

The capital structure of enterprises in risky emerging economies under liberalization: the case of the Middle East and the Gulf Region countries.

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Abstract

In my research, I try to examine disciplines known in earlier researches as topics influenced by economic liberalization process like capital structure, disclosure and transparency on a sample of emerging markets. Does financing behavior of this sample of emerging markets differ from that in developed ones? What are the factors that have an important role on corporate capital structure in these markets? Does political risk level have a significant effect on corporations' financing options? Do certain steps taken by these economies towards integration with the world market like the issues of disclosure, investor rights, and law enforcement have an effect on the market performance and stock valuation?

The importance of this research is in its sample as well as in the period of the study. The Middle East has always been rated as highly risky region, especially politically, but this region has also been a target for investors both hedgers and risk takers. Also in late years countries in the Middle East and the Gulf region have adopted strategies to liberalize their economies as they recognized the importance of integrating into the world market. These influence of these strategies on corporate financing behavior needs to be inspected, to my knowledge; there are few researches, if any, on these topics that cover this region in recent years.

Professor Patrick SENTIS and I have conducted a research entitled: Determinants of capital structure in Gulf Region states and Egypt. A brief about the research follows through the text of this paper.

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1-Introduction.

a-Liberalization:

Much has been learned about emerging markets finance over the past 20 years. These markets have attracted a unique interdisciplinary interest that bridges both investment and corporate finance with international economics, development economics, law, demographics and political science. The designation ‘emerging market’ is associated with the World Bank. A country is deemed ‘emerging’ if its per capita GDP falls below a certain hurdle that changes through time. Of course, the basic idea behind the term is that these countries ‘emerge’ from less-developed status and join the group of developed countries. In development economics, this is known as convergence. History is important in studying these markets. Paradoxically, many complain about the lack of data on emerging markets. This is probably due to the fairly short histories available in standard databases. The International Finance Corporation’s Emerging Market Database (EMDB) provides data from only 1976. Morgan Stanley Capital International data begins ten years later. However, many of these markets have long histories. Indeed, in the 1920s Argentina had a greater market capitalization than the UK (Harvey, 2002).

Part of what makes emerging markets research so interesting is that there is an immediate ‘out of sample’ test of new theories as new markets migrate to the status of ‘emerging.’ In addition, one cannot do emerging markets finance research in a vacuum. Emerging markets finance research is touched by many different disciplines. That is, it is very difficult to conduct meaningful research in emerging markets finance without having some knowledge of development economics, political science and demographics—to name a few.

Researches learned that liberalizations have characteristics and may entitle different effects on emerging markets, like:

1. The theory of market segmentation and market integration

Considerable research has focused on the evolution of a country from segmented to integrate with world markets. There are at least two levels to this evolution. Economic integration refers to decreased barriers to trading in goods and services. Financial integration refers to free access of foreigners to local capital markets (and local investors to foreign capital markets). In a completely segmented market, assets will be priced off the local market return. The local expected return is a product of the local beta times the local market risk premium. Given the high volatility of local returns, it is likely that the local expected return is high. In the integrated capital market, the expected return is determined by the beta with respect to the world market portfolio multiplied by the world risk premium. It is likely that this expected return is much lower. Hence, in the transition from a segmented to an integrated market, the theory suggests that prices should rise and expected returns should decrease. Harvey, 2002 found that this is, indeed, the case. The average annual average geometric returns for 20 emerging markets, the IFC composite portfolio and the MSCI world market portfolio, pre-1990 and post-1990 shows a sharp drop in average returns which is consistent with the theory.

2. Dating market integration is complicated

Market integration induces a structural change in the capital markets of an emerging country. Hence, for any empirical analysis, it is important to know the date of these structural changes. Regulatory liberalizations are not necessarily defining events for market integration. Indeed, one should be careful to distinguish between the concepts of liberalization and integration. For example, a country might pass a law that seemingly drops all barriers to foreign

participation in local capital markets. This is liberalization—but it might not be an *effective* liberalization that results in market integration. Indeed, there are two possibilities in this example. First, the market might have been integrated before the regulatory liberalization. That is, foreigners might have had the ability to access the market through other means, such as country funds and depository receipts. Second, the liberalization might have little or no effect because either foreign investor does not believe the regulatory reforms will be long lasting or other market imperfections exist.

3. Market integration is often a gradual process

Market integration is a gradual process and the speed of the process is determined by the particular situation in each individual country. When one starts from the segmented state, the barriers to investment are often numerous. Bekaert (1995) details three different categories of barriers to emerging market investment: legal barriers, indirect barriers that arise because of information asymmetry, accounting standards and investor protection and risks that are especially important in emerging markets such as liquidity risk, political risk, economic policy risk and currency risk. These barriers discourage foreign investment. It is unlikely that all of these barriers disappear at a single point in time (Harvey, 2002).

4. Market integration has an ambiguous impact on market volatility

Foreigners tend to abandon markets when risk increases (Lensink, 2000; Zak, 2006), leading to higher volatility. Hence, the empirical evidence shows no significant changes in volatility going from a segmented to an integrated capital market.

Harvey, 2002 analyzed the annualized standard deviation of 20 emerging market monthly returns before and after 1990. While it is true that some countries have seen a dramatic decrease in volatility (Argentina), there is no obvious pattern. In the 19 countries, 9 experience decreased volatility and 10 have increased volatility.

5. Market integration leads to higher correlations with the world

Theoretically, it is not necessarily the case that market integration leads to higher correlations with the world. A country with an industrial structure much different than the world's average structure might have little or no correlation with world equity returns after liberalization. However, correlations do, on average, increase. 17 of 20 emerging markets experienced increased correlation with the world after 1990 (Harvey, 2002). The correlation of the IFC composite with the world return in 2002 has doubled since 1990.

6. Capital flows increase after liberalization

As barriers to entry decrease in emerging equity markets, foreign capital flows in. The initial foreign capital flows bid up prices and help create a 'return to integration'. While there is an initial increase in flows, in general, these flows level out in the three years post-liberalization (Stulz, 1999). While most countries welcome foreign equity investment, many are concerned about the potentially disruptive impact of capital flight during a crisis.

7. Contagion happens

Contagion refers to the abnormally high correlation between markets during a crisis period. Emerging markets have experienced many crises: Mexico in 1994–1995, East Asia 1997–1998, Russia 1998, Brazil 2000 and Argentina in 2002. Some part of the increased correlation is expected. Correlations are higher during recessions than during growth periods (Erb et al, 1994, 1998).

8. Emerging markets are relatively inefficient

While it is common for informational efficiencies to exist in new and smaller equity markets, many emerging equity markets do not behave like developed markets. Emerging market equity returns have higher serial correlation than developed market returns. This serial correlation is symptomatic of infrequent trading and slow adjustment to current information (Harvey, 1995). Moreover, emerging market returns are less likely to be impacted by company-specific news announcements than developed market returns. The evidence suggests that insider trading occurs well before the release of information to the public. While there is no 'prove' that these markets are inefficient, the preponderance of evidence suggests that these markets are relatively less informationally efficient than developed markets.

9. There are important links between the real economy and finance

Market integration is associated with lower expected returns. Effectively, the cost of capital decreases. It makes sense that investment should increase as more projects have a positive net present value (Henry, 2000). Finance also impacts other aspects of the real economy. In addition to investment increasing, evidence shows that the trade balance worsens after equity market liberalizations suggesting that the additional investment is indeed financed by foreign capital. Finally, real GDP growth increases. The evidence suggests that real economic growth increases, on average, by 1% per year over the five years following the opening of equity markets (Bekaert, Harvey and Lundblad, 2002; Bakaert et al, 2001, 2002; Luigi et al, 2004).

10. Corporate governance and the legal environment

In order to compete in world capital markets, a number of countries are grappling with setting rules or formal laws with respect to corporate governance. There is a growing realization that inadequate corporate governance mechanisms will increase the cost of equity capital for emerging market corporations as they find it more difficult to obtain equity investors (Klapper and Love, 2002). There are also important issues with respect to the legal environment. What is the optimal level of securities regulation in these countries? Trying to replicate the US Securities and Exchange Commission may cause firms to list on other exchanges with less stringent regulations. The existence of regulations or the establishment of a regulatory body does little, unless it is supplemented with credible enforcement (Harvey, 2002).

b- Corporate Capital Structure:

Liberalization process has an effect on financing sources that companies have depending on the type and strategies of development and whether these strategies were successfully applied. For example, the degree of financial openness and the credit market development have an impact on leverage. An increase in emerging markets openness to foreign markets has a positive correlation with levels of debt. In the contrary, increases in stock market development (which allow firms to substitute equity for debt) may lead to decreases in debt ratios. Credit and stock market development have an opposing effect on leverage, as each one's effect will outweigh the other's effect. As a result, financial openness (and though the ability to obtain debt financing from foreign sources) and credit market development may have contributed to the increase in emerging markets leverage, but this increase is offset by the growth of domestic equity markets (Mitton, 2007).

Although the relative costs and benefits of debt financing may be in question, clearly debt financing has played an increasingly visible part in emerging market finance over the past

quarter century. The increase in debt ratios in emerging markets was due to that firms have changed in a way that their optimal level of debt has increased (Mitton, 2007). Studying 34 emerging markets, Mitton, (2007) found that the median market-value debt ratios increased from 4% in 1980 to 18% in 2004, a rise of 14 percentage points, exceeding that in developed markets which decreased slightly (by half a percentage point) over the same period. Other researches found that firms in emerging markets still employ low debt ratios relative to those ratios found in developed markets (Pandey, 2001 Omet, 2006). Financial system is essential to the long-term growth prospects of developing countries. Efficient equity markets are as important as banks as engines of growth. Thus, even in the early stages of growth, countries cannot afford to concentrate only on the development of banks at the expense of corporate stock and bond markets. Doing so would stifle the most important source of capital in the developing world. New equity finance plays a more central role in corporate growth in developing country firms.² Glen, (1992), indicates that stock markets have played a vitally important role in the growth of the developing country economies in the 1980s.

