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The Role of Macroeconomic Factors on Sukuk Market Development of Gulf Cooperation Council (GCC) Countries

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ABSTRACT

Macroeconomic factors are regional or national economic factors which externally impact the financial strategies of governments and corporations, including debt financing decisions. The literature related to the financial management acknowledges the significant role that macroeconomic factors play to determine the financial market development. The aim of this paper is to propose a conceptual model/framework for investigating the role of macroeconomic factors on Sukuk market development (SMD) in gulf cooperation council (GCC). GCC economies depend heavily on oil revenues which makes them subject to oil prices fluctuations. Therefore, GCC's governments should diversify their economies by looking for Sukuk as an alternative source of financing, to cover their budget deficit, when the price of oil decreases, and reduce their reliance on oil, because Sukuk has advantages compared to the conventional bond particularly in terms of less information asymmetry. The prior studies have mostly focused on firms' characteristics determinants of Sukuk issuances but gave a little consideration to the role of country' characteristics on SMD. This paper proposes a framework to explain the main macroeconomic determinants of SMD with a focus on the GCC countries that have the largest region in terms of the Islamic financial assets. It is anticipated that the outcome will support policymakers to improve the current state of Sukuk market.

Keywords: Sukuk, Macroeconomic Variables, Gulf Cooperation Council Countries
JEL Classification: E6

1. INTRODUCTION

Several types of research have been carried out on the determinants of the development of capital market including both equity and debt market. Hence, the determinants of the stock and bond market development were the subject of major theoretical and empirical studies in both developed and developing countries from the different perspective. On the contrary, the growing importance of Sukuk markets around the world has recently opened a new avenue of research into the challenges and factors which the development of Sukuk market are facing. Nevertheless, there are relatively a very limited amount of literature focusing on Sukuk market. Though, this paper has not found any study on the role of some macroeconomic variables on Sukuk market development (SMD) in GCC countries.

The financial market is important to contemporary economies. This is because it plays the role of a mediator between lenders and borrowers. Thus, Sukuk market might play a key role in economic development and support the gross domestic product (GDP) of countries. This can be done through the mobilization of savings and by channelling these savings to useful and Islamic law compliant investments. Several businesses and policymakers are viewing at the Sukuk markets as a long-term financing source. Since they are a mechanism of financing for the long-term and thanks to their investment diversification, they can finance potential projects in industry infrastructure, and agriculture (Tariq and Dar, 2007).

Kusuma and Silva (2014) argued that as many countries tried to establish sources of long-term financing, Sukuk appears to be the most relevant way of assisting such countries, expand the pool of capital for investment's financing and reinforce growth. Thomas

(2007) further claimed that there is a huge potential for Sukuk whose growth is largely dependent on the gulf cooperation council's (GCC) and Asia's strong economic base. Sukuk as significant players of Islamic financial market operate in an external business environment, which is an interdependence of several factors related to a society that form and determine their activities. The external business environment is comprised of political, environmental, social, macroeconomic, legal, and technological factors that impact and form the financial markets and institution's activities. Sukuk issuances are determined by these external business environment determinants which externally impact the financial strategies of corporations, including debt funding decisions.

Shahida and Sapiyi (2013) highlighted that identifying the factors that determine the issuance of Sukuk be it based on internal or by external incentives are noteworthy. However, several countries are completely involved in efforts aimed at developing their domestic Sukuk markets, but with diverse levels of success recorded to date. Accordingly, Kusuma and Silva (2014) pointed out that the current approaches adopted for the development of the domestic Sukuk market vary significantly across countries, due to country-specific circumstances. Moreover, Jobst et al. (2008) considered the issue of identifying the factors that may hold back further market development, which is one of the most important issues related to the issuance of Sukuk. In particular, it is important to identify the main economic, legal, and regulatory challenges that need to overcome. Furthermore, Samoui and Khowaja (2016) noted that countries trying for the promotion of their Sukuk markets should strive to establish their economies and adopt stable macroeconomic policies to create an attraction for investors to hold Sukuk securities.

