Ethical behavior and trustworthiness in the stock market-growth nexus

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While formal institutional quality has been used to explain the finance-growth nexus, the role of social capital has not been fully addressed. The proposition of “better finance, more growth” is important amidst concerns over the erosion of ethics and trust in finance in the aftermath of the 2007/2008 global financial crisis. Using threshold estimation technique, this study examines whether the growth effect of stock market development differs according to the distinct levels of ethical behavior and trustworthiness in a cross-section of 73 jurisdictions during the post-crisis period. The results demonstrate that the impact of stock market liquidity on gross domestic product (GDP) and total factor productivity (TFP) growth is positive and significant only where there is high level of ethical behavior in firms. Similar effect is discerned in the case of strong trustworthiness and confidence. However, there is mixed evidence when formal institutional quality in the form of regulation and supervision of securities exchanges is considered. In terms of policy implications, this study upholds the “better finance, more growth” proposition and contributes to the identification of thresholds above which ethical behavior and trustworthiness can influence positively the relations between stock market development and macroeconomic performance.

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1. Introduction

The financial crisis of 2008 and the manipulation of the London Bank Interbank Offered Rate epitomize the deficiencies of the modern corporation that have resulted in an emergence of a trust and ethical crisis (Mayer, 2013). The prevailing low level of trust in the stock market was evident among people in the United States who attributed the crisis to managers’ greed and bad corporate governance (Sapienza and Zingales, 2012). In fact, financial services and banks still remain the least trusted industries according to the Edelman Trust Barometer results in 2012 and 2013. Causes of these financial services and banks scandals are mainly internal factors that are within business’ control such as corporate culture driven by risk-misaligned compensation, corruption and conflict of interest. As a result, the role of finance in promoting growth has been called into question since a financial system that performs its functions poorly will tend to curtail economic opportunities and destabilize economies (Čihák et al., 2012).

In this regard, a contention emerges stressing the importance of institutions as necessary enabler of a positive finance–growth relation. This contention is well-placed given that financial transactions operate under the backdrops of financial market frictions and asymmetric information. Several studies have suggested that “better finance, more growth” is the more appropriate proposition than “more finance, more growth”. The former is grounded on the notion that a financial system entrenched in sound institutional scaffolding of property rights, transparency, justice, trust and ethics, promotes economic growth.

For example, Arestis and Demetriades (1999) suggested that the presence or absence of good governance is likely to affect the causal relationship between banking sector development and economic growth. Negative correlation between economic growth and financial development (measured in terms of currency, narrow money and broad money) can also be attributed to weak regulatory environment that hampers the efficiency of financial institutions in the allocation of their resources (Al-Yousif, 2002). Empirical works such as Demetriades and Law (2006) show that banking sector development has greater effect on growth when the banking system is operating within a sound institutional framework. The effect is particularly prominent in middle-income countries which are characterized by higher institutional quality. However, in low-income countries, financial development in the absence of strong institutions may not yield the desired economic outcomes in the long term. Recently, Law et al. (2013) find that banking sector development has a significantly positive impact on growth only after exceeding a certain institutional quality threshold (control of corruption, rule of law, bureaucratic quality or government effectiveness).

While most studies have examined the role of formal institutions such as governance and rule of law in the banking sector development and growth nexus, there is a smaller set of literature that examines the inter-linkages between the informal aspects of institutions, stock market development and total factor productivity (TFP). Informal institutions are equally important as formal institutions do not develop in a vacuum (Dasgupta, 2011) and their functioning depends on “a prior sense of moral community, that is, an unwritten set of ethical rules or norms that serve as the basis of social trust” (Fukuyama, 1995, p. 90). As part of institutions, ethical rules, shared norms and social trust are important dimensions of social capital and are an ever-ready social lubricant that permits voluntary participation in production and exchange (Arrow, 1974).

In the case of the stock market, only investors with high enough trust will invest in stocks. Less trusting investors are less likely to purchase stock, and even if they participate in the stock market, they will purchase fewer stocks (Guiso et al., 2008). Trust is associated with stock market development and appears to be a key complement to formal institutions when a society has little regard for the latter, vice versa (Calderón et al., 2001). However, Law and Ibrahim (2013) found that the role of social capital is more prevalent in the banking sector development when institutional quality is low, but there is no significant relationship between social capital and stock market development.

Empirical studies show that trust has significant impacts on aggregate economic activity, and can promote savings and foreign direct investment (Knack and Keefer, 1997; Zak and Knack, 2001; Guiso et al., 2009). However, the relationship between social capital and TFP is mixed. While Dettori et al. (2012) showed that a large part of TFP differences is elucidated by disparities in the endowments of
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