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Stock market development and economic growth: Evidence from seven sub-Saharan African countries

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ABSTRACT

The paper examines the long run and causal relationship between stock market development and economic growth for seven countries in sub-Saharan Africa. Using the autoregressive distributed lag (ARDL) bounds test, the study finds that the stock market development is cointegrated with economic growth in Egypt and South Africa. Moreover, this test suggests that stock market development has a significant positive long run impact on economic growth. Granger causality test based on vector error correction model (VECM) further shows that stock market development Granger causes economic growth in Egypt and South Africa. However, Granger causality in the context of VAR shows evidence of bidirectional relationship between stock market development and economic growth for Cote D'Ivoire, Kenya, Morocco and Zimbabwe. In Nigeria, there is a weak evidence of growth-led finance using market size as indicator of stock market development. Based on these results, the paper argues that stock markets could help promote growth in Africa. However, to achieve this goal, African stock markets need to be further developed through appropriate regulatory and macroeconomic policies.

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1. Introduction

The relationship between financial development and economic growth has been debated quite extensively in the literature, yet the direction of causality relationship remains unresolved. The debate has focused on whether financial development causes economic growth or economic growth causes financial development or whether a two-way relationship exists. While some studies found

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a unidirectional causality running from financial development to economic growth; others reported the obverse. Few other studies found evidence of bidirectional relationship while a handful provided evidence of neutrality of finance and economic growth¹. However, the general observation from the literature is that most studies on the causal relationship between financial development and economic growth have focused on developed economies. Although few studies, based exclusively on African data, exist on the finance–economic growth puzzle, none has considered the relationship between the stock market of financial development and economic growth. For most of the studies on stock markets in Africa, the emphasis has been on testing for market efficiency, development of the stock markets and the impact of economic variables on stock markets². Moreover, none of the known existing studies have used the autoregressive distributed lags (ARDL) bounds test in examining the causal relationship between stock market development and economic growth³. Hence, the objective of this paper is to investigate the cointegration and causality relationships between stock markets development and economic growth using the ARDL bounds test and the Granger causality (GC) test based on vector error correction model (VECM). The paper contributes to empirical literature in many ways. First, it investigates the long run link between stock markets and economic growth focusing exclusively on Africa. This is important considering the characteristics of the African stock markets. They are relatively recent in origin, small by world standards and faced with low price earnings multiplier as well as inadequate regulatory framework. Secondly, the application of the ARDL and the GC test based on VECM is an innovation that helps to obviate the problem associated with the estimation of short time series data.

The structure of the paper is organized as follows. Section 2 provides a brief summary of theoretical and empirical issues on relationships between stock markets and economic growth. Section 3 gives the methodology adopted in the work. Section 4 provides the discussion of the results. The last section contains the concluding remarks.

2. Literature review

2.1. Theoretical issues

The idea that financial development promotes growth was first put forth by Schumpeter as early as 1911 (Schumpeter, 1912). Several other economists have investigated this relationship and hold the view that financial development is a necessary condition for achieving high rate of economic growth (Goldsmith, 1969; Mckinnon, 1973; Shaw, 1973). This is what Patrick calls the ‘supply leading’ role of financial development. Financial development is seen as contributing to economic growth through various channels: (i) efficient allocation of capital as the proportion of financial saving in total wealth rises, (ii) mobilization of savings by providing attractive instruments and saving vehicles, (iii) provision of vehicles for trading, pooling and diversifying risk, (iv) lowering of cost of gathering and processing information and thereby improve the allocation of resources and (v) increased specialization in production, development of entrepreneurship and adoption of new technology. In short, it is argued that the existence of a well functioning financial sector will assist in the mobilization of limited resources from the surplus units to the deficit units thereby promoting efficient allocation of resources and thus lead other economic sectors in their growth process.

In contrast, is the view called ‘demand following’ argument. According to this view, financial development is viewed as the handmaiden of economic development, reacting passively to the demand for financial services by a growing economy (Robinson, 1952; Romer, 1990; Stem, 1989). The development in the financial sector is facilitated by growth in the real sector of the economy. The argument is that

¹ The pioneer work on the causal relationship between financial development and economic growth by Gurley and Shaw (1955), Goldsmith (1969), Shaw (1973) and Mckinnon (1973) concluded that the development of the financial markets was significantly connected with the level of per capita income. However, Robinson (1952), Stem (1989) and Romer (1990) found that growth causes finance.

² Some of the studies include Bundoo (2000), Osei (2002); Mlambo and Biekpe (2003) and Jefferis and Okeahalam (2000).

³ Most existing studies have adopted either simple OLS regression (Levine & Zervos, 1993); Instrumental variables procedure (Beck et al., 2000); difference panel estimator (Rousseau & Wachtel, 2000); Generalized method of moment technique (Beck & Levine, 2002). Some have equally used cointegration and error correction approach (Arestis et al., 2001; N’zue, 2006; Rousseau & Sylla, 2005).

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