GCC states are exporters of oil and any variations in international oil prices can influence growth in GDP, government budgets, development programs, exports, fiscal revenues, and other macroeconomic factors. Resultantly, this substantial dependency on oil puts the GCC economies at a high level of exposure to external shocks that could additionally endanger the stability of Sukuk markets. Recently, the markets have seen the appearance and fast growth of Sukuk certificates. These instruments seem to offer governments and corporations not only with an alternative source of financing in compliance with Sharia rules but also can be seen as a way to avoid crises. However, the Sukuk market has strived in the prior couple of years because of the uncertainty in the global economy which is the main reason behind the dearth of new players.

The tendency of recent studies is to focus on the firms' characteristics and their impact on the choice decisions of bond or Sukuk issuance in the firm's finance structure. However, the influence of macroeconomic factors on SMD has remained vague and not fully understood because of lack of the studies. This paper tries to fill the gap by offering a model that can be utilized to explain this research issue and makes an addition to the literature through explaining the relationship between macroeconomic variables and SMD in GCC countries.

The paper proceeds as follows: Section 2 concentrates on the "Sukuk." Section 3 discusses various literature related to macroeconomic variables and bond market development. Section 4 offers the expected policy implications. Section 5 offers some conclusions.

2. WHAT IS SUKUK?

Sukuk (plural of sakk) are explained as Islamic bonds, literarily denote Islamic type of investment certificates that are likened to conventional bonds. Issuances of Sukuk and Islamic banking are two of the most famous and broadly accepted Shariah-compliant practices in the industry of Islamic finance where Islamic banks are considered as conventional bank's counterparts and Sukuk offers the Shariah-compliant type of conventional bonds. Sukuk, usually recognized as Islamic bonds, is an investment certificate which follows Islamic law. Accounting and Auditing Organization for Islamic Financial Institutions (2010) describes Sukuk as "certificates of equal value representing undivided shares in ownership of tangible assets, usufruct and services, or the assets of particular projects or special investment activity."

Further, Godlewski et al. (2013) opined that Sukuk is investment certificates that are characteristic of both bond and stock-like features that are allotted for financing trade activities or in producing tangible assets. Contrarily, as compared to conventional bonds, the Sukuk do not offer guaranteed returns and cash flows; there is no interest payment, as returns on Sukuk are associated with the profit generation that is achieved by real transactions from an underlying real business risk (Zakaria et al., 2012). This striking disparity among Islamic and conventional financial tools provides a contribution to comparatively positive performance of Islamic finance during and post global financial crisis 2008.

Sukuk (Islamic bond) and conventional bonds are similar in purpose and both are used for long-term financing. As noted by Ahmad and Radzi (2011) and Saad et al. (2016), in some respects, the Sukuk is like the conventional bonds, it is a security instrument that offers an expected return's level. Though, the fundamental structure and provisions of the Sukuk are dissimilar. In that a bond is a representation of the actual debt of the issuer, the Sukuk is a representation of certificates of equivalent value with undivided beneficial (proportional to the investor's participation) ownership in the underlying assets, usufruct, services or investment in certain projects or activities of special investment. Contrary to this, conventional bonds can be classified as either pure debt contracts or represent financial claims on opaque projects where the underlying asset may not have a real economic value.

3. REVIEW OF THE RELATED LITERATURE

Despite the emergence of Sukuk across different markets worldwide, there are few studies on this subject. Consequently, in what follows, it is worth assessing the literature on the macroeconomic determinants of conventional bond markets.

