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Financial development and stock returns: A cross-country analysis

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Abstract

We examine stock returns in a cross section of emerging and mature markets (49 countries) over the period 1980–1999. Stock returns are found to be significantly related to the degree of financial development. In general, a deeper and higher quality banking system is associated with lower volatility of stock returns and a greater synchronization in the movements of domestic and world returns. International synchronization is also greater the more liquid the stock market.
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1. Introduction

There exists a large literature dealing with the cross-country analysis of stock returns (Bekaert and Harvey, 1995, 1997; Erb et al., 1996a,b; Rouwenhorst, 1999).

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Interestingly, this literature has been exclusively preoccupied with the determinants of cross-country differences in stock return performance *within* a type of market (emerging or mature) rather than across different types. In this paper we pool emerging and mature equity markets together and investigate to what degree the observed cross-country differences in the moments of stock returns can be accounted for by an obvious but so far overlooked candidate, namely the level of financial development.[1]

Our motivation for investigating this relationship is based on the observation that the behavior of asset returns is related to the properties of the financial markets in two distinct ways. First, asset returns directly depend on how well the financial system carries out its main functions: the provision of liquidity, the facilitation of the trading, hedging and diversification of risk, the monitoring of managers and exertion of corporate control, etc. For instance, shortage of liquidity may exaggerate asset price movements. A segregated national capital market may experience smaller comovements with world markets. Surprisingly, these issues have not received any formal attention before. Secondly, financial markets affect asset prices indirectly through their effects on macroeconomic fundamentals (for instance, on the volatility of economic growth). The relationship between macroeconomic performance and financial development has been the subject of a substantial body of recent research.[2] A presumption seems to have emerged that financial development leads to higher economic growth. But the link between financial development and volatility seems to be ambiguous, both theoretically (Bacchetta and Caminal, 2000) and empirically (Beck et al., 2001).

In this paper, we examine quarterly stock returns in a group of 49 countries over the period 1980–1999. We employ standard measures of financial development, pertaining to the size and quality of the banking system as well as the liquidity of the stock market, that have been extensively used in the literature (see, e.g., Levine et al., 2000). The value of using several, alternative measures of financial development lies in the fact that as they represent different aspects of the financial system, they may help shed light on which elements of underdevelopment are responsible for the observed patterns (e.g., market size, efficiency, restrictions to international capital movements).

The results tend to differ somewhat depending on the indicator of financial development used and the currency of denomination of returns. Nevertheless, irrespective of the currency denomination of the returns, we find that financial development is significantly related to the behavior of the second moments of the distribution of stock returns. In general, "deeper" and more efficient banking

[1] This issue has been partly and indirectly studied in the context of the implications of financial liberalization (see Bekaert and Harvey, 1995; Stulz, 1999).

[2] See King and Levine (1993), Levine and Zervos (1998), Levine et al. (2000), Beck et al. (2000) for the relationship between financial development and growth. And Bernanke and Gertler (1990), Greenwald and Stiglitz (1993), Kiyotaki and Moore (1997), Aghion et al. (1999), Bacchetta and Caminal (2000), Beck et al. (2001), and Denizer et al. (2002) for the relationship between financial development and output volatility.

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