers will not undertake any transactions in the black market for personal gains even at times when there is no national emergency; they will rather accept the decision of the MC to link the MSP to average net worth as a word of the gospel and will not violate it irrespective of whether the MSP is in their opinion fair or unfair.

This is an extremely simplistic model and all that it has accomplished is to show that share prices may fluctuate below the ceiling set by the MC but cannot fluctuate above the ceiling because transactions will not be allowed to become effective at prices above the MSP and no black market will develop. The author has probably assumed that fluctuations below the MSP do not create instability but that those above the MSP do so.

The questions of equity have not been discussed at all. Also missing is a discussion of the factors that generate instability in share prices in the stock exchange and how this dual condition of MSP and infrequency of dealings will help remove the impact of those factors on prices.

It would therefore be useful to look first at the equity considerations ignored by Dr. Metwally and then to discuss some of the major destabilizing factors and see how they could be overcome in an Islamic economy.

Equity Considerations

Relative stability in share prices is not needed for its own sake but because of the imperative of fairness to both the buyers and the sellers. It is not possible to realize justice by requiring a shareholder to sell shares at less than or equal to the MSP but not above the MSP and by requiring him to sell his shares only within prescribed periods and not at the time of his own choice. Such policies can hurt mainly the small investors because, if adverse economic circumstances force them to disinvest, they can sell their shares at prices equal to or lower than the average net worth when market forces have reduced them to that level. However, when underlying economic conditions have turned to their advantage they cannot benefit because the MC has decided, in its great wisdom, that prices cannot rise above the average net worth. Moreover, the party to fix the MSP and the trading periods will be the MC, the members of which themselves have a vested interest.

Average net worth of a company does not necessarily determine the price of shares in the stock market in the same way as cost of production does not determine the price of any product in the market place. Net worth, like the cost of production, serves only as a guideline. It cannot be the sole factor determining share prices. The major factors which determine share prices are supply and demand which are affected by the expected rate of profit, the ability to sell shares, which the seller does not have (otherwise the stock of shares of a company available in the market remains constant), the availability of credit (through margin purchases), the disclosure (or non-disclosure) of pertinent information, and rumours sometimes purposely spread by vested interests.

The net worth of two companies A and B producing products A' and B' may be the same, but the prices of their shares need not be the same. Even if they are the same initially, they may change over time with the change in the relative demand for products A' and B' and the quality of management. If the demand for A' rises due to domestic or international factors and hence the prospects for profit improve, the price of A's shares will rise above the net worth. The net worth will however go up only after windfall profits have been made and a part of these have been ploughed back for expansion. Prices are determined by *ex ante* factors whereas net worth is determined by *ex poste* factors. To force the holders of company A's shares to sell them only at the MSP in spite of higher profit expectations is grossly inequitable.

Although there is justification to fix prices of certain essential goods and services in an Islamic economy when this is considered necessary in the larger public interest, there is little justification to fix the prices of shares except, may be, in exceptional circumstances. While people have to buy medicines, food and other life-sustaining goods and services they don't have to buy shares. If prices are higher than what the buyers think are reasonable, they can wait. People cannot wait to buy food until prices fall. Hence, under normal circumstances, there is no justification for fixing the maximum price of shares. Moreover, giving the MC the power to fix MSP and to prescribe trading periods could introduce gross injustice to the large number of small investors who usually have no influence. If a price is to be fixed under some special circumstances, it should be done by an impartial body and not by the MC.

However, while it is not desirable to fix share prices, it is necessary to ensure that they reflect underlying economic conditions and do not fluctuate due to speculative forces, credit availability, and manipulation by stock market operators or directors of companies.

Causes of Stock Market Instability in Shares' Prices

Hence, what is essentially needed is to bring about a rational behaviour in stock markets and to remove the erratic movements in stock prices. This can be done by

(i) banning speculation
(ii) allowing only cash purchases of shares, and
(iii) removing management malpractices.

