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On the relationship between economic freedom and equity returns in the emerging markets: Evidence from the Middle East and North Africa (MENA) stock markets

Kamal Smimou [a,*], Amela Karabegovic [b,1]

[a] Faculty of Business & IT, University of Ontario Institute of Technology (UOIT), Oshawa, Ontario, Canada L1H 7K4
[b] The Fraser Institute 4th Floor-1770 Burrard Street, Vancouver, BC, Canada V6J 3G7

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ABSTRACT

Although the relationship between economic freedom and equity returns has been investigated in the literature, the Middle East and North Africa (MENA) equity markets were usually excluded. The aim of this paper is to fill in this gap by examining the relationship between economic freedom index and equity market returns after accounting for a number of control variables. Evidence shows that changes in economic freedom have a positive impact on equity market returns, which are not explained by business-cycle control variables related to expected returns, and that legal structure and security of property rights have the most significant impact.

1. Introduction

The financial liberalization of equity markets over the past three decades led to a large and growing body of literature on the impact of these reforms on both financial markets and the rest of the economy. Academic interest in these markets is mainly due to the fact that the equity market liberalization allowed,

* Corresponding author. Tel.: +1 905 721 8668x3699.
E-mail address: kamal.smimou@uoit.ca (K. Smimou).

[1] The authors of this paper have worked independently and opinions expressed by them are, therefore, their own, and do not necessarily reflect the opinions of the supporters, trustees or other staff of the Fraser Institute.

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for the first time, foreign investors to invest in domestic equity markets and domestic investors to invest in foreign security markets directly (Bekaert et al., 2003). These reforms also created an opportunity for investors to reduce the risk of their portfolio by diversifying investments in developing stock markets.

This opportunity is a result of stock markets of developing nations not being integrated with the world's developed capital markets (Darrat et al., 2000). Equity markets of developed nations, on the other hand, are highly integrated, in the sense that fluctuations in returns are highly correlated. This further means that a large proportion of the volatility in returns of a developed nation is explained by changes in returns in the rest of the developed nations (Bekaert and Harvey, 2002).

In addition to creating investment opportunities, financial liberation of equity markets, through lifting restrictions on capital flows, also leads to a better allocation of scare resources. If there are no restrictions on capital flows and no transaction costs, then two assets with the same risk should be priced the same, regardless of where they originate (Darrat et al., 2000). Numerous restrictions on capital flows and high transaction costs segment the markets and prevent allocation of scarce resources where they are valued the most. For this reason, the role of financial markets in general and stock markets in particular plays an increasingly important role in today's globalized world.

In this study, we explore the financial nature of the MENA markets, and some specific circumstances arising in these markets. We also consider a host of other issues, such as impact of economic freedom (EF) and the extent to which economic freedom could explain the behavior of equity market returns in some influential MENA markets. Thus, this paper contributes to the literature on emerging markets by investigating some of the features of the MENA equity markets, which were initially observed in the developed markets (Bekaert and Harvey, 2000, 2003; Achour et al., 1998). The main focus of this study is investigation of the impact of institutions on equity market returns in the MENA region. This paper is part of the new flow of studies on stock markets in emerging economies (e.g., Billmeier and Massa, 2008; Bekaert et al., 2007; Kortas et al., 2005; Chang et al., 2004; Hagelin and Pramborg, 2004; Bekaert and Harvey 2003).[2]

Examining the performance of the MENA stock markets and the drivers behind their market returns presents some challenges for researchers mainly due to the lack of reliable data. In addition, these markets are in transition and hence not stable, yet they offer an opportunity to investors who are looking to reduce risk in their portfolios (Lagoarde-Segot and Lucey, 2007, 2009). Some known models in finance literature may not capture the nature of these markets. General models for integrated and segmented markets do not capture the dynamics of a nation moving from one state to another (Barry and Rodriguez, 2004; Bekaert and Harvey, 2003; Bekaert et al., 2003). However, the recent strong interest in emerging markets in general, and frontier markets—pre-emerging equity markets—in particular have provided momentum for future investigation in that direction and called for further study of current models to capture new conditions in these markets.

Surprisingly, the growing body of research on economic freedom and financial markets primarily focuses on the developed markets; arguably the most organized and established markets in the world. In contrast, our study focuses on markets where economic freedom may be particularly weak, namely the MENA markets. In fact, country-specific risks and various barriers to international investment caused by the lack of information, discriminatory taxes, lack of rule of law, and restrictions on funds flows or simply fear of expropriation were always mentioned as some of the reasons that prevented foreign institutional investors from investing in MENA markets (Rajan and Friedman, 1997 and Erb et al., 1996). This led to the observed bias of investors toward domestic stocks in the developed countries. However, we think that the risk premiums in the emerging markets are important features of these markets; thus, the focus on MENA markets should help and maybe yield particularly powerful tests and useful independent evidence (Barry and Rodriguez, 2004).

In line with the argument made by Bekaert and Harvey (2002), we believe that equity market integration—within the MENA region and the MENA with the rest of global market—is in progress. This is surely a gradual process towards a full integration, which will depend on the economic and political circumstances in each country or sub-region and it is most likely that all barriers will disappear (e.g., Soofi, 2008). Some empirical evidence of recent years reveals the growing importance of some trends, such as cross-border trade, to support

[2] The World Bank defines "emerging economies" as nations with per capita GDP below a certain level. In other words, emerging economies are those nations that are on the path from a less-developed to a developed status (Bekaert and Harvey, 2002).