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Emerging equity markets and economic development[☆]

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Abstract

We provide an analysis of real economic growth prospects in emerging markets after financial liberalizations. We identify the financial liberalization dates and examine the influence of liberalizations while controlling for a number of other macroeconomic and financial variables. Our work also introduces an econometric methodology that allows us to use extensive time-series as well as cross-sectional information for our tests. We find across a number of different specifications that financial liberalizations are associated with significant increases in real economic growth. The effect is larger for countries with high education levels. © 2001 Elsevier Science B.V. All rights reserved.

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1. Introduction

We present new evidence on the relation between financial equity market liberalizations and economic growth for a collection of emerging economies. We

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find that average real economic growth increases between 1% and 2% per annum after a financial liberalization. Our results are robust across a number of different economic specifications. This analysis, of course, reveals no causality. However, even after we control for a comprehensive set of macroeconomic and financial variables, our financial liberalization indicator retains significance.

There is a substantial literature that tries to explain the cross-sectional determinants of economic growth. Barro (1991) and Barro and Sala-i-Martin (1995) explore the ability of a large number of macroeconomic and demographic variables to explain the cross-sectional characteristics of economic growth rates. More recent research in the growth literature has focused on the potential benefits of economic integration (the degree to which trade flows are free) and general financial development. For example, Rodrik (1999) examines the relation between openness to trade and economic growth with a standard cross-country regression methodology. With a proxy for the general openness to trade, the evidence suggests that the relation between economic growth and openness is statistically weak.

Following the development of endogenous growth models where financial intermediation plays an important role, there is also an interest in determining the influence of the financial sector on the cross-section of economic growth. King and Levine (1993) focus on several measures of banking development, and find that banking sector development is an important factor in explaining the cross-sectional characteristics of economic growth. Levine and Zervos (1998) explore the degree to which both stock market and banking sector development can explain the cross-section of economic growth rates. They find evidence in support of the claim that equity market liquidity is correlated with rates of economic growth. Additionally, they argue that banking and stock market development independently influence economic growth. They also find that there is little empirical evidence to support the claim that financial integration is positively correlated with economic growth.

Unlike previous work, we focus exclusively on the relation between real economic growth and financial liberalization. Our work is partially motivated by Bekaert and Harvey (2000) who examine the relation between financial liberalization and the dividend yield. While the dividend yield contains information about the cost of capital, it also houses information about growth prospects. A reduction in the cost of capital and/or an improvement in growth opportunities are the most obvious channels through which financial liberalization can increase economic growth. After finding reduced dividend yields for countries that undergo financial liberalization, Bekaert and Harvey also examine the relationship between economic growth and liberalization at very short horizons and find a positive association.

Our work is also distinguished by the extensive use of time-series as well as cross-sectional information. Indeed, the advent of financial liberalization suggests a temporal dimension to the growth debate that is not captured by the standard

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