(i) Speculation

Speculation consists in the forward purchase or sale of stocks on margin without the intention of taking or making actual delivery. Only about 1 percent of all futures contracts are settled by actual delivery, the rest, about 99 percent, are liquidated prior to the delivery month by offsetting transactions. In fact it is generally felt that trading in futures contracts is for purposes other than the exchange of titles.[1]

The speculator either sells short or buys long. A 'short' sale is a sale of securities that the seller *doe's not own* at the time of the sale or does not intend to deliver from his own portfolio. The short seller, popularly called a bear, expects the price of the security sold short to decline and hopes to be able to 'cover' his short-sale through an 'offsetting' purchase at a lower price before maturity date to secure a profit. The long buyer, known as a bull, buys stock which he does not want in the hope of making an 'offsetting' sale at a higher price before the date of maturity.

While forward purchases or sales of certain agricultural commodities or manufactured goods perform an economic function by making an allowance for the time period it takes to produce the goods, thus providing producers as well as users with the assurance that they can sell or receive the goods when ready or needed, the for ward market in shares performs no such function. The quantity of shares is constant and the 'forward' seller has no role to play. He sells "something he cannot consume or use in his business, upon which he performs no work and to which he adds no value."[2]

Spot purchases against cash payment and reciprocal receipt of shares do not constitute speculation irrespective of when the purchaser decides to resell them. This is be cause the spot seller already owns the shares purchased against cash and his decision to resell them will be determined by changes in his economic circumstances or his perception of the market, both of which may, but not necessarily, change immediately.

(ii) Afargin Purchase's

The ability to make margin purchases provides the speculator with a high degree of leverage and enables him to make a larger purchase with a smaller amount. In a margin purchase, the customer is required to deposit with the broker, either in cash or acceptable securities, a fraction of the purchase price to protect the stock broking firm against loss in the event of default. The balance is loaned to the customer by the brokerage house which obtains the funds usually by pledging the purchased securities with a bank for a collateral loan. The stock buyer is required to keep the margin good by depositing additional cash or acceptable securities in the event of a decline in prices below the minimum margin requirement. Conversely the customer may withdraw cash or securities from his account if a rise in price should increase his margin substantially above the requirement.

Speculative sales combined with margin purchases bring about an unnecessary expansion or contraction in the volume of transactions and, hence, contribute to fluctuations in stock prices without any real change in the supply of stocks which remains constant, or the underlying economic conditions, which do not change from day to day. Variations in margin requirements and interest rates tend only to add a further dimension of uncertainty and instability into the stock markets. The lowering of margin requirements and/or interest rates generates unnecessary heat in the market. Their raising afterwards with the objective of restoring sanity' to the market only forces speculators to liquidate their positions. This brings down prices and ruins some of the speculators at the altar of others who are usually insiders' and who know what is coming.

(iii) Stock Market Malpractice's

Stock market speculation combined with the availability of credit through margin purchases has in fact contributed to excessive price swings by promoting excessive buying, when prices are expected to rise, or selling, when prices are expected to fall. The claim that speculation helps stabilize prices would be true only if the speculators operated in different random directions and their separate actions were mutually corrective. The claimed stabilizing effect would require that there be no marked disparity in the speculators' purchases and sales. But speculation involves judgement, or anticipation of a rise or fall in prices, and gets accentuated when something happens or some information is available on which judgement can be based. The same events or rumours give rise to the same judgements.

In the real world, because of rumours, sometimes purposely spread by insiders and vested interests. there is a wave of speculative buying or selling concentrated in the same direction leading to abnormal and unhealthy fluctuation in prices It is generally acknowledged that prices in the stock markets are susceptible to manipulation and rigging. There are, in the words of Marchand Sage, "intrigues, lethal competitions, tense lunch-time deals, high-stake gambles, the subterfuges, cover-ups, and huge payoffs that make Wall Street the greatest playground in the world".[3] There are "safeguards against such rigging but they don't work," because "Wall Street plays its games seriously, sometimes so well that neither you nor I - nor, seemingly, the Secunties Exchange Commission - knows who is in there playing."[4]

Abolition of Speculation and Margin Purchases

Continued sanity in the stock market could only be attained through a number of reforms. The most important of these being the abolition of 'sales' of shares which the sellers do not own' at the time of sale and the imposition of a l00 percent margin, which implies that buyers can make only cash purchases. These reforms will put an end to options or privileges available in the form of 'puts', 'calls' and 'straddles', which permit the speculator to take a position with a small amount at risk.