3.1. Overview of GCCs' SMD

The development of Sukuk market in GCC countries has undergone through three distinct stages. The first stage from 2001 to 2007 which coincided with the oil boom and rapid development of the global market; around 41% of the total Sukuk issuances so far were within this period, and only 27% of the total Sukuk issuances so far were in the second stage 2008-2010 which was low because of the global financial crisis. The third stage started from 2011 and continues to date. The best time was since 2001 in terms of Sukuk issuance in GCC countries, as the number of issuances was 60 in 2012, which was the highest issuances obtained in GCC countries. The issuing value reached a new record, which broke the records of 2007 with a big margin. The beginning of the year 2013 was good for the GCC Sukuk market as the number of issuances was 18 within only 3 months. Evidently, Bahrain was the first issuer of Sukuk and the Central Bank of Bahrain issued Salam and Ijarah Sukus are typically oversubscribed. However, the UAE issues the highest number of Sukuk in terms of volume, making it the leader in GCC region, while Bahrain is leading in terms of number of issues in Sukuk market.

According to Thomson Reuters Report (2016), there has been deterioration in the percentage of GCC's total Sukuk issuance in the recent years. The GCC's share of global Sukuk issuances decreased in the recent years, where the volume of Sukuk issuances in the GCC continued to fall since 2013, while the volume of bond financing increased. Table 1 presents the descriptive statistics of SMD across GCC countries; named Saudi Arabia, United Arab Emirates, Bahrain, Qatar, and Kuwait; over the period 2001-2016.

Table 1 shows that United Arab Emirates has the lowest level of SMD, which is about <1% with standard deviation 0.008 and varies from as low as 0 (no Sukuk issuance) to a maximum of 0.89%, while Bahrain has the highest level of SMD, which is about 9.17% with standard deviation 0.045 and ranges from a minimum of 2.73% to a maximum of 17.6% of GDP. Also, the percentage of Sukuk market volume relative to GDP for Kuwait and Saudi Arabia seems to be within the same level which is about <1% (0.36% and 0.38% respectively). The level of SMD in Qatar reported in this study is 78% and ranges from a minimum of 0 to a maximum of 5.4% of GDP. As it can be seen in Table 1, the total average of GCC's SMD is very small relative to GDP, which is 2.17% with a maximum value of 17.6% in Bahrain. This result is consistent with Grassa and Gazdar (2014), who found that the Sukuk market is new and normally small capital market in the GCC countries, thus GCC's Sukuk market do not approach the level of threshold that enables them to contribute towards economic growth.

Based on the above discussion, it becomes imperative to conduct this study as an initial attempt to explore the factors affecting the SMD in the GCC countries as these factors being overlooked by previous researchers.

3.2. Macroeconomic Determinants of SMD

It is apparent that there is a scarcity of literature associated with the Sukuk markets at country level, but, in particular, there is also a lack with regard to the GCC's Sukuk market. Actually, the empirical literature reviewed in this paper, two studies only include the SMD and analyzed the influence of foreign factors on its dynamic behaviour. These two studies conducted by Smaoui and Khawaja (2016) and Said and Grassa (2013), are very similar, which only focused on some macroeconomic and financial factors over the same period for 13 countries from different regions. Hence, the further empirical investigation becomes necessary. Therefore, the current literature reveals research gaps about the factors of SMD in GCC countries.

There are many macroeconomic factors that can govern the country's SMD level. Many authors adopted the following variables (such as, Adelegan and Radzewicz-bak, 2009; Bolgorian, 2011; Bhattacharyay, 2013; Eichengreen, 2006; Felman et al., 2014; Le et al., 2015; Plummer and Click, 2005) for examining the association among macroeconomic variables and bond market development, which are suitable to Sukuk market too; hence they can be used in the proposed study (Figure 1).

3.2.1. Stage of economic development and SMD

This is a significant macroeconomic factor that has played a role in determining bond market development over the years and the majority of the researchers have determined a significant association among stage of economic development and bond market development. Majority of the results tend to be significant and positive (Bhattacharyay, 2013; Cherif and Gazdar, 2010; Garcia and Liu, 1999a; Yartey, 2008; 2010). GDP measures the development stage of the economy through per capita as purchasing power parity of the population. Economies falling in the higher stages of economic development tend to have better institutions and less unstable economic conditions, which uplift the development of sound financial markets; consequently, a positive association among the two is noted.

