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Political uncertainty and stock market volatility in the Middle East and North African (MENA) countries[☆]



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ABSTRACT

This paper examines the impact of political uncertainty (caused by the civil uprisings in the Arab World i.e., “Arab Spring”) on the volatility of major stock markets in the MENA region. Our main findings are as follows. First, by distinguishing between conventional and Islamic stock market indices, we find that these two groups of investments react heterogeneously to the recent political turmoil. Specifically, we document a significant increase in the volatility of Islamic indices during the period of political unrests whereas the uprisings have had little or no significant effect on the volatility in conventional markets. Such difference is confirmed by further analysis in a multivariate GARCH model. Second, regardless of its impact on volatility, there is little evidence to suggest that MENA markets have become more integrated with international markets after the political revolution. Third, similar results are not found for the benchmark indices which indicate that the changes are the result of political tensions. In general, these results are robust to model specification and consistent with the notion that political uncertainty contributes to financial volatility. Overall, the findings are important in understanding the role of political uncertainty on stock market stability and are of great significance to investors and market regulators.

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1. Introduction

On December 18th, 2010, a young vegetable vendor from a small town in Tunisia set himself ablaze in protest of the alleged police corruption and ill treatment. This incident reignited the political activism of the entire region, triggering a revolutionary wave of demonstrations and protests firstly in Tunisia and then elsewhere in the Arab world. These widespread protests and demands for reforms (the so-called “Arab Spring” movements) have led to varying degrees of political changes with rulers being forced from power in some countries along with changes of domestic and foreign policies in many governments.¹

The opportunity for political reforms in the Middle East and North African (MENA) region brought along by Arab Spring is enormous and unprecedented. However, a major political event like this can also have an explosive effect on stock market volatility because of its economic and social implications. On the one hand, the revolutionary movements provide an opportunity for MENA countries to develop a more transparent and effective governance to unleash their economic potential. On the other hand, political uncertainty caused by the unrest could manifest itself in stock market cycles and volatility reactions shaking international investor confidence in the region.² It is, therefore, imperative and informative to examine whether these political movements have indeed changed the political, social, and financial landscape of MENA countries. Several studies have looked at the effects of Arab Spring on the economic performance as well as the social or political environment (e.g., O’Sullivan et al., 2012; World Bank, 2011). Yet, three years on, it remains relatively unclear whether, and to what extent, the recent political turmoil has affected the overall financial market. In this paper, we attempt to fill this gap by examining the change (if any) in MENA stock market stability and integration during the Arab Spring movements. Specifically, we seek to address the following questions:

- (1) Have the civil uprisings in the Arab World, i.e., “Arab Spring”, affected the financial volatility and integration of major MENA stock markets, and if so to what extent?
- (2) Are there any differences in the effect across two major types of investment vehicles i.e., conventional and Islamic stock indices?

Given the growing importance of MENA countries in the world economy in general and the Shariah-compliant Islamic financial assets in particular, there is a pressing need for a rigorous research to examine the effects of Arab Spring conflicts in order to better understand the relationship between political uncertainty and financial volatility.³ In addition, the results of our analyses are of direct interest to financial authorities and policymakers who wish to evaluate the role of major political events in triggering or exacerbating stock price movement, and to the investors who wish to invest in emerging MENA stock markets and/or Islamic indices. Furthermore, this paper adds to the growing literature studying the determinants of stock market volatility in a number of ways. Firstly, whilst increasing evidence showing that standard economic variables perform poorly in capturing stock price movements and political uncertainty is emerging as a new avenue to explore the forces driving market movements (Erb et al., 1996; Mei and Guo, 2004), most prior studies in this field have been primarily concerned with political events such as presidential elections, military invasions/wars and terrorists attacks. Little research has been conducted on the potential influence of an important source of political

¹ The *Foreign Affairs*, published a special issue, “The New Arab Revolt” (May/June 2011, vol. 90, no. 3), including several articles on the causes and timeline of key events that have led to “Arab Spring”.

² The political unrest has taken a toll on financial markets in many MENA countries since early January 2011. For example, the Egyptian stock exchange (North Africa’s second-largest exchange) fell by 16% to the lowest level in two years shortly after the reopening of its stock market closure as political unrest led to the overthrow of the country’s president. The Tunisia stock exchange has also declined substantially following the unrest.

³ In the years that the world leading economies are still suffering from the most severe financial crisis since the great depression, many economists predict that MENA region has the potential to become an emerging market leader and engine of world growth (e.g., the *World Economic Forum* on “the Middle East and North Africa”, Winter 2010). In addition, MENA region has vast reserves of oil and natural gas that make it a vital source of global economic stability. Nevertheless, it is also recognized that a better cooperation and increased economic integration is necessary to unlock its potential.

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