The only adverse effect of such moves would be to reduce the short-term trading volume in the stock market with near-elimination of the gyratic movements in prices and a healthy effect on the long run trend. As Wendell Gordon has aptly remarked, "the market machinery encourages turnover and consequently price fluctuations", because the greater the volume of sales, the more money made by the brokers."[5]

The reduction as well as the dampening of fluctuations in the turnover through the abolition of sales of shares that the seller does not have and of margin purchases would help undermine speculative frenzies, maintain sanity in the stock markets and enable stock prices to reflect underlying economic conditions. Speculative activity in existing stocks on the basis of margins not only fails to perform any useful economic function as already indicated, but also harms savers and 'true' investors by generating undue fluctuations in stock prices and injecting an undesirable element of uncertainty and instability in the stock markets. Largay has concluded, on the basis of his analysis of 71 New York Stock Exchange and 38 American Stock Exchange stocks placed under special margin requirements during 1968-69, that, "the empirical results support the a *priori* hypothesis that banning the use of credit for transactions in individual issues is associated with a 'cooling off' of speculative activity in these stocks".[6] Bach has also observed that "if rising stock prices have been financed by borrowed money, a downturn in the market may precipitate a major collapse in stock prices, as lenders call for cash, and may place serious financial pressure on banks and other lenders. A high market based on credit is thus far more vulnerable than a cash market and is more likely to be a cyclically destabilizing force" .[7]

The *Fiqhi* Position

The above policy prescriptions (abolition of stock market speculation and introduction of cash purchases of shares) have been suggested because they would serve the larger public interest of maintaining sanity in the stock markets, which is extremely important for the efficient working of an equity-based Islamic economy.

These same policy prescriptions could also be derived from the teachings of the *Shari'ah*, on the basis of nusus (legal texts) as well as maslahah or public interest, which plays an important role in *fiqh* discussions.[8]

According to the Majma 'al-Fiqhi, Makkah, forward purchases and sales of shares and commodities in the stock and commodity markets are not permissible because these involve the sale of what the seller does not have and the *Shari'ah* has prohibited such sales.[9] Furthermore, the *Shari'ah* does not allow a forward purchaser to sell until he has acquired formal possession of the goods. Forward sales and purchases unnecessarily inflate the total volume of business through a chain of transactions starting from the first seller who sells what he does not have and the subsequent buyers selling without acquiring possession of the shares or commodities. Such transactions create an unnecessary heat in the market and generate erratic fluctuations in prices.

The Majma al-Fiqhi has also ruled, and rightly so, that although the *Shari'ah* allows forward sales in the form of (*salam*)[10], speculative sales in the stock or commodity markets are not in the nature of *salam* because in a *salam* sale the purchaser is required to make full payment for his forward purchase while in a speculative forward purchase the purchaser makes only a margin payment. The wisdom behind the constraint imposed by the *Shari'ah* is rational and understandable because such a constraint would prevent an artificial expansion (or contraction) in the volume of transactions and considerably reduce the amplitude of price instability in the stock and commodity markets.

The Abolition of Riba

The abolition of *riba* from the Islamic economy would also help minimize stock market speculation based on margin purchases because when the lending bank is aware that it has to share in the risk of speculative business and is not assured of the return of its principal with interest, it will tend to be extra careful in its lending for speculative purchases. Nevertheless, lending against the collateral of stocks to purchase stocks is an unhealthy practice. It breeds speculation and needs to be discouraged. The purpose of credit should be to finance productive investments and not to encourage speculative buying or hoarding. Federal Reserve Chairman Paul Volcker, in a letter to the chief executives of all member banks, warned against speculative loans, loans made to retire stocks, loans to finance takeovers, and loans involving any extraordinary financing "except as they may clearly involve the improvement in the nation's productive capabilities".[11] This warning of Mr. Volcker may remain unheeded under capitalism because the system is not tuned to its acceptance.[12] In the Islamic system, however, every effort should be made to minimize the use of scarce credit resources for all unproductive purposes.