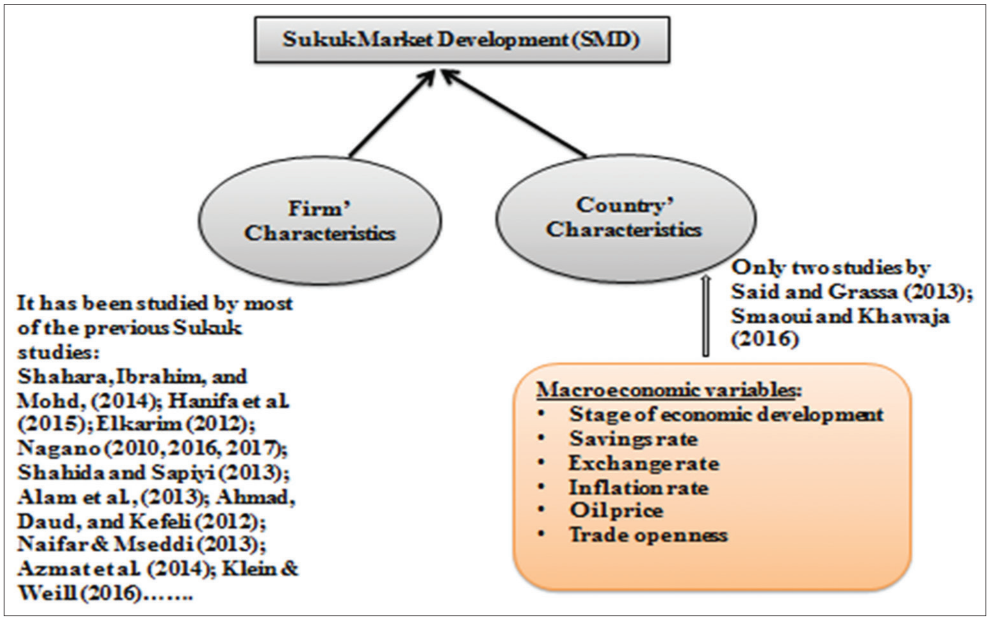
Concerning Sukuk, Said and Grassa (2013), also concluded that GDP per capita has a significant and positive association with SMD among 10 countries from different regions. On the contrary, Smaoui and Khawaja (2016) found no significant relationship between the GDP per capita and SMD. Hence, the further empirical investigation becomes necessary. For this paper, we suggest the log GDP per capita in assessing the association between SMD and stage of economic development. Our expectation is that higher stages of economic development will lead to improving the development of Sukuk market.

Table 1: Descriptive statistics of SMD by countries over 2001-2016

Country	N	Min.	Max.	Mean±SD
Saudi Arabia	16	0	0.0137364	0.0038345±0.0039324
United Arab Emirates	16	0	0.008851	0.0016253±0.0083509
Bahrain	16	0.027306	0.1761255	0.0917529±0.0449971
Qatar	16	0	0.0540362	0.0078257±0.0134053
Kuwait	16	0	0.031756	0.0036019±0.0023473
All countries	80	0	0.1761255	0.0217281±0.0410029

SD: Standard deviation, SMD: Sukuk market development

Figure 1: Theoretical framework



3.2.2. Savings rate and SMD

Sukuk market, like financial intermediaries and banks, represents one way to pooling the savings from surplus units and channelling them into productive investments. On the other hand, if the banking sector is more developed, Savings might channel through the banking system rather than Sukuk market, reflecting the greater ability of banks to fund themselves and also corporates through deposits in high-saving countries. The rate of savings is assumed to have a significant influence on stock and bond market, where a positive relationship was found (Aduda et al., 2012; Garcia and Liu, 1999; Naceur et al., 2007; Adelegan and Radzewicz-bak, 2009; Yartey, 2008).

Mukherjee (2006) argued that high Asian savings rates discourage bond market development by giving banks ample deposits to lend. Therefore, the highest savings rates in GCC countries might affect Sukuk market positively or negatively. Hence, the further empirical investigation becomes necessary. However, there is a consensus among researchers on the measurement of savings rate in relations to stock and bond market development. Following prior studies, the savings rate is calculated as the ratio of gross domestic saving as a percentage of GDP.

