Editorial

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Biographical notes: Ibrahim A. Onour graduated with a PhD from the University of Manitoba, Canada, and taught Finance and Quantitative Economic courses in a number of Universities in Canada, Africa, and lately in the Middle East countries. He has publications in leading international and regional referred journals. Currently, he is working as a Research Associate Professor in International Finance at The Arab Planning Institute in Kuwait.

Bruno S. Sergi is currently teaching International Economics at the University of Messina. His research interest concerning unstable economic contexts of Russia and all post-communist states has led him to publish numerous reference books and scholarly papers about economic transformation in Eastern Europe and global business themes as well as to teach at several academic institutions in Europe and the USA. He also works with several scientific journals as either an editor or a member of the editorial board.

1 Introduction

The global economy has undergone substantial changes in the past decade, both in terms of structural changes caused by globalisation and the shifting balance of economic power. As a result, financial markets globally have undergone even greater changes both in terms of type of instruments traded in these markets as well as the type of risks taken into account. In the past, entry restrictions to capital markets in emerging economies restricted the spillover effects of shocks within local or regional domains, but more recently transmission effects of financial crisis in developed and in emerging markets became more global. The spillover effect of the Asian financial crisis in 1997–1998 was limited to Asian financial markets, but the effect of the more recent subprime crisis of 2008 in USA was more global as did not spare even the economies with no trade nor investment activities with USA. More recently, Dubai financial crisis sent waves of havoc and high tensions in the global financial markets, though with a lesser effect than

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the subprime crisis. When tracking the effects of these crisis and their global ramifications, it should be noticed that the countries with lesser effect are the ones whose economies built on real production sectors, rather than on financial sectors slightly linked with the real economy.

The exposure of Middle East capital markets to the international crisis was at varying degrees, as some countries more significantly affected, while the effect on others was relatively less significant. GCC countries, mainly Saudi, Kuwait, UAE and Qatar, affected directly, as they held part of their financial wealth in foreign assets investment related to US bonds and securities. In the financial sector, few banks in GCC countries have publicly admitted they had losses related to the spillover after of the subprime crisis. These losses are believed to have taken the form of credit default risk and Structured Investments Vehicles (SIVs) and mortgage-backed securities, as well as losses related to the sovereign wealth funds. The effect on the other countries in the region was limited to the indirect effect related to the local stock markets downfall. It is becoming evident to many observers and researchers that the Middle East capital markets, in general, have overreacted to the events in US capital markets, as the impact on these markets was quite substantial compared with the economic value of information transmitted to these markets.

Despite commonality of social and cultural features that characterise Middle East countries, their economies are substantially diverse. The Middle East economic diversity is a reflection of the difference in natural resource endowments. While the regional conflicts and instability are exerting tremendous pressure on sustainability of economic growth, economic diversification strategies and tendency towards regional economic integration played a positive role in recent years.

During the past seven years, the soaring oil prices contributed towards substantial economic performance in Middle East countries. With crude oil price exceeding $100 a barrel by the end of 2007, the major oil-producing countries like Saudi Arabia, Kuwait and UAE registered record oil revenues, and record trade and budget surpluses with moderate inflation rates and stable exchange rates that pegged to the US dollar rate. With expected crud oil prices likely to be maintained above $70 a barrel till 2014, coupled with easing government fiscal positions set to fund mega projects, the economic growth in most Middle East countries, albeit GCC countries, is more likely to be sustained close to its current levels. However, the two most pervasive factors for Middle East capital markets are:

Regional conflicts and fluctuation in oil prices, both create significant challenges and exert tremendous pressure on economic growth and on the investment climate in the Middle East region. During the past five years, Middle East capital markets undergone substantial change in terms of openness to international investment community and integration with emerging and developed markets. The most important changes in this respect include rapidly expanding Initial Public Offering (IPO) markets related to privatisation programmes and openness to foreign investments. As a result, it is fair to say that Middle East capital markets face a challenge in keeping up with rapidly growing economies, growing corporate finance activities, increasing openness to foreign investors and the rapidly growing Islamic financial institutions. Global equity fund managers have realised that since oil-producing Middle East economies growth associated positively with oil price hikes, then such countercyclical feature with industrial countries business cycle trend is an exploitable feature for risk-hedging strategies.

The outlook for 2010, though is not favourable compared with the global pre-crisis era, the coming two years expected to be better for Middle East Economies, due to emergence of stronger institutions and healthier financial system. The current liquidity squeeze in GCC countries is not due to the financial crisis but mainly due to the strong demand for finance by fast growing private sector in the region.

While the Middle East capital markets in the midst of a massive overhaul, it must be admitted that relatively little research has been done in the past on the region's capital markets. After the US financial crisis and its global ramifications, the issue of risk transmission across capital markets is expected to gain momentum and become the subject matter of much research in financial economic literature in coming years. The primary objective in this special issue is to instigate debate at an international level between academics and professional practitioners on the region's capital markets, to help guide policy-makers in the Middle East region and facilitate new opportunities for international investors. As a result, it seems especially appropriate and timely to publish this collection of five papers on various aspects of Middle East capital markets and investment issues.