The literature on capital structure has focused primarily on developed economies, mostly the US companies (Gaud, 2005), and since modern - financial markets in developing countries emerged in the early 1990's (Joeveer, 2006), there have been a limited number of empirical studies that used data from developing countries. Some exceptions are international comparisons that include emerging economies. Consequently, little is known about the financing activities of firms operating in these countries at large (Omet, 2006).

c- Disclosure standards and transparency:

One of the main outcomes of liberalization is the increased level of governance and low enforcement. Firms in countries with weak overall legal systems have on average lower governance rankings; while firms with better corporate governance have higher market valuation. Love (2004), found that operating performance (measured by ROA) of these firms also is higher. In countries of weak shareholder protection and poor judicial efficiency, firm-level corporate governance is more important to investors than country-level legal efficiency. (Negative coefficient found between corporate governance and legal efficiency). In other words, the legal system matters less for the well-governed firms, which is plausible because firms with better governance will have less need to rely on the legal system to resolve governance conflicts (Love, 2004). This conclusion does not replace firm-level corporate governance for country-level judicial reform. Firms have on average significantly lower governance rankings in countries with weak legal systems, which suggests that firms cannot completely compensate for the absence of strong laws and good enforcement. Firms can independently improve their investor protection and minority shareholder rights to a certain degree, this adjustment mechanism is a second best solution and does not fully substitute for the absence of a good legal infrastructure. Although the task of reforming investor protection laws and improving judicial quality is difficult, lengthy, and requires the support of politicians and other interest groups, improving corporate governance on a firm-level is a feasible goal.

² Turkish corporations financed about 60% of their growth from equity issues in the 1980s. This level of reliance on external equity is way higher than Japanese and West German corporations which finance relatively large part of their growth from external sources. (Glen,1992)

Even prior to legal and judicial reform, firms can work on establishing credible investor protection provisions. Firm-level corporate governance is even more important in countries with poor investor protection. However, the task of reforming the legal systems should remain a priority on the policymaker's agenda (Love, 2004). Countries with poorer investor protections have smaller and narrower financial markets relative to the size of the economy, individuals in these countries trade less often in financial markets; the value of publicly traded securities is lower; and the overall number of market participants is also lower (La Porta, 1997).

The quality of law enforcement has a large effect on the valuation and breadth of both debt and equity markets. There are large systematic differences between countries from different legal origins in the size and breadth of their capital markets. Whether measured by capitalization of equity held by outsiders, by the number of listed firms, or by IPOs, common law (English) countries (which have higher levels of investor protection and law enforcement) have larger equity markets than civil law ones (French, Scandinavian, and German laws). Common law countries also have larger aggregate liabilities than do the civil law countries (except the German). Faster growing economies have higher capitalization stock market to GDP. For example, the anti-director rights score and the one-share-one-vote score have a positive effect on the market capitalization ratio. By raising the anti-director rights score from its French origin average of 1.76 to its common law average of 3.39 raises the market capitalization to GNP ratio by 19%, which assures that the quality of the legal environment has a significant effect on the ability of firms to raise external finance (La Porta, 1997). Investor protection has a larger positive effect on growth for countries that impose lower restrictions on capital flows (Macdonald, 2002).

c-1- Importance of transparency:

The concept of disclosure is difficult to measure. First, an important attribute of a trading system is market transparency, defined by O'Hara (1995) as "the ability of market participants to observe the information in the trading process." Information, in this case, can refer to knowledge about current or past prices, quotes, or volumes, the sources of order flow, and the identities and motivations of market participants. Consequently, transparency has many dimensions (Madhavan, 1995, P: 255). The dimensions to the concept of disclosure are more or less difficult to measure. One can distinguish the timeliness (of press briefings), the periodicity (quarterly results versus first and second-half results), the quantity, and the quality (truthfulness) of disclosure (Nier, 2004). Second, there are a number of different channels of disclosure. Firms may disclose information in published annual accounts, but they may also communicate material information to analysts and the financial market using ad hoc press briefings. Indeed, depending on their listing status, firms may be required to issue profit warnings when there is information indicating that the firm may not achieve its stated earnings target. Information may also be disclosed by third parties. Rating agencies have access to information that is not available to the public at large and that the agency feeds into the rating assigned to the firm.

The focus on transparency and disclosure has increased in the wake of recent events beginning with the Asian crisis in the later half of 1997 and continuing with the recent financial crisis in the US and the world markets. One of the main functions of regulators is to ensure an investment environment where gains from private information are minimized ex-ante and penalized ex-post. Financial literature has analyzed the agency problems arising from the asymmetric information between a firm's management and financial stakeholders for well over 75 years, with an increasing focus over the last 25 years. Disclosure benefits firms in different ways. For example, it lowers the cost of capital as the firm makes its shares more accessible to nonresident investors who would otherwise find it less advantageous to hold the shares because of barriers to international investment. And as disclosure increase shareholder base, it consequently reduces their risk premium, to demonstrate with the case of cross-listing in the U.S. markets. If U.S. investors face obstacles in investing in a foreign firm and if a U.S. listing for that firm reduces these obstacles, the risk of the firm becomes shared more widely following the listing provided that the cross-listing leads to an expansion of the firm's shareholder base. This greater risk-sharing reduces the risk premium investors require to hold the shares of the firm (Stulz, 2002).

Also, disclosure facilitates access to developed foreign capital markets, and though increases ability to raise equity. For example, by listing in the U.S., firms can issue securities in the U.S. Since the U.S. capital markets are deep and liquid, foreign firms can raise funds at lower cost than at home. Firms that cross-list in the U.S. become less credit-constrained in that their new investment depends less on their cash flow after the U.S. listing than before. With this benefit, firms that expect to have to raise funds would be more likely to cross-list in the U.S. and firms that do not anticipate the need to raise funds would have no reason to list.

Disclosure also lowers stock volatility by reducing information asymmetries which in turn is likely to increase the effectiveness and reduce the cost of stock-based executive compensation (Nier, 2004, P: 32). It increases bonding and monitoring. For example, a cross listing in U.S. markets enhances the protection of the firm's investors and, consequently, reduces the agency costs of controlling shareholders. Compared to the rest of the world, investors are extremely well protected in the U.S. Foreign firms can obtain some of the benefits of the apparatus that protects investors in the U.S. by listing in the U.S. The extent to which they gain these benefits is high when they list on an exchange, these benefits are lower for over-the-counter (OTC) listings or Rule 144a private placement issues. In particular, firms that list shares on a U.S. exchange are subject to many of the same U.S. laws and regulations as U.S. firms. In addition, firms that list in the U.S. are also subject to greater scrutiny and monitoring from the press and from the investment community, which further increases the protection of minority shareholders (Stulz, 2002).

Finally, firms with higher transparency and disclosure are valued higher than comparable firms with lower transparency and disclosure (Patel, 2002). It seems that more disclosure makes stock more liquid, and adds visibility, exposure, and prestige as reported Stulz, (2004) in the case of cross-listing in highly transparent markets as in the U.S. exchange.

On the other hand, disclosure is costly, and this cost must be offset by resulting benefits for it to be justified³ (Nier, 2004, p. 31) like the existence of sophisticated investors who normally require and need more transparency for their investing decisions. Moreover, too much discretion (i.e., a lack of standardization) over what is disclosed will have a negative effect on what, when and how to disclose, which will add confusion on investors interpreting not unified data. Also, disclosure reveals proprietary information that could be used by competitors.

An increase in quantitative disclosures may not necessarily increase transparency. In the words of the Federal Reserve Chairman Alan Greenspan: “A more complex question is whether greater volume of information has led to comparable improvements in transparency of firms”. In the minds of some, public disclosure and transparency are interchangeable. But they are not. Transparency challenges market participants not only to provide information but also to place that information into a context that makes it meaningful” (Nier 2004, p. 31).

The available evidence in the U.S. suggests that the relatively low disclosure requirements for OTC firms helped to create an environment where shareholders of these companies were often poorly informed and had few avenues available to penalize management for failing to maximize shareholder value. For example, in a study of a random sample of OTC securities conducted in 1962 found that: more than a quarter of the firms did not provide any reports on the firms’ financial position or results in that year; 73 percent of proxy solicitations involving the election of directors failed to include the names of the nominees; only 16 percent of these solicitations listed the directors’ qualifications; 95 percent of proxy solicitations for election of directors failed to report on management compensation; 24 percent of the firms failed to solicit proxies before shareholder meetings; and in two-thirds of the solicitations involving modifications of securities, the effects of the modification on the rights of existing security holders were not given (United States Securities and Exchange Commission [1963]).

Even if OTC firms released independently audited financial statements, the information may not have been considered credible by market participants. In the case of firms not covered by the 1934 Securities Act, state courts had generally ruled that investors could not sue accountants for negligently prepared financial statements unless they had direct dealings with them. In principle, investors in these companies could sue accountants for fraudulent statements, but, in practice, the legal standard for fraudulence was very difficult to meet. Consequently, these investors had little scope to penalize fraudulence through the courts. The “vast majority of securities fraud occurred among firms not subject to the SEC’s period reporting requirements”. Moreover, it was widely believed that many OTC firms chose not to list on exchanges precisely to avoid the stricter disclosure requirements on the NYSE and AMEX (Madhavan, 1996).

³ The costs of disclosure include the direct costs of producing and disseminating information, but also indirect costs that might arise when a bank’s competitors are able to exploit the information that the bank provides to the financial market (Nier, 2004).

2- A brief on the Middle East and the Gulf states economies: (Oxford Business Group, country report, 2008, International Monetary Fund)

Egypt

Egypt has been pursuing an aggressive program of reform in recent years, with the opening of both political and economic arenas. GDP annual growth was 7.1% in 2007, (World Bank). Hydrocarbons are among Egypt's most valuable resources, though textiles and tourism play important roles in the country's economy. The economy has managed to sustain high growth for the past 10 years. The prime drivers of the economy are foreign direct investment (FDI), remittances, Suez Canal fees and tourism. Changes in economic policy have been made to minimize the state's role. More than 100 traditionally state-owned firms have been earmarked for privatization, a program that brought in \$3bn for the year 2006/07. A rationalization of the tax code has worked to encourage more FDI (Foreign Direct Investment), with 27 tariff categories cut down to six and a reduction of duties of around 75%.

Privatization has a major effect on the banking sector. The dominance of public banks is starting to subside with four of the country's major banks being sold. \$500m loan from the World Bank will allow the recapitalization required in order for two of the biggest public banks to comply with Basel II standards. Along with privatization comes new legislation, bringing the sector in line with international standards and causing a series of mergers and acquisition. Banks are however treading carefully in some areas. Mortgages, for example, are an area that could benefit the entire population, yet firms are waiting to see what happens in courts regarding what some see as inadequately tested laws.