3.2.3. Foreign exchange rate and SMD

The nature of the exchange rate regime is expected to have implications on the level of bond market development. Bases on extant empirical submissions, the link between exchange rate and market size can be both positive and negative, this is due to the fact that exchange rate is critical to balancing how the demand and supply of assets are determined. It is also important for the individuals who hold domestic and foreign assets in their portfolios. Bhattacharyay (2013), Adelegan and Radzewicz-bak (2009), Mu et al. (2013) found a negative and significant influence on bond market development.

Regarding Sukuk, Sukuk trading has been listed in US dollar rate. Therefore, the change in the US dollar rate creates change in Sukuk return, which in turn, influence on the volume of Sukuk issuances. Currency exchange risk occurs when an investor buys Sukuk in foreign currencies. High currency volatility creates uncertainty to the real value of the Sukuk and thus creates an impediment to SMD. Ahmad and Radzi (2011) found that both Sukuk and conventional bond issuance in Malaysia consider foreign exchange to be the major cause of bond and Sukuk issuance. On the other hand, Smaoui and Khawaja (2016) found that no significant relationship between the volatility of changes in exchange rates and SMD. Consequently, our expectation is that the higher the volatility of a country's exchange rate, the lower is the development of its Sukuk market.

3.2.4. Inflation rate and SMD

The rate of inflation is presumed to have a significant impact on the general price level of goods and service in a specific economy which might also include the prices of Sukuk. Certainly, inflation is capable of increasing interest rates, which makes fixed interest rate instruments to deteriorate in value. Also, when the inflation rate increases, the price fixed interest rate instruments tend to decrease. This supposition might be true particularly if the price of a fixed interest rate instrument tends to drop, due to the fixed interest rate may not be adequately defraying interest to stay ahead of inflation. Among the contributors to the association between inflation and Sukuk issuance (Ahmad et al., 2012; Naifar and Mseddi, 2013). Interestingly, Shariah-compliant instruments are exposed to inflation but not as much as conventional bonds, because inflation increases the market price of the underlying assets positively. This argument supported by Said and Grassa (2013) who found that inflation does not seem to have a strong effect on the development of Sukuk market.

There is no consensus on a single measurement of inflation among researchers. Said and Grassa (2013) used the rate of inflation to measure its association with SMD. However, Ahmad et al., 2012 used a proxy of consumer price index to measure annual rate of inflation. Though, for the proposed study this paper suggests the adoption of the inflation rate, because it offers a fair indication of inflation rate in the country.

3.2.5. Oil price and SMD

According to Cunado and Garcia (2005), oil prices have a different impact on bond prices depending on whether the country is an exporter or importer of oil and the level of economic development of this country. The price of oil determines the level of government budget revenues, and hence, aggregate demand in the whole economy. However, studies about oil price and stock market found that there is a positive relationship between them (Basher and Sadorsky, 2006; Gjerde and Sættem, 1999; Harrathi and Almohaimeed, 2015). On the other hand, the effect of the price of oil on financial markets in net oil importing countries, i.e.,USA and Australia, is expected to be a negative (Faff and Brailsford, 1999; Huang et al., 1996; Sadorsky, 1999).

Changes in the price of oil may indirectly affect the prices of Sukuk via its effects on the expected inflation rate and the expected real interest rate. GCC economies are characterized by the robustness of their reserves surplus, meagre debt levels and strong credit profiles. Yet, these economies suffer from their high dependence on oil revenues. This situation implies a high and significant volatility to variations in international oil prices. Indeed, oil exports have a considerable influence on GCC countries' earnings, government budget revenue, expenditure, and aggregate demand. GCC countries have a broader oil sector, accounting for 45% of global oil reserve. According to Thomson Reuters reports (2016), there were expectations that oil-exporting countries (particularly those of the GCC) hit by low oil prices would be driven to widen and deepen their Sukuk markets to raise finance and solve the major revenue cut in their budgets, but these expectations were not met.

