

Does economic freedom enhance stock market returns?



ECONOMIC FREEDOM

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Over the past couple of years, capitalism has repeatedly been blamed for the financial crisis of 2008 and the subsequent economic downturn. Judging from all the media coverage on the issue, many people agree with that conclusion. However, a recent paper published in the *Emerging Markets Review*, titled “On the Relationship between Economic Freedom and Equity Returns in the Emerging Markets: Evidence from the MENA Stock Markets,” provides empirical evidence to the contrary (Smimou and Karabegović, 2010). The paper finds that capitalism—notably, the free market system—is not detrimental to stock markets; instead, it is a prerequisite for stock market development and performance.

The paper examines the impact of economic freedom (i.e., a proxy for capitalism) on stock market performance in 11 Middle Eastern and North African (MENA) nations: Bahrain, Egypt, Jordan, Kuwait, Lebanon, Morocco, Oman, Saudi Arabia, Tunisia, Turkey, and the United Arab Emirates (UAE).

Economic freedom’s impact on stock markets

Economic freedom is measured by the Economic Freedom of the World Index, published by the Fraser Institute in an annual publication titled *Economic Freedom of the World*.¹ The foundations of economic freedom are personal choice, voluntary exchange, freedom to compete, and security of private property. In other words, economic freedom measures the extent to which individuals and families are free to make their economic decisions regarding where to work, what to buy, what to sell, where to invest, and so on. The Economic Freedom of

the World Index is based on 42 different components or indicators, which are grouped into five broad categories: (1) size of government; (2) legal structure and security of property rights; (3) access to sound money; (4) freedom to trade internationally; and (5) regulation of credit, labor, and business.

Economic freedom has both direct and indirect impacts on stock market performance. Economic freedom may directly deter stock market development and performance through restrictions on capital flows and transaction costs (i.e., restrictions on freedom to trade financial instruments such as stocks and bonds), which are part of a broader measure of economic freedom. Indirectly, economic freedom both attracts investment and makes it more productive. A high level of economic freedom improves the business environment by not only strengthening the rule of law and enforcement of contracts, and thus eliminating any potential uncertainty regarding expropriation, but also by making businesses more dynamic and efficient through the elimination of unnecessary barriers and hurdles that are usually associated with high levels of red tape. A nation that has no restrictions on capital flows but has high taxes, a high level of red tape, and lacks a robust rule of law (i.e., it fails to enforce contracts or to protect private property) may still fail to attract investment. To fully benefit from stock market liberalization, a nation must eliminate restrictions on capital flows and create proper economic policies that encourage stock market development.

The impact of economic freedom on economic growth and development has been studied extensively. The research indicates that economic freedom is a key driver of economic development.² However, the relationship between a broad measure of economic freedom and stock market development and performance has not

been studied as extensively. This has started to change recently; however, the MENA region has almost always been overlooked.

The goal of the recent *Emerging Markets Review* paper was to fill this gap. The level of economic freedom, as well as the level of restrictions on capital flows that are part of the fourth area of economic freedom (freedom to trade internationally), differs quite substantially among MENA nations. For example, the Saudi Arabian stock market only allows its bank shares to be purchased by Gulf Cooperation Council (GCC) members, but not by other foreigners (Bley, 2007).³ In contrast, Egypt, Lebanon, Morocco, and Turkey allow 100% ownership by foreigners. The remaining MENA nations fall somewhere in the middle, allowing only partial ownership, ownership of certain firms, and/or ownership by GCC members only (Bley, 2007). Similarly, United Arab Emirates has one of the highest levels of economic freedom (ranking 19th out of 141 nations worldwide) in the MENA region, whereas Tunisia and Morocco each have a very low level of economic freedom, ranking 90th and 104th worldwide, respectively (see Gwartney et al., 2009). This diversity among the MENA nations allows us to study whether the difference in economic freedom levels among the nations has a significant impact on stock market returns.⁴

Results

The study found that increases in economic freedom have a positive impact on stock market returns. Specifically, the study found that a 1% increase in the overall level of economic freedom increases stock market returns by about 3%. Moreover, the study also looked at the impact of the five areas of economic freedom and found that the second area, legal structure and security of property rights, had the most significant impact on stock market returns. This is not surprising since a lack of rule of law—for example, the inability to enforce contracts or protect private property—makes the benefits of capital flows, and trade in general, limited.

The paper looked at the period before the current financial crisis, i.e., from 2000 to 2007. The precise causes of the financial crisis are yet to be identified and confirmed in empirical studies. So far, a number of culprits have been established, though it is not certain to what extent each has contributed to the crisis. While it is true that economic freedom makes stock markets more integrated with the rest of the world and thus may make them more vulnerable to financial crisis outside of the market, research shows that, without economic freedom, stock market development and growth cannot take place. It is difficult, if not impossible, to find a nation with a developed and dynamic stock market that has a low level of economic freedom.

Conclusion

Developing nations need economic freedom, the foundation of a market economy, to encourage stock market development and growth. A lack of rule of law, high levels of red tape, and capital controls impede the development of dynamic stock markets. The study in the *Emerging Markets Review* provides a road map to policy makers in developing nations by shedding light on which institutions and policies have an effect on stock market performance.

Notes

1 The *Economic Freedom of the World* and *Economic Freedom of the Arab World* reports can be found at www.freetheworld.com.

2 A sample of academic papers examining the relationship between economic freedom and economic growth and development can be found at www.freetheworld.com.

3 Members of the Gulf Cooperation Council (GCC) include Saudi Arabia, Bahrain, Kuwait, Oman, Qatar, and the United Arab Emirates (UAE).

4 To our knowledge, there are two commercial investment funds that are based on economic freedom: the Index of Economic Freedom 2007 Fund and the World Freedom Select Fund. The former fund is based on the economic freedom index published by the Heritage Foundation and is offered by First Trust Portfolios; the latter fund is based on the Fraser Institute's *Economic Freedom of the World* report and is offered by Sanderson and Stocker (Lawson and Roychoudhury, 2008).

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