The Cairo and Alexandria Stock Exchange is an attractive destination for investors who can find a plethora of industries among the top 30 companies listed within the 550 companies listed on the bourse. The overall capitalization of the market has grown to \$103.5bn in July 2007. The future is expected to offer a steady stream of IPOs from the private sector, as well as new licenses for brokers to provide margin trading and short-selling services. The Capital Markets Authority is also calling for higher standards of corporate governance, which will surely lead to a more stable market. (Oxford Business Group, 2008)

Jordan

Even though inflation pushed its way up to the 13% mark in the first half of 2008, the shocks to the system are far less than in neighboring Egypt where inflation crept up to around 23%. Jordan's economy has come under some pressure in 2007 and perhaps more so in 2008, primarily from global increases in oil and food prices that have affected the government budget and the current account balance. While Jordan is facing enormous economic pressures, it is managing to sustain good levels of GDP growth and foreign investment. There are a number of sectors that have performed well in 2007, including minerals, pharmaceuticals and tourism. Light industry has to face stronger competition and rising energy costs. For the construction materials sector, Chinese goods benefitting from low labor costs and Gulf products capitalizing on low energy costs could make life difficult for many local producers of light industrial goods. However, Jordan's free trade agreements, investment incentives and low transport costs for shipping to major markets are still drawing producers to the country. Steel and cement producers are not expected to face the same challenges as light industry and cement production is due to rise. The government is also pushing ahead with the

establishment of economic zones to attract new industry and services to less developed areas of the country.

Overall results for Jordan's banking sector in 2007 were good, with the total profits of the 15 listed banks up 14.89% to JD640m (\$909m). Jordan's strong growth of 6% in 2007 was reflected in a 20.57% expansion in net credit to JD17.9bn (\$25.4bn) by the end of the year. Trade, construction and industry saw most improvement. Many banks suffered from the sharp correction in the Amman Stock Market in 2006, encouraging them to focus on core banking business in 2007, and this was reflected in a 16.65% rise in net interest and commission income to JD1.32bn (\$1.87bn). They were fortunate, however, that the stock market also picked up in 2007 and total portfolio income losses decreased. Also, although Jordan's banking sector is small by global standards, it has attracted strong interest from regional investors in Lebanon and the GCC. New regulations introduced by the CBJ, in addition to historical political stability, have helped to create a favorable investment environment.

The resurgence in confidence and liquidity in the region as the price of oil began to fall contributed to the positive turn in Amman Stock Exchange by the end of 2007. At the end of 2007 market capitalization rose by 39% over 2006 and equivalent to 289% of Jordan's GDP as a result of better prices, capital increases and a strong appetite for initial public offerings. The number of companies that are listed on the market has increased from 161 in 2003 to 245 by the end of 2007. While inflation and the credit crunch mean that 2008 will be a challenging year, the Jordanian market is less volatile than neighboring markets and there are hopes that the effective presence of strong regulators and good reporting will help to mitigate the global financial crisis.

Oman

Oman's careful economic planning over the years has left it well-positioned as the global economic crisis set in at the end of 2008. Over this period, public debt was reduced significantly and Oman was also the first country in the region to establish a state general reserve fund (SGRF) to provide a cushion against a reduction in income when prices inevitably dipped. The government is committed to diversification and willing to move quickly to keep the economy working smoothly when necessary. Under the Vision 2020 programme, the government's long-term ambition is to move away from its strong reliance on oil, and boost the GDP contribution of non-oil sectors such as industry and tourism, and boost trade – already a strong point of Oman's economy – in the wider region. Between the end of 2008 and the start of 2009, Oman enacted a free trade agreement (FTA) with the United States and signed, along with its GCC partners, FTAs with India and Singapore. In 2009, GDP growth is expected to slow. It registered a remarkable 13% in 2007.

Thanks to a highly capitalized market, Oman's banking sector had little need to look outside its borders for investment support and was thus relatively insulated from the sub-prime fallout in the United States and Europe. Still, the country has not been entirely immune to the effects of the global financial meltdown. In the second half of 2008 the Central bank of Oman (CBO) had to shift its policy direction from one of tightening credit conditions in an effort to contain rising inflation to helping an economy that was facing a shortage of liquidity. In late October it began to offer dollar loans to local institutions to ensure they could find the cash they needed. The debate over Oman's currency peg to the dollar continued throughout 2008, following the rise and subsequent dip in inflation that played out over the course of the year. The CBO maintained its commitment to retaining the peg, clearly stating that it considered it

beneficial to the overall economy. Financing for small and medium-sized enterprises (SMEs) also gained a more prominent role in the banking sector as the government looks to develop this growth segment and encourage privatization. Despite a few negative signals, such as the Bank of Muscat's January 2009 reporting of international losses, Omani bankers remain positive and are focusing on long-term prospects. Official reserves are strong and the government can maintain its plans even in times of dull oil revenues.

Like most bourses in the region, the Muscat Securities Market (MSM) in Oman experienced a rather steep correction in 2008, in a clear break with its stable and scrupulous history. For six consecutive years leading up to 2008 the benchmark index of the Muscat Securities Market (MSM) climbed steadily – a record unmatched by any of its Gulf Cooperation Council (GCC) peers. By the spring of 2008 foreign ownership had risen from historic levels of 11% to almost 28%, heralding the heavy influx of equity investors scared off by trembling American and European markets.

Dubai

Nowhere has enjoyed as much success with diversification as Dubai. The emirate is full of 'biggests'. The world's biggest airport is being constructed there, as is Dubailand, the world's largest entertainment and leisure complex. Dubai is one of the leading lights in the Islamic finance product sector. All this activity comes from within an emirate blessed with a stable and liberalizing government that realized long ago the importance of diversifying away from a total reliance on oil. The Dubai economic model consists of focusing on areas where the government can quickly cash in – hydrocarbons for example – and then, by way of diversification, investing in an economy largely based on the service sector. Indeed Dubai's non-oil sectors grew by over 15% on average during 2000- 2005. Two major segments in Dubai's economy are real estate and tourism (e.g., Dubailand). Part of the attraction of Dubai for developers and tourists alike is its location; an estimated 1.8bn people, over one-quarter of the world's population, living within a five-hour flying distance of the emirate. Dubai's position also makes it an attractive market for the emerging powerhouses of India and China while Dubai's local companies look outwards. In recent years Dubai International Capital (DIC), part of the state-owned conglomerate Dubai Holdings, has purchased stakes in the UK's HSBC Holdings and Standard Chartered. Dubai's biggest economic challenge lies in managing to curb its double digit inflation which was 21.8% in 2000 and 14.3% in 2005 for all UAE, (the World bank). It is, meanwhile, expected that a single currency, modeled on the euro, will be in place by 2010, following the launch of the GCC common market in January 2008.

In regard to the banking sector, the emirate is now known to be the financial centre of the region. The number of banks in the UAE, both foreign and local, reached 52 in 2007. Despite the unstable global economic climate, international banks are establishing local offices in the UAE with Deutsche Bank, Credit Suisse, Citibank, Lazard and JP Morgan establishing a presence in Dubai.

Dubai's capital markets performed well in 2007 and the first two quarters of 2008 and are back to pre-2006 correction levels, despite the volatility on the global markets. The drivers for growth are internal: solid economic foundations; rapid non-oil related GDP growth and high oil prices in the medium term. External factors are assisting the emirate too: low returns in other equity markets and worldwide interest in Dubai, spurring overseas investment. In the future, the number of IPOs is likely to be boosted by efforts towards maintaining greater

transparency and oversight and new regulations on majority control. Segments to watch are the debt market and sukuks; the Dubai International Financial Exchange (DIFX) is building on its position as the world's largest sukuk (the Islamic, sharia-compliant equivalent of a bond) exchange by establishing the first state-of-the-art product platform in the GCC to offer sharia-compliant structured products. Meanwhile Dubai is set to benefit from the most up-to-date trading technology as a result of its deal with the American stock exchange NASDAQ.

Abu Dhabi

Since the discovery of oil, revenues from oil and gas have transformed the emirate into one of the world's richest locations. Indeed, the UAE sits upon 9% of the planet's natural gas reserves, with Abu Dhabi enjoying the lion's share of this – 95% of oil and 92% of gas. Government reforms aimed at minimizing dependence on the public sector and encouraging privatization. Abu Dhabi's GDP has been on the rise on the back of strong oil revenues and new investment in infrastructure, real estate, industry and tourism. Although the energy sector continues to dominate the economy, non oil-based activity is increasing as a result of Abu Dhabi's successful economic diversification and global integration program. In 2008, the government unveiled its five-year strategic plan with an expenditure of \$200bn on the new infrastructure needed to support the diversification program, boost GDP growth and attract foreign investment.

The UAE banking sector posted very strong results for 2007 and has become the largest in the Gulf Cooperation Council (GCC) in terms of assets. The UAE's expanding economy and rising population have led to a notable expansion of credit in 2007, particularly mortgage and personal lending. It rose by 40.1% to \$19.7bn, while deposits rose 29% to \$196.2bn. Banks saw net profits rise by 23.6% to \$6.65bn, with Abu Dhabi Islamic Bank (ABID) experiencing the largest growth in profits. The number of Islamic banks in the UAE rose to eight in 2007. Meanwhile, the global credit crunch has forced many US and European banks to stem lending activity, creating an opportunity for local banks to provide the necessary funding for the ever-increasing number of projects in the Gulf. The banks are currently showing more interest in moving abroad - anywhere from the within the region to China - than in going for consolidation at home.

The Abu Dhabi Securities Exchange (ADX) ranked fifth among the 15 Arab stock exchanges in terms of 2007 annual turnover, and by market capitalization. Meanwhile, in October 2007, HSBC became the first international bank to be awarded a license to trade shares on the Dubai and Abu Dhabi domestic stock exchanges. Of the 66 securities listed in mid-2008, 47 were open to non-UAE nationals, a sign of the increasing effort to encourage foreign investors in the market and an indication that restrictions on foreign ownership are being eased. Many foreign funds that left Abu Dhabi in August 2007 as a result of the US sub-prime fallout returned to the country in early 2008. Abu Dhabi is not insulated from external events, but the fundamentals remain strong. Besides, improvements in the quality of market research and codes for disclosure and transparency are being improved.

