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Does stock market liberalization spur financial and economic development in the MENA region? [☆]

Samy Ben Naceur [a,b], Samir Ghazouani [a,c], Mohammed Omran [d,e,*]

[a] *Laboratoire d'Economie et Finance Appliquées (LEFA), University 7 November at Carthage, Tunisia*
[b] *Institut des Hautes Etudes Commerciales (IHEC), University 7 November at Carthage, 2016 Carthage, Tunisia*
[c] *Ecole Supérieure de la Statistique et de l'Analyse de l'Information (ESSAI), University 7 November at Carthage, 6 Rue des métiers, 2035 Charguia II, Tunisia*
[d] *Arab Academy for Science and Technology, College of Management and Technology, PO Box 1029, Miami, Alexandria, Egypt*
[e] *Cairo and Alexandria Stock Exchanges, 4 (A) El Sherifein St., Down Town, Postal code 11513, PO Box 358, Mohammed Farid, Cairo, Egypt*

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In order to investigate the impact of stock market liberalization on economic growth in the MENA region, we need to place our contribution in the economic growth literature. Our study is related to the literature on policy impacting growth rather than the debate on "convergence" between low-income and high-income countries which dominates the current research on economic growth. Our study is one of the few studies that focus on MENA countries. Several issues are addressed about the impact of stock market liberalization on economic growth. Using annual data from 11 MENA countries over the 1979–2005 period, the empirical results indicate that stock market liberalization has no effect on economic and investment growth, whereas the impact on stock market development is negative in the short run but turns positive in the long run. However, when we include certain pre-conditions for liberalizing the stock market, we find that a more developed stock market prior to liberalization; less government intervention and by not fully opening the economy to foreign trade, reinforces the positive impact of liberalization on stock market development. These results could have some important policy implications in which domestic financial reforms should precede policies that aim at liberalizing the stock market. This is not only easier and faster to accomplish, but from a policy sequencing perspective it pays to reform the trade regime before totally liberalizing the (portfolio component of the) capital account. In conclusion, reforms should first and foremost start in the domestic economy before opening it fully to foreign participation. Our results are robust to several specifications but they should be tentative since there may be some measurement error in the calculation of several variables which could downward bias the estimates. *Journal of Comparative Economics* **36** (4) (2008) 673–693. Laboratoire d'Economie et Finance Appliquées (LEFA), University 7 November at Carthage, Tunisia; Institut des Hautes Etudes Commerciales (IHEC), University 7 November at Carthage, 2016 Carthage, Tunisia; Ecole Supérieure de la Statistique et de l'Analyse de l'Information (ESSAI),

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* Corresponding author. Arab Academy for Science and Technology, College of Management and Technology, PO Box 1029, Miami, Alexandria, Egypt.

E-mail addresses: sbennaceur@lycos.com (S. Ben Naceur), samir.ghazouani@fsegt.rnu.tn (S. Ghazouani), momran@aast.edu, mmomran@egyptse.com (M. Omran).

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University 7 November at Carthage, 6 Rue des métiers, 2035 Charguia II, Tunisia; Arab Academy for Science and Technology, College of Management and Technology, PO Box 1029, Miami, Alexandria, Egypt; Cairo and Alexandria Stock Exchanges, 4 (A) El Sherifein St., Down Town, Postal code 11513, PO Box 358, Mohammed Farid, Cairo, Egypt.

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1. Introduction

A large number of emerging markets have embarked on a series of reforms in the last twenty years, including liberalization of the domestic stock markets. Stock market liberalization is a decision made by a country's government which allows foreign investors to purchase shares in that country's stock markets (Henry, 2000a). Despite the intense reform agenda, the performance of domestic capital markets in many emerging economies has been well under expectation. Although some countries experienced development of their local markets, this growth in most cases is disappointing compared to developed countries. These reforms have stimulated an important amount of theoretical and empirical literature on the effects of stock market liberalization. The first looks at the financial implications of stock market liberalization. It has been shown that stock market liberalization leads to an increase in equity prices (Bekaert and Harvey, 2000), a decrease in the cost of capital (Stulz, 1999), a reduction in equity risk premium (Ahimud et al., 1997), and an increase of the size and liquidity of the domestic stock markets (Fuchs-Schündeln and Funke, 2001). The second looks at the real effects of stock market liberalization, and shows that such liberalization leads to increased investment (Henry, 2000a), and higher economic growth (Bekaert et al., 2001, 2005).

Most countries in the MENA region began to liberalize their stock markets in the 1990s, far later than comparative regions such as Latin America and Asia. Contrary to other regions, there are very few papers that evaluate the effect of stock market liberalization on the economic growth in the MENA region. Achy (2005) assesses empirically the effect of domestic financial liberalization on economic performance in the specific case of MENA countries and finds that domestic financial liberalization impacts negatively private investment and economic growth in Egypt, Jordan, Morocco, Tunisia and Turkey over the 1970–1998 period. Also, Neaime (2005) explores whether MENA markets can offer international investors unique risk and returns characteristics to diversify international and regional portfolio. His empirical evidence suggests that the GCC[1] stock markets still offer international investors portfolio diversification potentials while other emerging MENA stock markets like those of Turkey, Egypt, and Morocco and to a lesser extent Jordan have matured and are now integrated with the world financial markets. Recently, Gentzoglanis (2007) examines the link between the degree of financial openness and economic growth and documents that this link exists only within the group of high income countries but this relationship is rather weak for the low income MENA economies. Privatization alone, although necessary, is not enough to spur economic growth.

However, in this paper we investigate the effects of stock market liberalization on economic growth, investment and stock market development in the MENA region using dynamic panel data method. More specifically, the state of capital markets in the MENA region after stock market liberalization is analyzed. Our focus on MENA countries is motivated by the fact that these countries were at the forefront of the capital market reform over the last two decades. Despite the intense reform endeavors, capital markets in the region remain underdeveloped, not only relative to developed countries, but also compared to emerging economies in other regions.

Using annual data from 11 MENA countries over the 1979–2005 period, we document an improvement in the stock market indicators following stock market liberalization. Our empirical findings, however, indicate that stock market liberalization has no effect on economic and investment growth whereas the impact on stock market development is negative in the short run but turns positive in the long run. However, when we include certain pre-conditions for liberalizing the stock market, we find that a more developed stock market prior to liberalization, less government intervention and not fully opening the economy to foreign trade, reinforce the positive impact of liberalization on stock market development. These results could have some important policy implications; in which domestic finan-

[1] Gulf Cooperation Council.