The abolition of *riba* and speculative sales along with the introduction of a system of only cash purchases in the stock market should undoubtedly help bring about an orderly behaviour of stock prices, and protect investors. If these reforms are implemented it will not be necessary to adopt the two measures, to fix the MSP and to prescribe trading periods, suggested by Dr. Metwally.

Nevertheless, some other reforms would also have to be introduced in the light of Islamic teachings to eliminate all those unhealthy practices which create destabilizing conditions in the stock market and hurt the public interest. These should include: requirement of full disclosure of all material facts on stocks and shares sold in the primary and secondary markets; curbing of unfair trading practices; and elimination of the manipulation of share prices by brokers and jobbers, and directors or large stock holders, on the basis of their insiders' knowledge of the stock market or company affairs.

Notes

(1) See Edward I. Altman (ed.). *Financial Handbook* (New York: John Wiley. 5th ed.. 1981), p. 21.15, and Thomas A. Hieronymus. *Economics of Future Trading* (New York: Commodity Research Bureau. 1971), p.28.

(2) M.S. Rix. *Stock Market Economics* (London: Sir Isac Pitman and Sons Ltd., 1965), p.204.

(3) Marchand Sage. *Street Fighting at Wall and Brood*: *An Insider's Tale of Stock Manipulation* (New York, Macmillan. 1980). p.i. Marchand Sage is a *nom deplume* for the writer who is a sophisticated and successful veteran on Wall Street and hence does not wish to reveal his identity.

(4) Alan Lechner, *Street Games*: *Inside Stories of the Wall Street Hustle* (New York: Harper and Row. 1980). pp.108 and 84.

(5) Wendell Gordon, *Institutional Economics* (Austin: University of Texas. 1981). p.223.

(6) Reported by Irwin Friend in his paper "Economic Foundations of Stock Market" in James L. Bicksler, *Handbook of Financial Economics* (Amsterdam: Northholland Publishing Company. 1979). p. 156.

(7) G.L. Bach, *Economics*: *An Introduction to Analysis and Policy* (Englewood Cliff, N.J.: Prentice Hall, 1977,9th ed.). p. 182.

(8) For a valuable discussion of stock and commodity market speculation from the point of view of the *Shari'ah*, see Fiqhi Decision entitled "Suq al-A wraq al-Mavah maliyyah al-Bada-'i' (al-Bursah)" issued by the Majlis al-Majma' al-Fiqhi al-lslami of the Rabitah al-'Alam al-lslami in Qararat Majilis al Majma' al-Fiqhi al-Islami (Makkah: al-Amanah al-Ammah, Rabitah al-Alam al-Islami, 1985), pp. 120-5: and the article of Dr. Ahmad Yusuf Sulayman in AI-Ittihad al-Dawli li al-Bunuk al-Islamiyyah, Al-Mawsuah al-Ilmyyah wa al-Amaliyyah, vol. 5, pp. 389-431, particularly the summary on pp. 429-31. See also, Bayt al-Tamwil al-Kuwaiti), Al-Fatawa al-Shariyyah (Kuwait, 1980), pp. 45-9.

(9) Majlis al-Majma' aI-Fiqhi al-Islami, *op. Cit*. pp. 123-4.

(10) While the Shari'ah has prohibited the sale of something which the seller does not own. certain exceptions have been made. The most important of these is salam which refers to a contract to sell any fungible good, which can be clearly defined in terms of generic description. quality and quantity without any ambiguity and which is continuously available in the market during the contractual period, with the delivery to be effected at a specified future date and the agreed purchase price to be paid fully in advance. Partial payment will make the salam contract unenforceable. For details about the salam contract see 'Abd al-Rahman al-Jaziri, Kitab al Fiqh 'Ala al-Madhahib al-Arba'ah (Cairo: Al-Maktabah al-Tijariyyah al-Kubra, n.d.), vol. 2, pp. 302-18.

(11) Paul Volcker in *Fortune*, 17 December 1979, p. 110.

(12) See the views of Prof. Horvitz following Volcker's warning, *ibid*.