Kuwait

With an estimated 10% of the world's oil reserves, every sector in Kuwait has reaped the benefits of oil profits. Kuwait is slowly beginning to diversify its economy, with the hopes of reducing its dependency on oil profits. Kuwait's GDP increased 176% between 2000 and 2006, with growth averaging 26% a year.

The banking sector has greatly benefited from the recent oil boom. The economy doubled between 2003 and 2006. Bank profitability reached record levels in 2007.⁴ Islamic banking in Kuwait is becoming increasingly popular and now claims 25% of total bank assets in the country. In some cases it has managed to take business away from conventional banks and draw in customers who had previously avoided formal banking. The Islamic finance industry is expected to grow significantly, with some estimates indicating that the demand for Islamic financial products will rise from \$400bn to \$4trn in the next five years. Kuwait currently has three Islamic banks. All three are experiencing strong growth and have expanded their operations internationally.

Kuwait's capital markets experienced some turbulence in 2006, but quickly bounced back in 2007 and recorded impressive growth. High levels of liquidity, strong oil prices and increased government spending have led to greater investor confidence. The Kuwait Stock Exchange (KSE) is the second largest in the Gulf Cooperation Council, recording a total market capitalization of \$207bn in August 2007. This can be largely attributed to Kuwait's strong macroeconomic environment, with the financial sector ranking 27 out of 122 countries in 2006 and first among Arab countries. However, the lack of a mature bond market and availability of foreign capital have caused some concern. In addition, regulatory activities are governed by a confused array of official bodies that often lead to complaints about transparency. The government needs to simplify the regulatory structure and impose stricter penalties for those who violate market rules. Plans are also in the works to establish an independent authority to monitor the exchange. If these problems were addressed, the flow of new companies onto the bourse would increase and therefore ensure the KSE's growth.

Qatar

Qatar possesses some excellences in terms of its hydrocarbons supplies and its political role as a mediator in the Gulf region. The current Emir, Sheikh Hamad bin Khalifa Al Thani, is bringing in many liberalizing changes while steering his country's economy towards a well-planned diversification process for when, one day, the oil and gas run out. The industrial sector is key to this, as are the financial services and tourism sectors. The Qatari population is one of the richest in the world, with surging GDP growth of over 8% and 2007 per capita GDP estimated at \$78,754.439 (Table 1). Indeed, Qatar is unlikely to find it hard to attract foreign investment, with the IMF projecting an average annual growth rate of 12.3% between 2008 and 2012, with real GDP set to rise from an expected \$83bn in 2008 to \$134.4bn by 2012. Bringing inflation under control is one of the major challenges for the future;

Qatar's banking sector is on a roll, off the back of an expanding economy and a growing population. The combined net profits of the listed banks rose by an impressive 56% in 2007. The retail market is where the big prizes could lie, with predictions that it could be worth \$1.7bn by 2011-2012; there is room for growth, as use of internet banking and ATMs are well below the global average. Corporate lending to the construction and real estate sectors is growing quickly, as is Islamic banking. New Islamic Financial Services institutions, both local and foreign, have appeared and existing ones have broadened their activities. Even non-Islamic banks are getting in on the act and opening up Islamic windows. This follows a GCC-wide trend towards sharia-compliant services, in particular investment and banking.

⁴ Profit growth averaged 30% per year between 2004 and 2006 as a result of an increasing asset prices and large-scale developments in construction which have kept the demand for project financing strong. (Oxford Business Group)

Meanwhile the global sukuk, or Islamic bond market, could grow by as much as 35% globally in the next few years, according to Moody's Investor Services.

When operations on the Doha Stock Market (DSM) began in 1997, there were 17 listings, a market capitalization of about \$1.7bn and trading was limited to Qatari citizens only. As of late March 2008 there were 43 listings and a market capitalization of slightly over \$110.2bn, with the market opening up to limited participation by non-Qataris in 2005, although foreigners still cannot participate in IPOs. An extra push towards market security could come from the London Stock Exchange, which is developing a multi-faceted strategic relationship with the DSM.

KSA

Despite the stumbling of the global economy in 2007 and 2008, The Kingdom of Saudi Arabia, the world's largest exporter of oil, continued to register double-digit growth, a large budgetary surplus for the sixth consecutive year and a rise in imports. The Kingdom is committed to encouraging foreign investors; it improved its ranking for ease of doing business on the World Bank's "Doing Business" report from 33rd place in 2006 to 23rd place in 2007, making it the highest ranking country in the Middle East. Saudi Arabia is well on track to reach the goal set by Saudi Arabian General Investment Authority to be one of the top-ten most competitive economies in the world by 2010. Owing to the increased liquidity from strong oil revenues and recent liberalization measures, the Saudi banking sector is well-recovered from the 2006 stock market correction. Regulatory changes are also afoot - in 2007 the foreign equity limit was increased from 40% to 60%, and in early 2008 the Saudi Arabian Monetary Authority (SAMA), the central bank and banking regulator, adopted Basel II banking regulations. The Basel regulations aim to ensure that capitalization of banks is adequate and sensitive to varying degrees of risk.

With the arrival of Al Inma Bank and its \$2.8bn IPO in April 2008, Islamic banking in Saudi Arabia seems to have hit its stride. One estimate puts Islamic assets at over 60% of the Kingdom's total banking assets. As more and more Saudis opt into the system, the financial services sector as a whole has been strengthened – the sector's contribution to GDP is expected to rise from approximately 3% of GDP today to 6% by 2015, while assets of purely Islamic banks enjoyed a compounded annual growth rate of 18% between 2003 and 2007. Economic reform and a new regulatory regime have made Saudi scholars more receptive to sukuk and the West has become more aware of the potential within the market - Standard & Poor's estimates it will break \$100bn by the end of the decade. While the Islamic Finance sector is not without its problems, namely a lack of human resources and a need for regulatory reform, it is built upon strong local demand and should see a path to robust success.

Robust oil revenues, healthy government spending, and increasing foreign investment in recent years have combined to provide ample liquidity in Saudi Arabia's markets. The Saudi stock exchange, the Tadawul All-Share Index (TASI), is however subject to market volatility due to the highly speculative, individual investor-driven nature of the market. The regulatory body, the Capital Market Authority (CMA), is focused on addressing these issues through investor education and increased transparency. The regulator also authorized the use of a new book-building system for IPOs, which was first utilized in May 2007, while merger and acquisition (M&A) regulations were signed into law on October 2007. The CMA stated that new disclosure laws are likely to be released in 2009.

Bahrain

GDP growth in Bahrain was estimated at between 6.8% and 7% in 2007, while the rate of inflation stood at 4.8% in February 2008 according to the International Monetary Fund (IMF). Bahrain has had petrodollars in abundance for decades, and, over the past 30 years, has built up a banking sector to service them, with just over 400 financial institutions currently operating in the Kingdom. Indeed the CBB (Central Bank of Bahrain) is facing up to the competition by improving market transparency and conditions through adjustments to its rules and regulations. Meanwhile Bahraini investors are looking overseas, in particular at Central and Eastern Europe's transport, logistics, finance and real estate sectors

Investors are attracted by the ethics behind Islamic finance, with its precepts of risk sharing. Bahrain is now home to 29 Islamic banks, both retail and wholesale, with their assets representing just fewer than 7% of the total banking system and balance sheet assets of \$16.4bn at the start of 2008, up 34.4% from the beginning of 2007. The Kingdom's Islamic banks had a stellar year in 2007, with healthy profits for most of the big lenders, including, for example, \$144m in 2007 for Al Baraka Banking Group, up 79% on 2006.

The Bahrain Stock Exchange (BSE) has made steady progress to be the best-run and most stable financial services industries in the GCC in recent years. New innovations include the offering of Indian stocks by the Bank of Bahrain. Growth and liquidity could accelerate thanks to new trading mechanisms on the BSE, bringing technical capacity on the bourse to the level of its regional neighbors.

Table 1: Gross domestic product, current prices, in Billion U.S. dollars units for the sample economies.

International Monetary Fund, World Economic Outlook Database, April 2009

Country	1995	1998	2001	2004	2007
Bahrain	5.848	6.183	7.969	11.233	18.443
Egypt	60.163	84.821	95.399	78.802	130.346
Jordan	6.731	7.912	8.975	11.411	16.532
Kuwait	27.189	25.945	34.901	59.439	111.755
Oman	13.803	14.085	19.949	24.772	40.391
Qatar	8.138	10.255	17.538	31.734	71.041
Saudia Arabia	142.457	145.967	183.257	250.673	381.938
United Arab Emirates	40.726	48.514	68.677	107.304	180.180

Table 2: Inflation, average consumer prices, Index, 2000=100.

International Monetary Fund, World Economic Outlook Database, April 2009

Country	1995	1998	2001	2004	2007
Bahrain	98.140	102.057	98.781	102.190	110.484
Egypt	78.472	93.720	102.425	117.060	147.245
Jordan	87.292	98.740	101.768	108.866	126.160
Kuwait	91.402	95.511	101.448	104.563	118.371
Oman	100.132	100.697	99.159	99.658	111.186
Qatar	84.996	96.267	101.436	111.052	153.734
Saudi Arabia	102.183	102.451	98.862	100.025	107.213
United Arab Emirates	89.405	96.637	102.736	114.564	147.708

3- Literature review

a-Capital Structure :

The major theoretical models that explain the choice of capital structure are: The trade-off theory (TOT) and the pecking order theory (POT). The trade off theory states that capital structure is the result of an individual firm's trading off the benefits of increased leverage (e.g., a tax shield) against the potential financial distress caused by heavy indebtedness. Financial distress includes the costs of bankruptcy or reorganization, and the agency costs that arise when the firm's solvency is called into question (Fernandez, 2005; Gaud, 2005).

The pecking order theory, developed by Myers and Majluf (1984) and Myers (1984), is a consequence of information asymmetries existing between insiders of the firm and outsiders (i.e. the capital market). Under the assumptions that managers are better informed about the firm's investment opportunities than outsiders, and that corporate managers act in the best interest of existing shareholders, the model leads managers to adapt their financing policy to minimize the associated costs. More specifically, they will prefer internal financing to external financing, and risky debt to equity (Gaud, 2005).