There is no agreement on a single measurement of inflation among researchers. Basher and Sadorsky (2006) and Awartani and Maghyereh (2013) used the WTI crude oil because this measure is the foremost yardstick used for pricing oil imports into the U.S. However, the most of studies preferred the Brent oil price because it is used to price two-thirds of the crude oil inter-continentally traded. In line with the previous studies, this paper proposes the adoption of Brent oil price as a means of measuring oil price in relation to SMD.

3.2.6. Trade openness and SMD

Trade openness indicates to the level at which countries or economies allow trade or trade with other countries or economies (Zhang et al., 2015). More open economies do less to suppress the securities market because established interests may not be able to insist on policies that suppress competing sources of supply when the economy is exposed to international competition (Rajan and Zingale, 2001). Trade openness variable has been used by a significant number of studies (Rajan and Zingales, 2001; Eichengreen and Luengnaruemitchai, 2004; Bhattacharyay, 2013). These studies found the significant positive effect of the trade openness on bond market development in developed and Asian markets.

Corporations in open economies need more sources of capital to remain competitive. When there is a higher level of economy openness, it is easier to get access to external funding from the foreign investors. This will improve the development of Sukuk market. Sukuk markets will be able to do well in a more opened economy, but banks, the dominating finance sources, usually want to protect their influence in the market by limiting the development of securities market towards the foreign market. The expected positive relationship with Sukuk market is because of the openness that allows the developing economies in particular easy access to foreign savings or pool of funds. It also boosts international capital flows, enhances the liquidity of the domestic capital market, and reduces the cost of capital for industrial projects. Smaoui et al., (2017) found a positive association between trade openness and the development of the Sukuk market. In line with the previous studies, this paper proposes the use of the ratio of the total imports plus exports as a proportion of GDP in determining the relationship between SMD and trade openness.

As much as these macroeconomic variables can have a significant impact on the SMD, regulatory authorities and policymakers can do so much in ameliorating such effects thereby strengthening the Sukuk market.

4. POLICY IMPLICATIONS

The policy implications will be based on the outcome of the proposed research on the role of macroeconomic variables on SMD in GCC countries. If the empirical evidence establishes the macroeconomic factors influence the SMD then the policy implication will be for the governments, policymakers, investors, creditors and researchers, especially concerning issues relating to Sukuk market. It will be possible to make recommendations to support country's specific factors in the Sukuk market that are expected to contribute to the sustainable growth of Sukuk market with the findings. This proposed model will be served as a guidance or signal to investors in making a capital investment. This may aid them in making the right decision to invest in Sukuk is based on the significant macroeconomic variables.

Furthermore, it will also be possible to provide recommendations regarding, which factors the management should give more weight in managing risks or minimize the negative effect and avoid unnecessary disappointments. The practice of good factors knowledge will definitely help to promote the growth of the Sukuk market. In addition, the study may also offer insights for policy level as to the formulation and implementation of suitable monetary and fiscal policies that could assist in the financial market's stability by a focus on the macroeconomic variables that effect Sukuk issuance. This also will also help to mitigate different factors of macroeconomic involved in the Sukuk market.

5. CONCLUSIONS

In view of the ongoing global financial and economic crisis, low oil price and political instability, the development of Sukuk markets in GCC region assume high importance for financing the region's corporate and government sector and large demand for infrastructure. Well-developed Sukuk markets can provide GCC countries with alternative sources of financing and at the same time improve the region's financial resilience by balancing the high dependence on the oil exports and banking sector. Further, GCC countries also need to utilize its huge savings and international reserve for meeting large needs of productive investment in the region, particularly in infrastructure through Sukuk markets development. Local and regional capital can be channelled for long-term infrastructure projects and other productive investment through Sukuk markets. Therefore, to enhance the Sukuk market, there is the need for GCC countries to understand the role of macroeconomic factors on Sukuk market. This is essential to promote their Sukuk markets through struggle to develop their economies and follow stable macroeconomic policies to make it attractive for investors to hold Sukuk securities.

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