STOCK MARKET LIBERALIZATION AND THE COST OF EQUITY CAPITAL: AN EMPIRICAL STUDY OF JSE LISTED FIRMS

BY

DANIEL MAKINA

PROMOTER: **PROF. MINGA NEGASH**
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ABSTRACT

The main objective of the study has been to provide new insights into ongoing recent studies examining the impact of stock market liberalization at both macro and micro (firm) levels. The study focused on a single country, South Africa, whose exchange, the Johannesburg Stock Exchange (JSE), liberalized in the 1990s. Consistent with empirical evidence from other studies the study finds support at market, firm and sectoral level for the prediction by international asset pricing models that stock market liberalization reduces the cost of capital. More important, the study makes five major contributions to the literature on the impact of stock market liberalization in emerging markets.

First, it demonstrates that some emerging market specific risks such as political and economic risks can act stronger binding constraints to foreign investment than direct legal barriers which foreign investors are frequently able to circumvent. The second contribution is the observation that there are some firms (in the minority however) that will experience a significant increase in the cost of capital following liberalization, a situation where the local price of risk is higher than the global price of risk, contrary to international asset pricing theory. The third contribution is that it has been empirically proved that the reduction in firms' cost of capital following stock market liberalization is permanent. It is not a transitory phenomenon. The fourth contribution of the study highlights the influence of firm specific characteristics such as size of the firm, book-to-market ratios and leverage ratios on firms' response to impact of stock market liberalization. The preference for large firms by foreign investors is supported, contrary to Merton's (1987) recognition hypothesis, and hence highlights the inconclusiveness of the debate on whether stock market liberalization benefits both large firms and small firms. The fifth contribution is the observation that the effective liberalization date is not the same for all firms but varies from firm to firm.

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