Local country factors could be especially significant in explaining firm leverage. The trade-off theory and pecking order theory find that country institutional factors matter to firm leverage. Trade-off theory argues that firms balance the tax benefits of loans with potential bankruptcy costs to achieve an optimal leverage level (Miller 1977). Hence, local tax levels as well as bankruptcy codes matter. In pecking order theory of capital structure, firms prefer internal funds to outside sources since the latter are miss-priced due to the asymmetric information between owners and investors (Myers, 1984). Hence, the transparency of the firm's activities is important. This asymmetric information is expected to be especially large in transition economies, meaning that firms are less likely to turn to outside sources of finance even if the investment opportunities exceed the internal funds (Joeveer, 2006). Delcour, (2007) found that neither the trade-off theory, nor the pecking order theory, explained the capital structure choices in central and Eastern Europe companies (CEE). Rather, Companies follow the modified "pecking order" where the consequence of their financing was the retained earnings followed by equity issuance then debt instead of what is usually practiced in developed countries' firms where their second alternative is debt followed by equity as a last choice.

Capital structures vary across countries. For instance, American, German, and Canadian firms have lower book debt ratios than do their counterparts in other industrialized nations, such as Japan, France, and Italy (e.g., Rajan and Zingales, 1995). Capital structures also display industry pattern, which are similar around the world. Utilities, transportation companies, and capital-intensive manufacturing firms have high debt-to-equity ratios as opposed to service firms, mining companies, and technology based manufacturing firms, which employ very little long-term debt, if some at all (Fernandez, 2005).

a-1- The Determinants of Capital Structure:

Despite decades of intensive empirical research after Modigliani and Miller (1958), there is a surprising lack of consensus as to what factors determine optimal corporate capital structure. Empirical literature suggests a number of factors that may influence the financial structure of companies. The choice of the explanatory variables is fraught with difficulty. This is why different researchers have considered different key variables- like company size, profitability, asset tangibility and firm growth prospects- in their respective studies as possible determinant variables of the capital choice.

1. Profitability

According to the pecking order theory (Myers and Majluf, 1984), and as a result of asymmetric information, firms prefer using internal sources of financing first, then debt and finally external equity obtained by stock issues (Gaud, 2005; Omet, 2006; Supanvanij, 2006; Mitton, 2007; Jong, 2007). All things being equal, the more profitable the firms are, the more internal financing they will have, which means lower debt levels and higher retained earnings, and therefore we should expect a negative relationship between leverage and profitability.

In the trade-off theory framework, and according to the interest-tax shield, an opposite conclusion is expected. When firms are profitable, they should employ more debt to benefit from the tax shield. In addition, if past profitability is a good proxy for future profitability, profitable firms can borrow more as the likelihood of paying back the loans is greater (Gaud, 2005; Omet, 2006; Supanvanij, 2006; Mitton, 2007; Modigliani and Miller, 1963). Hence, a positive relationship between leverage and profitability will support the trade-off theory, whereas a negative relationship will support the pecking order theory. Rajan and Zingales, (1995) report a negative relationship between profitability and leverage in the G-7 countries. The negative influence of profitability on leverage becomes stronger as firm size increases. This is indeed the case for firms in the U.S. for small size firms, a unit increase in profitability decreases leverage by -0.26, whereas for large size firms, a unit increase in profitability decreases leverage by -1.09, over 4 times the effect as that for the smallest firms (and is significantly different).

The empirical researches have a consensus over the relation between firms' leverage and their profitability in emerging markets as to be negative, which is more profitable companies do not rely on greater levels of debt than less profitable companies, but results differentiated in the significance of this relation. Some empirical evidence found that the relation between firms' leverage and their profitability is negative and statistically significant (Delcour, 2007; Guad, 2007; Daskalakis and Psillaki, 2007; Mashharawe, 2003; Supanvanij, 2006; Pandey, 2001; Nivorozhkin , 2005), which supports the pecking order hypothesis in the argument that as a result of asymmetric information, and because external finance is costly, firms prefer to rely on internal sources of finance. Other empirical researches found a negative relation between profitability and leverage, but not of much significance (Omet, 2006; Supanvanij, 2006), which does not support neither the Myer's pecking order theory, nor the tax deductibility (tax shield) hypothesis.

The empirical evidence that supports the pecking order hypothesis in explaining negative and statistically significant relations between firms' leverage and their profitability revealed that the order of the external financing choices appears to be different. Managers may perceive retained earnings to be the quickest and easiest source of financing followed by new equity issuance, bank borrowing, and possible new debt issuance. These results corroborates Chen's (2004) explanation of the modified pecking order hypothesis in corporate capital structure among developing countries. Under the modified pecking order hypothesis, emerging countries follow a different “pecking order” in their capital structure decisions— retained earnings, equity, and at last debt. The relation between profitability and leverage in emerging economies is negative as it is in developed economies, but the reason for this negative relation is different. While it depends on a company's strategies, target leverage and available costs of financing sources in developed economies, it occurs that companies in emerging economies have to rely on equity as a first external financing source to finance their capital investments. This is due to that the bond market in the majority of emerging countries is still developing. Banks provide short-term liquidity loans rather than long-term financing to enterprises. In addition, shareholders' protection laws are still weak. Thus, managers prefer equity to debt financing. (Gaud, 2005, Titman and Wessels; 1988, Rajan and Zingales, 1995; Supanvanij, 2006) suggest using the ratio of operating income to total assets as indicators of profitability.

2. Tangibility

Tangible assets are likely to have an impact on the borrowing decisions of a firm because they are less subject to information asymmetries and they usually have a greater value than do intangible assets in case of bankruptcy. Myers and Majluf, (1984) pecking order theory suggests that firms may find it advantageous to sell secured debt. Since there may be costs associated with issuing securities about which the firm's managers have better information than outside shareholders, issuing debt secured by property with known values can avoid these costs. Hence, firms with assets that can be used as collateral may be expected to issue more debt to take advantage of this opportunity (Gaud, 2005; Mitton 2007). Tangible assets are easy to collateralize and thus reduce moral hazard and agency costs of debt because this constitutes a positive signal to the creditors who can request the selling of these assets in the case of default. As such, tangible assets constitute good collateral for loans (Gaud, 2005; Mitton, 2007; Pandey, 2001).

If a large fraction of a firm's assets are tangible, then assets should serve as collateral, diminishing the risk of the lender suffering the agency costs of debt. Assets should also retain more value in liquidation (Rajan and Zingales 1995). Leverage ratios seem to be negatively correlated with perceived costs of bankruptcy and financial distress. Firms rich in collateralizable assets (e.g., commercial, real state, and transportation) are able to tolerate higher debt ratios than firms whose principal assets are human capital, brand image or intangible assets (Fernandez, 2005). Therefore, the greater the proportion of tangible assets on the balance sheet, the more willing should lenders be to supply loans, and leverage should be higher (Rajan and Zingales, 1995).

Based on the agency problems between managers and shareholders, Harris and Raviv, (1990) suggest that firms with more tangible assets should take more debt. This is due to the behavior of managers who refuse to liquidate the firm even when the liquidation value is higher than the value of the firm as a going concern. Indeed, by increasing the leverage, the probability of default will increase which is to the benefit of the shareholders. In an agency theory framework, debt can have another disciplinary role: by increasing the debt level, the free cash flow will decrease (Grossman and Hart, 1982; Jensen, 1986). This disciplinary role of debt should mainly occur in firms with few tangible assets, because in such case it is very difficult to monitor the excessive expenses of managers (Gaud, 2005).

It seems that the relationship between tangibility and leverage depends on the type of debt. Tangibility has a positive relationship with long term debt, and a negative relationship short term debt (Omet, 2006). Most empirical studies concluded a positive relation between collaterals and the level of debt in developed economies (Rajan and Zingales, 1995; Kremp et al., 1999). With some exceptions like Daskalakis and Psillaki, (2007) who reported that asset structure has a negative relationship with leverage in small and medium sized enterprises (SMEs) using a sample of Greek and French firms for the period 1998-2002.

In emerging markets, the coefficient is positive and significant (Delcour, 2007; Supanvaij, 2006; Omet 2006; Gaud, 2005; Mashharawe, 2003; Nivorozhkin, 2005), which are consistent with the trade-off hypotheses, and also consistent with previous studies on firms in the United States. The results are consistent with the view that there are various costs (agency and bankruptcy) associated with the use of debt funds and these costs might be moderated by collateral. In some other researches, results were negatively related to debt (Joeveer, 2006; Daskalakis and Psillaki, 2007; Nivorozhkin, 2005). Pandey, (2001) found it significantly negative with short-term debt. The results imply that tangible assets remain a poor source of collateral in less advanced economies, although Nivorozhkin, (2005) found that the effect of tangibility on target leverage is moving towards the positive relationship observed in Germany, France, Italy and the UK of Rajan and Zingales, (1995). In the case of KSA (Saudi Arabia), the coefficient of tangibility was found negative and significant. The reason for this finding could be because certain percentage of the total liabilities are provided to companies from “Islamic” sources where fixed assets have no importance in the lending activity of Islamic banks. Moreover, Saudi companies have “large” cash holdings (cash to total assets is 8.83 percent), which make banks pay less attention to the value of collateralized assets (Mashharawe, 2003).

Even though that the rationale underlying tangibility is that tangible assets are easy to collateralize and thus they reduce the agency costs of debt. Berger and Udell, (1994) showed that firms with close relationships with creditors need to provide less collateral. They argue this is because the relationship substitutes for physical collateral. In Japan, stronger bank-firm relationships imply a lesser role for tangibility. Rajan and Zingales, (1995) found that a standard deviation increase in tangibility increases book leverage by about 20% of its standard deviation in all countries in G-7, in Japan leverage increases by 45%. Perhaps Japanese firms with fixed assets such as land could borrow more over the 1980s because the collateral value of the land appreciated and the appreciation was not reflected in the book value.

3. Company Size

The relation between size and leverage is somehow not obvious. While most empirical studies report a positive sign for the relationship between size and leverage. (Gaud, 2005; Daskalakis and Psillaki, 2007), others report a negative relation (Rajan and Zingales, 1995). Large firms have easier access to equity markets. They can also borrow at better conditions. That is, lower costs in issuing debt or equity (Omet, 2006).

