Evolving Capital Markets in the Era of Economic Uncertainty

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The recent years witnessed the setting-up of the new normal environment which is typically characterized by economic slowdown, and increased economic and financial uncertainty. In his recent article published by the Financial Times, Lawrence Summers, the former US Secretary of the Treasury mentioned the "secular stagnation".[1] The basic idea behind this is that the neutral real rate of interest (consistent with full employment) has fallen globally in the post-crisis period due to the expending of public resources on financial repair. This rate is expected to fall further below zero for a significant period in the future. This will lead global economies to fluctuate between slow growth and the growth observed in the period 2003-2007 relying on a wobbly financial base.

The frequent changes in economic uncertainty are another concern. They stem from the fact that the world's major nations are at different stages of their economic cycles. The slowdown in China and Japan may lead them to ease interest rates further, while the recovery in the United States and the United Kingdom may lead them to a tightening of the same. If the global economies were at synchronism with each other, then the markets would not be that chaotic and turbulent. Furthermore, rebellions against global integration in the West (by the leading U.S. presidential candidates against Trans-Pacific Partnership and the movement for a British exit from the European Union) are all adding to the ongoing turmoil and uncertainty.

Finally, there is a mixed sentiment during the new normal (or post-crisis period), which can be attributed to the above reasons: sluggish growth and economic uncertainty across the globe. This has led to the appreciation of the U.S. dollar and a depreciation of most currencies. This has increased the appeal of North American (United States and Canadian) financial assets over Europe,

[1] http://blogs.ft.com/larry-summers/2015/12/22/my-views-and-the-feds-views-on-secular-stagnation/

Asia Pacific and Latin America. Investors still expect stocks, real estate and precious metals to do well this year and plan to change their asset allocations accordingly. Investor sentiment is highest in Spain, China, France and United Kingdom, while it is lowest in Brazil. Policymakers need to heed the signs conveyed by the market before making any rash decisions.

The nine high-quality research papers, presented at the second Paris Financial Management Conference (PFMC-2014, 15-16 December 2014, Paris, France), we feature in this Special Issue are encompassed within this broader context. They can be categorized into two groups. The first group contains six papers which investigate some of the most important issues related to the dynamics of capital markets and corporate decisions within the new normal environment. The three papers in the second group address the consequences of recent crises on the behavior of financial markets and institutions as well as their stability.

New normal, capital market dynamics and corporate decisions

In their study "*Analyzing hedging strategies for fixed income portfolios: A Bayesian approach for model selection*", Wolfgang Bessler, Alexander Leonhardt, and Dominik Wolff pointed out stylized facts (e.g., volatility clustering, leptokurtosis and skewed returns as well as correlation spikes) of the EMU government bond portfolio returns during the recent sovereign debt crisis. These facts, coupled with the increasing level of uncertainty, have led asset managers to seek new hedging strategies. By analyzing single and composite hedges with the German Bund and the Italian BTP futures contracts and evaluating the out-of-sample hedging effectiveness for several competing models, these authors show that the Bayesian composite hedging strategy is useful during the public debt crisis and that it outperforms the others (OLS, constant and dynamic conditional correlation multivariate GARCH models). Low transaction costs and efficient futures markets are required conditions for the investors to take advantage of the hedging benefits.

The study "*Latency reduction and market quality: The case of the Australian stock exchange*" by Hamish Murray, Thu Phuong Pham, and Harminder Singh documents a positive impact of the latency reductions in the ASX on market quality, following the introduction of two new trading platforms (the Integrated Trading Platform and the ASXTrade). Low latency is indeed found to improve market liquidity, a condition that could increase operational efficiency and decrease adverse selection.

In the actual context of falling/low oil and commodity prices due to a negative demand shock, Zied Ftiti, Khaled Guesmi, and Ilyes Abid document in their paper "*Oil price and stock market* *co-movement: What can we learn from time-scale approaches?*" that oil-stock market linkages in the G7 developed countries are not alike and are more pronounced in shorter horizons than in longer horizons. Moreover, oil shocks originating from demand side have greater impacts on stock market returns.

