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Stock markets, banks, and economic growth: Empirical evidence from the MENA region[☆]

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Abstract

Over the last four decades, a wide theoretical debate is concerned with the fundamental relationship between financial development and economic growth. Recent studies shed some light on the simultaneous effect of banks and financial system development on growth rather than a separate impact. The empirical study is conducted using an unbalanced panel data from 11 MENA region countries. Econometric issues will be based on estimation of a dynamic panel model with GMM estimators. Thus, peculiarities of MENA region countries will be detected. The empirical results reinforce the idea of no significant relationship between banking and stock market development, and growth. The association between bank development and economic growth is even negative after controlling for stock market development. This lack of relationship must be linked to underdeveloped financial systems in the MENA region that hamper economic growth. Then, more needs to be done to reinforce the institutional environment and improve the functioning of the banking sector in the MENA region. Based on these results, other regions at the same stage of financial development such as Africa, Eastern Europe or Latin America should improve the functioning of their financial system in order to prevent their economies from the negative impact of a shaky financial market.

JEL classification: E44; O16; C33

Keywords: Bank development; Stock market development; Economic growth; Dynamic panel data models; MENA region

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1. Introduction

Theory gives contradictory predictions about the incidence of financial system development on economic growth, and about the separate impact of banks on growth and financial markets on growth. Boyd and Prescott (1986) argue that banks ease information frictions and therefore resource allocation while Stiglitz (1985) and Bhide (1993) defend the idea that banks are more efficient than equity markets in improving resource allocation and corporate governance. However, some models[1] stress that competitive stock markets reduce the counterproductive monopoly power of banks and boost innovation projects. Finally, some theories argue that banks and stock markets contribute together to economic growth by improving information dissemination and reducing transaction costs.

Most of the studies about the association between financial system development and economic growth omit stock markets development. We have to wait the publication of a study conducted by Levine and Zervos (1998) who empirically assess the relationship between both stock marketss and banks development and economic growth. However, their work suffers from many econometric problems. Although recent works have tried to solve some of the statistical shortcomings observed in this approach, statistical and conceptual issues remain. Rousseau and Wachtel (2000) provide a huge contribution to the growth literature by using panel data techniques. In order to study the relationship between stock markets, banks and economic growth, they use the difference panel estimator method developed by Arellano and Bond (1991) and show that both stock markets and banks development contribute to spur economic growth.

This paper uses new econometric techniques in the panel data context that solve statistical drawbacks with available data from 11 MENA countries observed over the period [1979–2003] in order to examine the relationship between stock markets, banks and economic growth. We choose MENA countries to carry out our empirical investigations not only because very few studies have been devoted to the region, but also because the size and the structure of the financial systems differ sensibly between these countries and because MENA countries embarked since mid 1980s in far reaching financial reforms. Besides, the results stemming from MENA region could be of interest to other developing countries in the same stage of financial development for instance like African, Eastern European and Latin American countries that are reforming a great deal their financial systems. More specifically, we test whether stock markets and banks development each have a positive impact on economic growth after controlling for simultaneity bias, omitted variables, and the routine inclusion of lagged dependent variables in growth regressions and controlling for many other growth determinants. We also examine whether variables related to banks and stock markets jointly enter the growth regression significantly taking advantage of the finding in recent growth studies that emphasize the importance of using panel data analysis in examining cross-country growth dynamics.

The rest of the paper is organised as follows. In Section 2, we discuss the relatively recent literature on finance and economic growth. Section 3 discusses the data sources, definitions of the variables used in our empirical work as well as the econometric modelling. Empirical results are presented in Section 4. Some concluding remarks are presented in Section 5.

[1] See Allen and Gale (2000).