Large size firms tend to be more diversified, and hence their cash flows are less volatile. Relatively large firms tend to be less prone to bankruptcy. Direct bankruptcy costs appear to constitute a larger portion of a firm's value as that value decreases. Therefore, size may be an inverse proxy for the probability of bankruptcy (default). If so, it should be strongly positively related with leverage, especially in countries where costs of financial distress are low like Japanese firms. Japanese firms are tied to a main bank; they may face a lower cost of financial distress because the main bank organizes corporate rescues. Size is found to be important in Japan; a standard deviation increase in size increases book leverage by 33% of its standard deviation (compared to 23% in the U.S.). Hence, size should have a positive impact on the supply of debt (Titman and Wessels 1988; Mitton, 2007, p.137; Supanvanij, 2006; Rajan and Zengales, 1995).

In small firms, the conflicts between creditors and shareholders are more severe because the managers of such firms tend to be large shareholders and are better able to switch from one investment project to another (Grinblatt and Titman, 1998). The result is that small firms tend to have less long-term debt. However, this problem may be mitigated with the use of short term debt, convertible bonds, as well as long term bank financing (Gaud, 2005). Daskalakis and Psillaki, (2007) indicated that size is positively related to debt (debt to asset) ratio in small and medium sized enterprises SMEs of Greek and French firms for the period 1998-2002.

Contrary to expectations, Rajan and Zingales, (1995) found a negative relationship between size and leverage in Germany. Large firms have substantially less debt than small firms. That is contrary to theories expecting a positive relation between size and financial distress, and that liquidation is very costly that makes small firms wary more of debt than do large firms (Rajan and Zengales, 1995). However, the negative relationship is not due to asymmetric information, but rather to the characteristics of the German bankruptcy law and the Hausbank system, which offer better protection to creditors than is the case in other countries (Gaud, 2005). The informational asymmetries tend to be less severe for larger firms than for smaller firms. Informational asymmetries between insiders in a firm and the capital markets are lower for large firms. So large firms may be more capable of issuing informationally sensitive securities like equity, and hence, have lower debt (Rajan and Zengales, 1995). Hence, it is not quite fully understood why large firms are reluctant to issue equity. Furthermore, there may be other unknown forces at work. Dynamic capital structure models (Fischer et al., 1989) take into consideration the costs of adjusting toward the target debt-to-equity ratio. Empirically, this behavior suggests that firms may follow a pecking order in the short term even though a long term target policy exists.

In emerging markets, researchers found consensus results over the relation between firm size and debt as to be a significantly positive relation (Omet, 2006; Delcour, 2007; Supanvanij, 2006; Gaud, 2005; Joeveer, 2006; Pandey, 2001; Nivorozhkin, 2005). This means that larger firms will finance more from debt than do smaller firms. This is in accordance with both trade-off theory and pecking order theory, and hence, large firms in emerging markets find it easier to raise debt finance. Yet the maturity of debt matters, size is more positively correlated with short term debt, it is negatively correlated with long term debt in some cases. In Central and Eastern European (CEE) countries, Delcour, (2007) had different results when she found that long-term leverage coefficients for the Czech Republic, Poland, and Slovakia were negative (-0.101, -0.116, and -0.225 respectively) and is 0.210 for Russia. She attributed the negative relations to: existence of information asymmetries and an underdeveloped state of the bond market in these transitional economies, laws dealing with financial distress are still developing, leaving debt holders unprotected in the event of default and forcing companies to acquire funds through short-term loans. The positive relation for Russian companies could be attributed to the progress in the transition from a banking to a market economy, the high Russian government ownership in enterprises, and the government directing credit programs to preferred sectors with price control in these sectors may have a significant impact on corporate financing patterns (Delcour, 2007).

Nivorozhkin (2005) found that firm size is positively and significantly related to target leverage in Bulgaria, the Czech Republic, and Romania, but it wasn't significant in Estonia and Poland. Results are consensus with the fact that size serves as a stability proxy for creditors, and that larger companies in these markets are also targets of government bailouts due to the higher social costs imposed by their distress. They are also often subject to some form of government-sponsored investment programs (Nivorozhkin, 2005). The same results were found by Delcour, (2007) when leverage was measured as total liabilities to total assets.

4- Non-debt tax shield

In emerging markets, Delcour, (2007) found that the coefficient for corporate tax liability is positive and statistically significant, which implies that the corporate tax rate affects firms' financing decisions in transition economies. In the contrary, Mashharawe, (2003) found that tax structure do not have a significant impact on the capital structure of a sample of listed non-financial companies. Delcour, (2007) also found a strong positive relation between the total, long-term, and short-term leverage and non-debt tax shield in Central and Eastern European companies. A possible explanation is that non-debt tax shield may be viewed as a measure of the firm's assets sociability, with more securable assets leading to higher leverage ratio. The factors that influence firms' leverage decisions in the CEE firms are the differences and financial constraints of banking systems, disparity in legal systems governing firms' operations, shareholders, and bondholders rights protection, sophistication of equity and bond markets, and corporate governance structure (Delcour, 2007). Mitton, (2007) shows that non-debt tax shield is positively correlated with debt ratios and the correlation is statistically significant. However, the interaction relation between tax and non-debt tax shield is negative and significant. One interpretation of this result is that firms increase their levels of debt when faced with higher tax rates, but that they are less likely to increase levels of debt in response

to higher tax rates if they are protected by having non-debt tax shields in place. In other words, firms with large non-debt tax shields have a lower incentive to use debt from a tax shield point of view, and thus may use less debt (Mitton, 2007).

5- Risk

Many authors have included a measure of risk as an explanatory variable of the debt level (Titman and Wessels, 1988; Gaud, 2005; Pandey, 2001). Previous studies found evidence that leverage and business risk are negatively related. High business risk should reduce the quantity of debt supplied to the firm at any given interest rate. The standard deviation of earnings is expected to be negatively related to leverage. But in a sample of Asian firms, Supanvanij, (2006) found that leverage increases with increases in operating risk.

According to the trade-off theory, higher risk (earnings volatility) increases the probability of financial distress. Thus, it predicts a negative relationship between leverage and risk (Pandey, 2001). The pecking order theory too predicts a negative relation between operating risk and leverage. Firms with high volatility of results try to accumulate cash during good years, to avoid under investment issues in the future. Hence, risk has negative relationship with long-term debt but it has a positive relationship with short-term debt as high variability shifts financing from long-term debt to short-term debt and equity (Pandey, 2001, Page: 4).

The empirical evidence in emerging countries shows different results on to how risk affects leverage. Delcour, (2007) found that leverage is inversely related to earnings volatility in Central and Eastern Europe (CEE) countries (Russia, Poland, Czech Republic, and Slovakia) during 1996 to 2002 period, which corroborates the trade-off theory. With positive bankruptcy costs, larger earnings volatility entails a lower leverage. The negative coefficient is higher in Russia than in other CEE countries. This difference may be explained by the fact that, in Russia, the bankruptcy law has been strictly enforced since March 1998. Contrary to the Russian Federation, creditors' rights in the Czech Republic are poorly protected. This affects banks' willingness to provide long-term loans and creates difficulties in collecting existing ones. Another problem that Czech corporate bankruptcy law faces is that most Czech judges lack experience with bankruptcy proceeding, causing a 3- to 4-year backlog in the bankruptcy courts. Furthermore, the secondary market for the liquidation of seized assets is small (Delcour, 2007). Pandey, (2001) reported a negative relation of earnings volatility with book and market value long-term debt ratio in Malaysian listed companies, which is consistent with the trade-off theory, but he reported a positive relation between risk and short-term debt ratios. He suggested that high variability shifts financing from long-term debt to short-term debt and equity (Pandey, 2001, P: 11). Contrary to Delcour, and Pandey, Supanvanij, (2006) found that in Asian emerging markets, and between 1991 and 1996, volatility had a positive but not significant relationship with leverage. This result is consistent with the findings in US firms where leverage increases with increases in operating risk.

6- Political risk

The Arab countries have gone through a process of privatization and stock market liberalization reforms. These reforms have had an impact on the relationship between risk and

return. Girard, (2007) determined that despite economic, financial and political reforms, and despite the privatization process and stock market liberalization in the Arab countries to deepen their markets and to improve corporate governance, political instability still a powerful obstacle to investments in these nascent emerging markets.

According to the Morgan Stanly Capital International (MSCI) index, the credit rating for U.S and Japan are 92.6 and 90.8 respectively (the highest rating is 100), the ratings for emerging markets range from 15.2 (Nigeria) to 75.5 (Taiwan), which suggests that the average level of country risk is sharply higher in emerging markets (Erb, 1998). Country credit rating has predictive power in discriminating between high expected returns and low expected returns countries. The difference in performance between the highest and the lowest credit risk portfolio is almost 12% /year according to the MSCI and the IFC index until 1993, (Erb, 1995).

Correlation between emerging markets portfolio return and the world wide portfolio is higher in recessions and lower in recoveries than the average. Moreover, emerging markets could hold what is called the contagion phenomena (regional markets responding to regional crisis). The correlation between the IFC emerging market composite with the world index increased from 0.42 for the period (1981-1998) to 0.61 in the last 5 years (1994-1998), while the standard deviation of the returns was lower (from 22.1 for the whole period to 19.1 in the last 5 years), that is reflecting the impact of the 2 regional crises.⁵ But the contagion phenomena hold dramatically when the neighboring countries shared the same fundamental problems with the country in crisis. For example, The Mexican crisis was a more one country crisis, and the Asian crisis involved multiple countries with similar problems (Erb, 1998).

There are different country risks like economic risk, political risk, and policy variability. Political instability is the most important factor associated with international investments and though, capital flight. Political risk exerts a significant influence on country ratings, it is of greater relevance since most of the government decisions affect the economic factors directly and it is difficult to define an accurate measure to predict cross border risks (Vij, 2005). Firms that face significant business risks (e.g., their exposure to political risk) have incentives to mitigate the costs of these risks by adjusting their capital structures (Desai, 2007). Political instability and uncertainty are particularly important in explaining the flight of capital: residents faced with such instability and uncertainty take their money and run to avoid the possibility that the government may in one way or another erode the future value of their asset holdings (Lensink, 2000; Quan, 2006). Studying 45 developing countries, Quan, (2006) showed that several types of political risks accelerate capital flight, including unconstitutional government change, internal uprisings, and the variance of policy implementation.