Focusing on the Eurocurrency interest rates (interest rates denominated in different currencies), the paper "*Interest parity, cointegration and the term structure: Testing in an integrated framework*" by Dimitris A. Georgoutsos, and Georgios P. Kouretas failed to show the joint validity of the expectations hypothesis of the term structure and the uncovered interest parity. Their finding thus suggests the lack of integration in money markets and thus the relative policy independence between domestic and foreign monetary authorities.

The paper "*Impact of foreign directors on board meeting frequency*" by Peter D. Hahn and Meziane Lasfer and the paper "*Corporate debt maturity in the MENA region: Does institutional quality matter?*" by Basel Awartani, Mohamed Belkhir, Sabri Boubaker, and Aktham Maghyereh cover the recent trends in board meetings, impacts of foreign non-executive directors, and corporate debt maturity from firm perspectives. In essence, while the former shows that the combination of increased board diversity and reduced board meetings weakens the internal governance mechanism, reduces the advisory role benefits of foreign non-executive directors, and exacerbate agency conflicts, the latter documents a positive link between the use of long-term debt in MENA firms and institutional quality (stronger rule of law, better regulatory effectiveness, better legal protection of creditors, and more developed financial intermediaries).

Financial crises, market behavior, and stability

Given their increased interdependence and integration, financial markets around the world have been strongly hit directly and indirectly by the US subprime crisis in 2007, which led to the global financial crisis of 2008-2009. The advent of the European public debt crisis since 2010 also contributed to elevate the crisis effects, with particularly a sharp rise in systematic risk. Three papers of this special issue are concerned by the evaluation of the enormous impacts of these financial crises at both the market and sector levels."

In their paper "*Stock market risk in the financial crisis*", Paul A. Grout and Anna Zalewska offer an original view of financial crisis effects while attempting to assess how the market risk of a sector is affected by a change in another sector that affects the composition of the stock market. They refer it to composition effect. Considering the pre- and during crisis market risk of the industrial, banking and utilities sectors, their main results show evidence of a higher market risk for industrials sector during the crisis than pre-crisis in the US and for most of the G12 countries. In particular, the market risk of industrials sector during the crisis increases with the pre-crisis market risk of the banking sector and the overall magnitude of systemic risk in a country.

The study "*Will the crisis 'tear us apart'? Evidence from the EU*" by Vasileios Pappas, Hilary Ingham, Marwan Izzeldin, and Gerry Steele takes a close look at the integration of the 27 European Union (EU) financial markets before and during the recent global financial crisis. Their results from a multivariate ADCC-GARCH model and a Markov-Switching models mainly show that the global financial crisis did not affect the EU country members in the same way, with the more recent members entering the crisis regime with some time lags and being less adversely affected. In addition, the higher levels of sovereign debt and lower levels of industrialization have a positive impact on crisis duration and intensity. This lack of synchronization signals the low level of market integration in the EU and as a result, a common policy to solve the crisis problem is simply not effective.

The last but not least paper "*A lost century in economics: Three theories of banking and the conclusive empirical evidence*" by Richard A. Werner provides an excellent review of the three theories of banking during the past century and proposes a new test for all these theories in controlled environment by simulating a bank loan transaction and booking it as if it was a real transaction, through the use of the relevant banking software. The author provides evidence to reject the validity of the financial intermediation and the fractional reserve theories of banking, which simply implies that capital adequacy based bank regulation is ineffective.

To sum up, we believe that the collection of papers in this special makes a great contribution to the understanding of how financial crises affect the financial system and the behavior of all economic actors. The many insightful results and new findings can be very useful for designing appropriate regulatory framework and improving policy decision making in the context of an eventual crisis.

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