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The effects of stock market development on growth and private investment in lower-income countries☆

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Abstract

Recent literature argues that stock market liberalisation has positive long- and short-run effects on macroeconomic growth and private investment, respectively. However, given a sample of up to 64 countries from 1981 through 1998, positive results for long-run growth are largely dependent on the inclusion of higher-income countries in regression samples, which limits the relevance for lower-income nations. Indeed, some evidence in this study indicates that stock market development has a more positive impact on growth for greater levels of per capita GDP, lower levels of country credit risk, and higher levels of legal development. Similarly, using a sample of 26 countries from 1981 through 1998, lagged equity price appreciation seems to boost private investment growth in the short-run, but only in rich countries. All in all, these results imply subdued enthusiasm regarding emerging equity market development.

JEL classifications: G1; G2; O16; F36

Keywords: Stock market liberalisation; Economic growth; Private investment

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1. Introduction

Recent literature germane to practitioners, policymakers, and academics argues that lower-income countries should liberalise their stock markets. This paper examines both the long- and short-term transmission mechanisms that support this component of capital account reform. The long-run view (Levine and Zervos, 1998a,b) argues that reform advances overall stock market development, which in turn enhances macroeconomic growth. The short-run view suggests that reform produces a one-time increase in stock prices, which in turn boosts private investment given the decrease in the cost of equity capital (Henry, 2000a,b).

This paper re-examines the final phases of both causal paths. First, considering the long run, several factors recommend re-examining the empirical link between stock market development measures and macroeconomic growth. Most germane to practitioners, previous econometric evidence includes higher-income countries in samples that produce positive relations, and a growing literature suggests that determinants of expansion differ across national income levels. Therefore, this study tests whether the positive correlation is robust in samples of exclusively emerging markets. If the relation between stock markets and growth is confined to higher-income countries, then the long-run perspective on stock market liberalisation would seem less applicable to poorer countries.

Second, with respect to the final phase of the short-run mechanism, this paper tests how private investment responds to changes in stock market valuation in both higher- and lower-income markets. While most research on Tobin's q and related mechanisms focuses on developed markets, particularly the United States (Barro, 1990), there is a dearth of evidence on emerging markets. Also, similar to the relation between stock market development and growth, this study examines the notion that the association between valuation changes and investment is more pronounced in higher-income cases. If the elasticity between valuation and investment is less salient or even non-existent in lower-income countries, then the short-run mechanism would also seem less persuasive for developing areas.

Section 2 outlines previous literature and econometric results, and Section 3 explains the motivation for re-examining the apparent positive empirical links between stock market development and growth in the long-run and between equity valuation and private investment in the short run. Section 4 presents the results regarding long-run growth, and Section 5 presents the results for private investment. Section 6 concludes.

2. Previous literature

A growing literature addresses the general merits of open capital accounts, with respect to foreign direct investment (FDI), portfolio investment (FPI), and bank lending (FBL). Given the focus on stock market behaviour and the real economy, this paper more specifically addresses sanguine perspectives on equity FPI. In his general overview of proposals for reducing 'global financial instability', Rogoff (1999) recommends a substantial shift from debt to equity finance. Briefly, he argues that equity finance introduces risk sharing, via reductions in moral hazard