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Foreign shocks and international cost of equity destabilization. Evidence from the MENA region ☆

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A B S T R A C T

This paper investigates whether foreign financial shocks can destabilize the cost of equity in emerging markets. After a theoretical discussion, we develop annual metrics for the international cost of equity, financial integration, spillovers and shift-contagion vulnerability in a sample of 535 Middle East and North African firms from Egypt, Tunisia, Morocco and Jordan over the 1998–2011 period. We then analyze the impact of foreign shocks on the international cost of equity, using a set of SGMM and PVAR models. Our results indicate that external shocks can increase the cost of equity in mature emerging markets.

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1. Introduction

International liberalization of emerging stock markets has often been recommended as a way to improve financing conditions for domestically listed firms. The main theoretical argument is that the international integration of domestic equity markets permits to enhance diversification opportunities for domestic and foreign investors, which in turn decreases risk premia, and ultimately the required rate of return for a given project (Stulz, 1999). Equity market integration is thus expected to reduce the cost of capital, increase investment, and ultimately enhance economic growth, this virtuous process being subject

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to a set of institutional conditions (Collins and Abrahamson, 2006; Edison and Warnock, 2003; Harvey, 1995). Empirical evidence was provided by Patro and Wald (2005), who highlighted that the cost of equity posted an average decrease of 3% in the three years following external liberalization in a panel of 18 emerging markets.

However, these empirical and theoretical studies were designed for periods of global financial stability. In particular, the theoretical models pointing to a decrease in the cost of capital post liberalization require the assumption that the correlation coefficient of domestic assets' returns with global assets returns is constantly lower than the domestic to global market volatility ratio (given that the latter exceeds unity) (Stulz, 1999). If this condition is not met, due to increases in global volatility, the increased exposure of domestic returns to exogenous international shocks may offset the diversification effect of liberalization, and by the same logic leads to a higher risk premium, and an increase in the international cost of capital. This mechanism may be relevant in times of global financial turmoil, where portfolio opportunities vanish due to an increase in short term linkages (leading to the well-known paradox that 'diversification works least when it is the most needed').

With the above in mind, this study adds to the existing finance literature by providing new insights on the micro-economic implications of international financial integration on the firm level cost of capital in the Middle East and North Africa (MENA) stock markets of Egypt, Jordan, Morocco and Tunisia. Our study fills several loopholes that currently exist in the literature on emerging markets as follows. First, analyzing the dynamics of firm-level cost of equity in periods of global turmoil would help complete our understanding of the relative benefits and costs of equity market integration. This will bridge an important gap in the literature which has so far failed to consider the dynamics of the cost of equity in periods of financial crises in emerging markets in general and the MENA region in particular. Second, while the empirical literature, so far, has focused on the consequences of financial crises in emerging markets from a macroeconomic perspective, our study will adopt and for the first time a microeconomic focus by looking at firm level data in four emerging countries in order to analyze the implications of financial crises on the cost of equity. In fact, our empirical results will show that destabilization is not confined to the macroeconomic level but also affects the microeconomic cost of capital. This may partly explain the observed drop in aggregate investment in the region in the aftermath of the global crisis (given that the cost of capital negatively affects the net present value of investment projects). Moreover, our empirical results will also provide new insights on the impact of international financial integration on the real sector. In the process, we will also be able to monitor integration levels and compare the cost of capital among the four MENA countries. Finally, the study would also help raise appropriate policy advice for policy makers and portfolio managers in emerging countries.

Our empirical analysis focuses on the four largest non oil producing Middle East and North Africa (MENA) countries: Tunisia, Egypt, Jordan and Morocco. Previous empirical analyses of the MENA markets have shown that these markets are (i) gradually integrating into global markets (Egypt and Jordan being the most integrated markets of the four) (ii) displaying low transparency levels (Lagoarde-Segot, 2013; Lagoarde-Segot and Lucey, 2006); and (iii) exposed to international spillovers and shift contagion (Khallouli and Sandretto, 2012; Lagoarde-Segot and Lucey, 2010; Neaime, 2012). The MENA markets therefore combine *de jure* liberalization, *de facto* integration, low transparency levels and vulnerability to financial shocks. They hence constitute an adequate sample for the purpose of our investigation.

The rest of the study is divided as follows. Section 2 presents the background and motivation for our research. Section 3 is dedicated to an overview of the MENA stock exchanges we study and presents our data. The empirical methodology and the empirical results obtained are presented in Sections 4 and 5. Finally, Section 6 gathers our conclusions and policy recommendations.

2. Implications of external crises in emerging markets

2.1. Contagion

Contagion vulnerability has long been observed as a fixture of emerging markets, including those of the MENA region (Lagoarde-Segot and Lucey, 2010). The effects of foreign crises on emerging financial markets vary according to their degree of financial integration with the more mature financial markets (Beirne et al., 2008; Frank et al., 2008). From a theoretical perspective, the roots of crisis transmission are manifold.

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