Returns on investment in politically risky countries are more volatile than returns elsewhere. American firms investing abroad face significantly greater risks than they do when they invest in the United States. Political risk is manifest in more volatile returns at the affiliate level. Firms respond to political risk by reducing their US and worldwide leverage. As these adjustments are costly, their magnitudes reveal one aspect of the costs that investors bear in

⁵ The Mexican crisis in late 1994, and the Thailand crisis in 1997 Claude, (1998)

politically unstable foreign environments. Multinational firms reduce their leverage in response to these political risks: a one standard deviation increase in foreign political risk is associated with 3.5% reduced leverage (Desai, 2007). Results were inconsistent with what is known as that more highly leveraged firms will undertake riskier investments. Risky investment returns faced by multinational firms appear to have implications for capital structure that are stronger than any effects of capital structure on the risk profile of foreign investments.

In the Arab world stock markets, political risk is likely to remain significant. Finance literature shows that changes in political risk in general tend to have a strong effect on local stock market development and excess returns in emerging economies, suggesting that political risk is a priced factor. In this context, the Arab economies are no exception. They have a relatively closed and highly concentrated political system with a poor mode of national governance. Consequently, any changes in political risk in these countries will be strongly associated with growth in stock market development indicators. Political risk has strong implications for stock market development. The problem of political risk has an important policy implication for growth in these thinly traded Arab markets. A great need exists to improve political risk in these Arab countries in order to attract more investment and better allocation of resources through stock markets. To achieve this, more institutional (stock market) reforms are needed with all other relating issues like improving the institutional and legal frameworks accountability, transparency and disclosure, corruption, rule of law and contract enforceability (Girard, 2007).

Other factors applied in researches as determinants of capital structure are tax, growth opportunity, ownership structure, liquidity, age, and trade credit.

b- Disclosure:

If volatility is a measure of investor uncertainty, and if disclosure reduces volatility, then volatility may be an indication that more disclosure reduces uncertainty in financial markets (Nier, 2004, P: 32). Disclosure has a strong negative effect on volatility, banks that disclose more information on key items of disclosure show lower measures of stock volatility than do banks that disclose less information (Nier, 2004; Diana Hancock). Benefits of negative effect of disclosure on volatility may be important for investors. But banks also do benefit from this effect. In particular, lower stock volatility may result in a lower cost of capital and increase the effectiveness of stock-based compensation. Benefits of disclosure also could reach supervisors that use market indicators of bank performance alongside supervisory information. In particular, a lower volatility of equity returns may reduce the likelihood that the stock price gives the wrong signal on the relative performance and risk of the bank (Nier, 2004).

Contrary to Nier and Hancock, Madhavan (1996) and Bushee (2001) reported different findings. Madhavan (1996) investigated the impact of greater transparency during the process of price formation on asset prices and market liquidity. He demonstrated that market transparency always reduces volatility and improves market quality only in sufficiently large and liquid markets; otherwise transparency can actually increase price volatility and lower

market liquidity. This case occurs even though transparency increases the precision of traders' predictions about the asset's value. Also, Bushee, (2001) investigated the impact of corporate disclosure practices on the composition of the firm's institutional investor base and the volatility of its stock price. He found that institutional investors are attracted to firms with more forthcoming disclosure. These attracted institutions are of very different types. The first one exhibits long investment horizons and low portfolio turnover. This type of institutions reduces the volatility of the firm's stock price. The second type of institutions is firms that exhibit short investment horizons and aggressive trading strategies, which in turn exacerbate the firm's stock return volatility. The second type of institutions immediately increase their holdings when firms improve their disclosure practices. Where the first type does not, leading to a significant increase in the firms stock return volatility (Bushee, 2001).

Healy et al. (1999) found that increases in disclosure are associated with increases in institutional ownership. Bushee and Noe (2001) confirmed this association, but find that increases in "transient" institutional investors (institutions that trade aggressively) are associated with increases in stock price volatility. Assuming that increases in stock price volatility are costly, this finding is consistent with the intuition that partial disclosure is optimal, and that too much disclosure can be as costly as too little disclosure.

The 1964 Securities Acts Amendments in the U.S. extended the mandatory disclosure requirements that had applied to listed firms since 1934 to large firms traded Over-the-Counter (OTC). Analyzing the effect of the 1964 mandatory disclosure laws on stock returns and operating performance of firms newly affected by this legislation found that firms that were required to begin complying with all four disclosure requirements outperformed (measured by differences in abnormal returns, and operating performance in terms of greater income and sales growth) firms that were only required to begin complying with two disclosure requirements. Results imply that with more commitment to more disclosure requirements, more positive effect would appear in the form of more abnormal excess returns and better operating performance results.

Moreover, the most affected firms outperformed OTC firms that were not targeted by the legislation. Complying OTC firms had abnormal excess returns of about 3.5 percent in the weeks immediately surrounding the announcement that they had begun to comply with the new requirements. OTC firms that were newly required to begin complying with all four forms of mandatory disclosure had statistically significant positive abnormal excess returns ranging between 11.5 and 22.1 percent, relative to size and book to market value matched NYSE/AMEX firms⁶. Operating performance also improved after the Amendments were in force. The most affected OTC firms had greater income and sales growth from 1962 to 1966 than unaffected NYSE/AMEX firms, suggesting that the market's expectations of improved performance were justified and helps to explain these firms' higher stock returns. Overall, the benefits of the 1964 Amendments substantially outweighed the cost of complying with this law as measured by stock returns (Greenstone, 2005).

⁶ OTC firms do not generally outperform the NYSE/AMEX firms.

The same results were found by Stulz, (2002) when investigating the effect of cross listing in the U.S markets on the company's premium in 1997. Higher disclosure standards in the U.S. were found to be important determinant for firms decision to cross-list in the U.S., firms listed in the U.S. have a Tobin's q ratio⁷ that is 16.5% higher than the Tobin's q ratio of firms from the same country that do not list in the U.S. Love, (2004) also reported that firms that trade shares in the United States have higher governance rankings, especially in countries with weak legal systems. The cross-listing premium (excess value of listed firms relative to non-listed firms) depends on the type of listing a firm chooses (whither it is Rule 144a or OTC or Exchange-listing). It reaches as high as 37% for companies that list on major U.S. exchanges where disclosure requirements are large and more frequent. Cross-listing premium is much smaller for over-the-counter listings OTC and private placements where disclosure requirements are less than those in major U.S. exchanges. The premium persists after controlling for a number of country-level factors and firm-specific characteristics.

The average cross-listing premium for Rule 144a private placement listings is 0.149, and 0.105 for OTC listings⁸. But when firms choose to list in a major U.S. exchange, the average cross-listing premium is 0.486⁹ (t-statistic across countries of 3.85), which corresponds to an average cross-listing premium of 36.5%. This average cross-listing premium is 226% of the average cross-listing premium for Rule 144a listings and 362% of the premium for OTC listings (Stulz, 2002).

T&D (transparency and disclosure) score varies highly among different regions, for example, Patel, (2002) reports that Asia has a score of 43; Europe and Middle East have a score of 36, while Latin America has a score of 29. The average T&D score present in annual reports, exhibit a low level of transparency and disclosure among emerging markets. Moreover, the number of companies disclosing information on more than 60% of the attributes is 15 (about 4% of the sample). The relationships between T&D scores and cross-holdings (1- float)¹⁰ is

⁷ Tobin's q ratio = (book value of total assets - subtract the book value of equity + market value of equity)/ book value of total assets).

⁸ Listings with Rule 144a private placements do not require compliance with U.S. GAAP or SEC disclosure rules. These listings are capital-raising issues in which the securities are privately placed to qualified institutional buyers and trade OTC among such buyers with very limited liquidity. There are only 116 such listings from 20 countries in the sample. Listing with the OTC. They are referred to as Level I ADRs for non-Canadian listings. They trade OTC as Pink Sheet issues with limited liquidity and require only minimal SEC disclosure and no GAAP compliance. These firms are exempt from filing Form 20-F. It allows home country accounting statements with adequate English translation, if necessary (Stulz, 2002).

⁹ The listing comprise ordinary listings (mostly Canadian firms and New York Registered Shares for Dutch firms) and Level II and III ADRs. As the most prestigious and costly type of listing, these require full SEC disclosure with Form 20-F and compliance with the exchange's own listing rules. Firms listed in exchanges are on average larger than the other firms from their home country that are also listed in the U.S.

¹⁰ A company with a low float is a company owned by government and strategic investors and is less transparent than a company with high float. (Patel, 2002)

negative for the emerging markets (Brazil, Poland, South Africa, India, Thailand) varying between -42% and -51%. Correlation between price-to-book ratios and T&D scores is positive suggesting that the market places a premium on better transparency and disclosure, and that market places a premium on companies with lower asymmetric information problem (Patel, 2002). Bushee, 2001 found that firms with greater analyst following and greater institutional ownership are less likely to have conference calls that provide open access to all investors. This evidence is consistent with the intuition that informed investors prefer less disclosure, but is also consistent with the notion that analysts and institutions produce information, and reduce information asymmetry and the need for conference calls.

I will investigate the effect of applying disclosure standards on stock prices and volatility, as well as to how much did firms commit to mandated disclosure standards, in other words, to find if mandated disclosure standards are well enforced.

Table 3: mandated disclosure standards dates of enforcement in a sample of countries in the Middle East and the Gulf states region.

Bahrain	01/01/2004
Palestine	30/09/2006
Amman	01/03/2004
Oman	01/10/2007

4- Thesis advancement:

In the aspect of capital structure, Professor Patrick Sentis and I have conducted a study to evaluate the determinants of leverage in a cross-country setting in the Gulf region states and Egypt's listed firms, over the years 2004-2007. Data were hand collected from their original sources for a sample of more than 80 firms. We questioned if the theories of the pecking order and the trade-off - which came out as results of researches on the US market, and which were successfully applied to the other developed countries - if these theories are also applicable to the sample of emerging markets in light of the fact that these markets have started and are still going through an extensive economic liberalization process. Some stylized findings emerged from our data set. Among others, Political risk has a significant influence on firms' capital structure. It occurred that the period of the study (2004-2007) was going on in parallel with a period of developments in the region as our sample countries have adopted many strategies to construct and reform their economies with higher and better readiness to integrate and emerge in the world market, the thing that added more importance to the study in this vital period. The empirical literature has been to identify some stylized factors that relate to capital structure. There are few studies that provide evidence from emerging markets in the Gulf region states and Egypt. The selection of countries (in the Middle East and the Gulf region)

depended on acquiring a sufficient number of enterprises that consolidated their annual statements during the period 2004-2007, if holding companies that consolidated were few in a country (e.g., Oman, Jordan, and Palestine), then the country will be exempt from our sample. Our final Sample included markets in Abu Dhabi, Bahrain, Dubai, Kuwait, Qatar, and Saudi Arabia from the Gulf region and Egypt. The selection of the variables (dependent and independent) is primarily guided by the results of the previous empirical studies in the context of some developed and developing countries, as well as the availability of data in our sample to measure these variables through the whole period of the study. Data limitations forced us to measure debt in terms of book values rather than market values, which forced us to exclude the dependent variable debt-to-equity as a measure of leverage where equity is measured in term of market value. Since independent variables may have different effects on the types of debt, we use three measures of leverage: Long-term debt to total assets, short-term debt to total assets and total debt to total assets ratios. Each debt ratio is measured in book value terms. The final independent variables were company profitability, tangibility, risk, political risk, size, and non-debt tax shield

The analysis relied on the following variables:

Leverage (1) = Long-term debt / Total assets (e.g., Omit, 2006; Delcour, 2007; Masharawee, 2003; Pandey, 2001)

Leverage (2) = Short term debt / Total assets (e.g., Delcour, 2007; Pandey, 2001).