The first paper, by Faouzi Abdennour and Karim Ben Khediri, employs a panel data during 1999–2006, to examine the effect of banks supervision on banks profitability in the Middle East and North African (MENA) region using a broad range of supervision measures, including deposit insurance, the structure, the scope and the independence of supervision. Investigation of banks supervision and banks profitability is important because the financial crisis in the past decade is linked with fragility of the banking system, and poor banking supervision, and monitoring. This paper addresses three important questions related to supervision of commercial banks: Is it better to have a single supervisor, like conventional central bank, or multiple authorities? In case non-central bank supervision is adopted, is it preferable to unify financial institutions supervision into a single agency responsible of the supervision of banking and non-banking activities? Is the independence of the supervisory authority crucial for bank profitability and stability? The paper shows that supervision differences matter for profitability of commercial banks in MENA countries, as banks profitability tends to be higher in countries in which the central bank is the sole supervisor and consistently monitors and takes legal action against external auditors for negligence. However, there is no evidence that the existence of single bank supervisory agency or more affect significantly the banks profitability in MENA countries. The findings of the paper also show, where there is a single financial supervisory agency for all of the main financial institutions as insurance companies, contractual savings institutions, savings banks, banks in MENA countries are less profitable. In addition, bank profitability is shown as negatively correlated with the existence of deposit insurance system. Also, several bank characteristics and macroeconomic factors are significantly related to bank profitability. Regarding bank-level variables, the paper shows that size of capital is important factor in banks profitability. Better-capitalised banks tend to be more profitable (economies of scale). Moreover, the cost income ratio is significantly and negatively related to bank profitability. Management efficiency appears to be an important determinant in MENA banks profitability. Moreover, macroeconomic variables, such as inflation, have a significant and positive effect on banks profitability.

The second paper, co-authored by Ibrahim A. Onour and Bruno S. Sergi, aims to answer the question of how risky the major stock markets in Gulf Cooperation Council (GCC) countries are they? The paper employs Capital Asset Pricing Model (CAPM) to

estimate time-varying systematic risk for a number of GCC markets including Saudi, Kuwait, Dubai and Abu-Dhabi stock markets, and show Saudi market is the most riskier as it shows wider range of risk variability among the group. This result implies that risk in Saudi stock market is not only highest, but also difficult to monitor and control. The paper also shows that the effect of S&P 500 is very minimal on GCC markets volatility, implying that internal factors are more important than external factors in volatility dynamics.

The third paper, co-authored by Ahmed A. Alzahran and Len Skerratt, examines the behaviour of the Saudi Stock Market (SSM) in response to quarterly earnings announcements in the absence of analysts' forecasts. The findings in the paper show that SSM underreacts to positive news for the first five days and then reactions tend to strengthen in the following weeks, indicating the presence of a Post-Earnings Announcement Drift (PEAD). It is also indicated that the SSM overreacts to negative news in the first five days and then reverses its direction and reports an upward PEAD. The authors believe that the dominance of individual investors as opposed to institutional investors in the trading activities in the market is the main cause of underreaction to positive news and overreaction to negative news. They also show that the SSM reacts strongly to year-end positive earnings announcements, whereas the market discounts bad news gradually on the quarterly base. A possible explanation for the stronger reaction to year-end positive news is that investors usually signal the future corporate performance at this time of the year. The authors indicate that the SSM predictable patterns of overreaction and underreaction around earnings announcements throughout the year are indication of market inefficiency.

The fourth paper, co-authored by Abdelgader M.A. Abdullah and Hassan B.A. Ghassan, analyses if the recent policy of foreign investors' entry to Doha security market has influence on its volatility. The paper shows that, using GARCH-based conditional volatility and structural change analysis, stock returns exhibit higher volatility due to the accession ease of foreign participation. The findings in the paper also indicate that foreign participation in Doha security market not only increased volatility of the market but also enhanced its persistence, and also show evidence of volatility clustering behaviour.

The final paper, co-authored by David Eagle, Arsen M. Djatej, Robert H.S. Sarikas and David Senteny, analyses the indexing paradox, which states that if all investors are rational with rational expectations and have a common risk-averse investment performance measure, then no investor can expect to beat the market. If the cost of indexing is less than the cost of active investing, then all investors would index, and that would result in market collapse. This paradox relies merely on markets being 'informationally efficient', as demonstrated in the paper using a model of different investors having different degrees of informational advantages and disadvantages. While the Indexing Paradox predicts a market collapse when all investors index, as long as some investors are active (albeit for irrational reasons) the rest of the market is not significantly affected. The paper concludes that both rational active investors and indexers should be thankful for the existence of irrational active investors in the market. The indexers benefit because without those irrational active investors, there would be no market. The rational active investors benefit because the irrational active investors allow the rational active investors to beat the market. However, the indexers have the comfort of knowing that they are not among the irrational active investors. Most active investors will never know with certainty that they are among the rational half of the

active investors rather than among the irrational half. Policy implications of the results of the paper include that enhancing the ability of investors to make more informed investment decisions, coupled with regulations and laws designed to protect invested wealth from opportunistic self-interested economic actors, would enhance the existence of stock market with active investors. Those who seek to invest and earn above market returns likely believe that they have the capability to process information about listed companies more effectively than some other investors.

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