Contagion Effects on Stock Market of Bangladesh: An Empirical Study on Dhaka Stock Exchange Shariah (DSES) Index

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ABSTRACT

Due to increased globalization and economic integration in the global economy, contagion effects have been considered an important matter for the investors and policymakers. In the wake of the global financial crisis of September 2008, Islamic financial products were thrust into the spotlight as alternatives to the shaken conventional equity markets. The objective of this study is to discover the Islamic stock market dynamics of Bangladesh with the global Islamic stock markets such as Saudi Arabia, UAE, Kuwait, Europe, UK and Japan. For understanding long run relationship or the theoretical relationships among the Islamic stock market and short run co-movements among Islamic stocks, Johansen co-integration test and Vector Error Correction model (VECM) have been applied respectively. Furthermore, the investigation on short run dynamics is also carried through Impulse Response Function (IRF) analyses. The study found that the Japanese Islamic Stock market is affected to changes in other Islamic stock markets while Kuwait stock market is the leader in the sense it affects other stock market greatly. Bangladeshi Islamic stock market is found to be marginally affecting other stock markets but not as strong as Kuwait. Global Islamic stock market seems to have very little impact to Bangladesh Islamic stock market. The evidence of co-integration and short run dynamics help a diversification benefit may be derived from the cross boarder investment. The empirical evidence of co-integration and short run dynamic relationship found in this study will help investors in making efficient investment decisions and also enhance their understanding of market behavior.

KEYWORDS

Co-Integration, Contagion, Islamic Stock Market, Shari’ah Compliant Stock Market, VECM

1. INTRODUCTION

Nowadays, the stability and the resilience of Islamic finance against the global financial crisis has been an interesting topic of several researches. Due to its resilient risk-return feature, the raising demand of Islamic stocks cannot be denied. Islamic stocks or Shari’ah stocks supports investment in Islamic economics by providing stocks of selected businesses which are free from interest (riba’), gambling (maisir) and uncertainty (gharar). These stocks obey a Shari’ah screening to qualify as Shari’ah compliant stocks. Islamic investing is based on five main principles, which include the prohibition
of interest (riba), the banning of excessive uncertainty (gharar), the interdiction of speculation (maysir) risk and return sharing, and the prohibition of investing in ‘unethical’ industries (haram) (Shanmugam & Zahari, 2009). However, there is still limited number of empirical studies examining the integration of Islamic stock markets and the potential benefit diversification across these markets. Therefore, examining the dynamic pattern of integration among Islamic financial markets has crucial implications for investors, fund managers and other market makers who are interested to international portfolio diversification mainly in turbulent financial context.

Since Islamic Finance stresses significantly on risk-sharing principle and Interest prohibition, Krichene (2013) addressed Islamic stock market can be the most suitable place to promote risk sharing principle. The Islamic stock market enables people to invest, earns profit (dividend) and participates in real business. It diverts the funds from savings which in Islam is not encouraged if it is a means to hoard the wealth. The Islamic stock market allows for the risk diversification necessary to manage systemic and systematic risk. Shari’ah screening has led to the establishment of Islamic stock indices. The first Islamic stock index in Bangladesh named DSEX Shariah index(DSES) was launched by Dhaka Stock Exchange in 2014. The purpose of this effort is to facilitate participation in equity investment that are compatible with Sharia principles. Stock market indices are used to gauge performance of the stocks in a particular stock market represented by the index.

Due to its resiliency, Islamic stocks have been getting a huge attraction to many investors. The shariah screenings criteria approved the scholars have allowed shariah complaint stocks to distinguish themselves from conventional stocks however investing in stock markets has inherent speculation elements in it. This simply means that one has to predict the future value of a stock prior to making any decision on to buy or not to buy the stocks. The situation raised the issue of whether the speculation which inhibits uncertainty is permissible. Another question is, day to day movements of the stock market are random; trying to time the market and profit from the random swings is gambling in a different form. Shari’ah scholars view investing in an Islamic stock market as permissible on the basis of investment decisions must be made on long-term speculation. In view of this, there is a need of knowledge on the mechanism and movement of Islamic stock market to keep speculations at minimal. On the small scale, the findings of this research would be particular useful and interest investors of Shari’ah compliant stocks in Bangladesh. On the bigger scale, it would be of use for Shari’ah compliant stock investors globally.

2. LITERATURE REVIEW

Increased globalization and economic integration among economies of the world has brought serious attention of investors and policy makers to the issue of interrelationships among capital markets around the globe. Studies concerning movement of stock markets, how stock market move together have been studied tremendously in the recent days due to the volatility in the global stock market. Various methods and technics had been applied by researchers in this area of study especially on the co-movement of stock markets indices. Bonfiglioli & Favero (2005) found that US and German stock markets has no long run interdependence. However, if there is a shock in the US stock market, German stock market is affected in the short run. Bonfiglioli & Favero (2005) uses VECM and to detect contagion effect using monthly data of the share prices, earnings and redemption yields on 10-year benchmark bonds from January 1980 to September 2002. D’ecclesia & Constantini (2006) also use monthly data of US, UK, Japan and Canada stock market indices spanning from year 1978 to 2002 but for detecting short run co-movement, use Serial correlation common feature (SCCF). They also apply VECM and use Johansen method in checking the co-integration between US, UK, Japan and Canada stock market. The analysis shows the four markets move together in the short run with US leading. In long run, three different trends are identified.

Patel (2012), examine the causal relationship using correlation among Asian stock markets namely BSE, FTSE, Hang Seng, JKSE, NIKKEI, CSE, SMI, SSE and TSEC from January 2001 to
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