Leverage (3) = Total debt / Total assets (e.g., Omet, 2006; Gaud, 2005; Mashharawe, 2003; Joeveer, 2006; Mitton, 2007; Pandey, 2001; Daskalakis, 2007)

The explanatory variables are the following:

- Profitability = Earnings before interest and tax to total assets
- Tangibility = Book value of tangible assets (net property, plant, inventory, and equipment) to total assets
- Risk = Standard deviation of earnings before interest and tax to total assets over the 4 years' observations.
- Political Risk = Classification from 1 (low risk) to 4 (high risk) according to Moody's, Standard and Poor's and Fitch rating ¹¹ (see table 2)
- Size = Natural logarithm of sales
- Non-debt tax shield = Depreciation and amortization to total assets

We have affected a rank to each market according to its political risk rating in the main risk rating agencies as shown in the following table.

¹¹ This data has been collected on the following web site:
<http://www.pri-center.com/country/index.cfm?pgid=2>.

Table 2: Political risk ranking of sample markets

	S&P	Moody's	Fitch	Our ranking
Tadawul	AA-	A1	AA-	1
Qatar	AA-	Aa2		2
Dubai, Abu Dhabi		Aa2		2
Bahrain	A	A2	A	3
Egypt	BB+	Ba1	BB+	4
Kuwait	AA-	Aa2	AA	1

<http://www.pri-center.com/country/index.cfm?pgid=2>

Two kinds of regressions are run. We estimate a classical pooled-OLS regression. This regression considers each single point as an individual. However, pooled-OLS only relies on the between comparison which is not well adapted to our historical data. Although time period is short (4 years) we could expect some within variation. Thus, we perform a panel regression in order to take into account both between and within effects. To choose between fixed and random effects, a Hausman test has been run. For each panel regression, the test has concluded in favor of random effects. All pooled regressions have been corrected for heteroscedasticity.

According to the hypotheses, the main model tested is the following:

$$\text{Leverage} = \alpha + \beta_1 \text{Profitability} + \beta_2 \text{Tangibility} + \beta_3 \text{Size} + \beta_4 \text{Non-debt Tax Shield} \\ + \beta_5 \text{Risk} + \beta_6 \text{Political Risk}$$

Because, non-debt tax shield is incomplete for many firms, we omitted this variable from the regression:

$$\text{Leverage} = \alpha + \beta_1 \text{Profitability} + \beta_2 \text{Tangibility} + \beta_3 \text{Size} + \beta_4 \text{Risk} + \beta_5 \text{Political Risk}$$

Moreover, when we control for multicollinearity, we observed that two variables are linked: Size and Political Risk.

To correct this effect we chose to perform regressions without Size variable:

$$\text{Leverage} = \alpha + \beta_1 \text{Profitability} + \beta_2 \text{Tangibility} + \beta_3 \text{Risk} + \beta_4 \text{Political Risk}$$

Furthermore, since many of the indicator variables are scaled by total assets or average operating income, we were forced to delete a small number of observations that included negative values for one of these variables. This procedure is similar to the one of Titman and Wessels (1988).

Results:

The median total debt to total assets ratio was (.4159) for the whole sample, which is still much lower than the global median total debt to total assets ratio reported by Glen (2004) which was (.51) in 2000. Median total debt to total assets ratio in our sample was also lower than that in a sample of developed countries of (.52) and lower than that in a sample of emerging markets of (.49) in 2000 (Glen, 2004). This finding suggests that companies in these countries are mainly equity capital financed.

- Results on the capital structure determinants: Pooled-OLS

Profitability is found to have a significant negative impact on long term debt which is consistent with previous studies. One explanation for this inverse relationship between profitability and leverage comes from Myers' pecking order theory; as more profitable firms prefer internally-generated funds (retained earnings) on externally funds in the form of debt because the later is more costly. An alternative explanation is that high profitability is associated with high risk which would also lead to a negative relationship via the bankruptcy cost theory. Moreover, results are consistent with the fact that bond market in the majority of these countries is still underdeveloped. However, the coefficient is not significant for short-term debt; it seems that banks in our sample are less reluctant to provide enterprises with short-term loans than they do with long-term loans.

Tangibility is a measure of the collateral value of assets. The coefficient of tangibility is positive and statistically significant which is consistent with the bankruptcy cost theory. Creditors can moderate costs associated with debt by obtaining security interests in property, plant, equipment and inventory which permit them to take possession in case of failure.

The relation between size and leverage is still not obvious. While most empirical studies report a positive sign for the relationship between size and leverage. (Gaud, 2005; Daskalakis and Psillaki, 2007), others report a negative relation (Rajan and Zingales, 1995). We found that size have no effect on financial decision. It is right that large firms can borrow at better

conditions, but they also have easier access to equity markets. That is, lower cost is associated also with issuing equity as well as issuing debt.

Non debt tax shield was negatively related to only short term debt decision, and was consistent with the trade-off theory that focuses on the substitution between non-debt and debt tax shields. Tax deductions for depreciation seem to act as a substitute for the tax benefits of short term debt financing.

Long term financial decision is positively related to operating risk. This counter-intuitive finding has been previously reported by other findings in the US firms where leverage increases with increases in operating risk, and with the findings in the Asian emerging markets where volatility has a positive relationship with leverage (Supanvanij, 2006). An explanation of this result could be that long term debt increases the incentive of management to invest in profitable but risky projects.

Finally, the political risk didn't affect long term debt financing. However, the coefficient between political risk and short-term debt is positive and, this indicates that due to political risk, banks shift their lending preferences towards short-term debt rather than long-term debt.

A possible explanation to the puzzling finding in risk and size variables could be in the existence of information asymmetries and an underdeveloped state of the bond market in these economies, investor and debt holders protection rights and law enforcement are still developing, leaving, in one hand, debt holders unprotected in the event of default and though they may show reluctance to provide long term debt even to big sized companies when information asymmetries are high, and, in other hand, making the issuance of stock an easier financing option for big firms who may make use of it's well known names and reputations in what could be described as an immature investor markets.

When regressions are performed without the Non debt tax shield variable, this step eliminated many observations for which data about this variable could not be calculated. Results remain consistent with those found earlier except for short-term debt financing which is significantly negatively related with risk. Again, this result differs from theory and findings in previous studies. Our explanation is that in a context of high political risk, financial intermediaries prefer to allocate short debt to less risky firms.

Because of the multicollinearity between Size and Political Risk variables, we performed the regression without the size variable. Results were consistent with the previous regressions. The main difference was in the increase of explanatory powerful of Political Risk variable. This variable is significant for all leverage measure except for Long Term Debt / Total Asset.

- Results on the capital structure determinants: Panel Regressions

Findings are globally consistent with the previous ones. Long-term leverage still seems to be negatively related to profitability and positively linked with tangibility. Short-term leverage is also positively related with tangibility. Political risk is a significant variable depending on the regression. Total leverage is positively linked with Political Risk. On the restricted regressions, Short term debt appears also positively related to Political Risk. Globally, these

results lead us to conclude that Political Risk influences the capital structure of firms. In order to further examine an eventual size effect, we split the sample into five size quintiles and form two samples: the first sample gathers the first two quintiles and the second sample gathers the last two ones. The median quintile was deleted. Then, we perform panel regression (and a restricted regression without size and non-debt tax shield variables) for each both samples. We found contrasted results according to the size of the firms. Interestingly, the long-term debt ratio of the small-size firms is only driven by the tangibility whereas the short-term debt ratio is solely affected by political risk. However, long-term debt seems to be mainly negatively related to profitability for the large-size firms consistently with pecking order theory as pointed out above. Short-term debt is explained by none of the regression variables. In others words, when the political risk is high, the small firms are provided with short-term debt which is not the case for the large-size firms.

Capital structure has been extensively examined in many countries, mainly in economically and politically developed ones. Addressing the question of capital structure in other areas of the world turns rapidly to be challenging. The main problem is that researchers are faced with a lack of reliable data. The purpose of this research was to revisit capital structure using a unique dataset collected from the Gulf Region and Egypt firms. We try to examine if political risk influences firm's leverage, since the financial patterns of these firms are particularly interesting to observe because they exist in an economically and politically risky environment.

The empirical results imply that some of the Western capital structure theories are transparent. The pecking order, trade-off and agency theories partially explain corporate capital structure choices in our countries. Firms in our sample tend to rely more heavily on short-term debt than long-term debt in their capital structure than is typical in companies in developed markets. Some variables (e.g., operating risk, size) did not produce robust results, but were interesting in regards to the intensive official plans in these countries to open their markets economically and financially.

We found some stylized facts about the variable political risk indicating that when the political risk increases, banks shift their financing to short-term debt from long-term debt, especially for smaller-sized firms, which is not the case for bigger-sized firms.

The above differences and similarities reflect the emerging nature of the Gulf region countries and Egypt markets and their corporate environment. This paper contributes to the existing body of knowledge about emerging economics in this region, by testing traditional theories of capital structure and it's applicability to the Gulf region and Egypt firms in the years between 2004-2007.

Further work needs to be done to determine how some firm-specific factors (ownership, dividend policies) and country-specific factors (economic and financial openness) affect financial leverage in this particular region which combines between being politically risky on one hand and a haven of investment on the other hand.

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