

DEVELOPMENT OF STOCK MARKET AND ECONOMIC GROWTH

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Abstract: *The paper examines the long-run relationship between development of stock market and economic growth in G-20 countries for the period 1980–2015. Using vector auto-regressive model for testing the Granger causalities, the study finds the presence of both unidirectional and bidirectional causality between development of stock market and per capita economic growth.*

Keywords: *Development of stock market Per capita economic growth Granger causality.*

Most studies on financial literature focus on the impact of financial markets and institutions on the economic development process and fund allocation to productive economic activities (Levine 1997). It is a commonly accepted fact that a wellfunctioning financial system constitutes a potential important mechanism for high economic growth by reducing information asymmetries, diversifying risks, mobilizing savings, reducing liquidity risks, directing the allocation of resources towards more productive uses, monitoring corporate controls, and facilitating resource mobilizations (Peia and Roszbach 2015; Enisan and Olufisayo 2009; Beck and Levine 2004; Levine and Zervos 1998; King and Levine 1993).

Numerous studies. have dealt with different aspects of this relationship at both theoretical and empirical levels (Law and Singh 2014; Pradhan et al. 2014). Overall, financial system is a multidimensional concept. The broadest division of a financial system is between financial intermediaries (banks, insurance activities, and pension funds) and markets (bond, stock, derivative, and commodity markets). A large part of an economy's savings are directed towards fruitful investments through financial intermediaries and markets. Since the rate of capital accumulation is a fundamental determinant of long-run economic growth, an efficient financial system is indispensable for an economy (Garcia and Liu 1999). In this paper, we scrutinize the relationship between per capita economic growth and four dimensions of the development of stock market, a sub-sector of the financial markets development.² Most of the studies provide wide-coverage on financial markets development, particularly with reference to banking sector development, and its link to economic growth. However, the inclusion of stock market in growth enhancing process is having low coverage and has received much less attention than that of banking sector development (see, for instance, Ngare et al. 2014; Peia and Roszbach 2015; Naceur and Ghazouani 2007; Arestis et al. 2001; Rousseau and Wachtel 2000; Beck et al. 2000; Levine et al. 2000; Harris 1997; King and Levine 1993).

The development of stock market and its role in economic growth is an important area of research in financial economics. A considerable number of theoretical and empirical studies on this linkage have appeared in recent years (see, for instance, Iqbal 2012). However in this study, we add the development of stock market coverage to the finance literature by addressing two important questions: first, the existence of cointegration between development of stock market (DoSM) and per capita economic growth (GDP); and second, the presence of long-run and short-run direction of causality between DoSM and GDP. The focus of this study is on G-20 countries during the period 1980–2015. The fact is that, like banking sector development, the development of stock market is a vital to high economic growth.⁶ In principle, development of stock market contributes to economic growth in many channels (Yartey 2008): first, by boosting domestic savings and increasing quantity and quality of investment; second, by providing an avenue for growing companies to increase capital at lower cost; third, companies in countries with developed stock markets are less dependent on banking finance, which can reduce the risk of a credit crunch; and fourth, stock market is also expected to perform like an ‘act of magic’ by permitting long term investment to be financed by funds provided by individuals, many of whom wish to make them available for only a very limited period, or who wish to be able to withdraw them at will (Iqbal 2012). Hence, like banks, stock market plays a central role in economic performance (Ngare et al. 2014; Korczak and Korczak 2013; Yartey 2008; Rousseau and Xiao 2007; de la Torre et al. 2007; Zhu et al. 2004; Rousseau and Wachtel 2000; Garcia and Liu 1999; Levine and Zervos 1998).

In analogy to other financial sectors like banking sector development (Uddin et al. 2013; Mukhopadhyay et al. 2011), the link between development of stock market and economic growth can be generalized in terms of four possible hypotheses (Enisan and Olufisayo 2009; Naceur et al. 2007). First, the supply-leading hypothesis (SLH) which contends that development of stock market is a necessary pre-condition to economic growth. Here, the causality runs from development of stock market to economic growth. The proponents of this hypothesis maintain that development of stock market may induce higher economic growth by facilitating savings in the form of financial assets and thereby spawning capital formation and hence, promoting economic growth. The studies supporting this hypothesis are Ngare et al. (2014), Peia and Roszbach (2015), Pradhan et al. (2013), Zivengwa et al. (2011), Akinlo and Akinlo (2009), Enisan and Olufisayo (2009), Nowbutsing and Odit (2009), Deb and Mukherjee (2008), Shahbaz et al. (2008), Argrawalla and Tuteja (2007), Nieuwerburgh et al. (2006), Levine and Zervos (1998) and Leigh (1997). Second, the demand-following hypothesis (DFH) which suggests that causality runs instead from economic growth to development of stock market. Supporters of the demand-following hypothesis suggest that development of stock market plays only a minor role in economic growth and it is merely an outcome of economic growth. The idea is that as an economy grows, additional stock market coverage may emerge in the financial market in response to

higher demand for financial services. The studies supporting this hypothesis are Pradhan et al. (2014), Peia and Roszbach (2015), Kar et al. (2011), Odhiambo (2008), and Dritsaki and DritsakiBargiota (2005). For Indonesia, Russian Federation, Saudi Arabia and Australia, there is a unidirectional causality from per capita economic growth (GDP) to development of stock market (GDP \Rightarrow SMC: stock market capitalization), whereas for Brazil, India, Mexico, Canada, France, Japan, Korean Republic and the United States, development of stock market causes per capita economic growth (SMC \Rightarrow GDP). Furthermore, for Argentina, South Africa, Germany and the United Kingdom, there is a bidirectional causality between development of stock market and per capita economic growth (SMC \Leftrightarrow GDP), while in the context of China and Turkey, per capita economic growth does not Granger cause development of stock market. Our study finds mixed evidence on the interrelationship between the development of stock market and per capita economic growth in the G-20 countries, both at the individual country and at the panel setting.

On some occasions, per capita economic growth leads to development of stock market, lending support to demand-following hypothesis of finance-growth nexus. On other occasions, it is the development of stock market that determines the level of per capita economic growth, lending support to supply-leading hypothesis of finance-growth nexus. There are also cases, where development of stock market and per capita economic growth are interdependent. That is the situation where both are self-reinforcing, supporting feedback hypothesis of finance-growth nexus. In addition, there are also cases, where development of stock market and per capita economic growth are independent of each other. That is the situation where both are neutral and subject to the support of neutrality hypothesis of finance-growth nexus.²³ The study accordingly suggests that in order to promote per capita economic growth, attention must be paid to policies that promote the development of stock market. This, in turn, requires efficient allocation of financial resources combined with wide-ranging movement in the stock market. Additionally, an establishment of a well-developed financial system, including well-functioning financial institutions and markets, particularly with reference to the development of stock market, can facilitate further investment and easier means of raising capital to support the economic activities in the economy. Given the possibility of reverse causality or bi-directional causality for some occasions, policies that increase per capita economic growth (such as actions to increase investment) would be desirable to bring the development of stock market. Therefore, it is suggested that government play a more positive role in order to foster the development of stock market and integrate with per capita economic growth (see, for instance, de la Torre et al. 2007; Claessens et al. 2006; Levine 1991). No doubt, in the globalization era, many developing countries have recognized the importance of financial markets development for high economic growth and accordingly, they have increased their efforts towards refining their financial systems.

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