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Stock market development and economic growth in Africa

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ABSTRACT

The objective of this study is to investigate the role of stock market development on economic growth in Africa. It uses annual data from a panel of 36 countries, of which 18 have stock markets, in Africa over the period 1980–2010. Panel data econometrics technique is used in data analysis. Our main findings are as follows: (i) countries with stock markets tend to grow faster compared to countries without stock markets, (ii) countries which are relatively developed and have stock markets tend to grow less faster compared to small countries with stock markets, (iii) Stock market development has a positive effect on economic growth, (iv) investment, human capital formation and openness positively influence economic growth in the Africa region, (v) macroeconomic instability (inflation) and government consumption impact economic growth negatively, and (vi) countries that are politically stable and less corrupt tend to grow faster.

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1. Introduction

The central role of the financial sector in economic growth has received a considerable attention since the pioneering work of Gurley and Shaw (1955), who argued that financial sector development promotes economic growth by enhancing physical capital accumulation. Following this evidence, studies by McKinnon (1973) and Shaw (1973) showed that financial sector development is key to economic growth subject to dismantling financial repression. This finding generated research interest; however, such an interest was mute in Africa until after the 1980s when the financial sector was liberalised in a number of countries. This interest arose following the financial sector reforms that were initiated in the 1980s in nearly all the countries in Africa. The theoretical justification for these reforms may be traced to McKinnon (1973) and Shaw (1973). However, these two studies did not explicitly outline the role of stock markets; – in fact Shaw argued that the development of stock markets in early stages of development may be very expensive for developing economies. Stock markets impact on the economy in the following ways: (i) it helps in savings mobilisation and therefore increasing the savings rate thus facilitating higher capital formation and economic growth, (ii) it reduces investment risks owing to the ease with which equities are traded. This therefore implies that the stock markets play a central role in economic performance.

A more structured analysis of the central role of stock market is due to Cho (1986) study which shows that credit markets cannot work efficiently without stock markets. More recently, the role of stock market development in macroeconomic performance has been investigated (see Adenuga, 2010; Boubakari & Jin, 2010; Carp, 2012; Enisan & Olufisayo, 2009; King & Levine, 1993; Levine, 2004; Levine & Zervos, 1998). Evidence from mature markets reveals that the stock markets development tend to be associated with key macroeconomic variables such as private investment (see Arestis, Demetriades, & Luintel, 2001; Khan & Kumar, 1997) and economic growth (see Atje & Jovanovic, 1993; Levine & Zervos, 1998; Obstfeld, 1994). In Africa, however, the contribution of stock market development on macroeconomic variables has not been adequately addressed. Most of the cross-country studies on Africa that come close to analysing financial development and economic growth tend to be biased towards the banking sector variables (see Demirgüç-Kunt & Maksimovic 1998; King & Levine, 1993; Levine, 1997; Misati & Nyamongo, 2011a, 2011b; Nyamongo, Misati, Kipyegon, & Ndirangu, 2012), while abstracting from the stock market development variables. This therefore tends to give an unbalanced view of the contribution of the financial sector on economic growth in Africa.

In addition, some time series studies on stock market and economic growth on specific countries in Africa are available in the literature (see Aknilo & Egbetunde, 2010; Enisan & Olufisayo, 2009; Ezeoha et al., 2009; Nurudeen, 2009; Obamiro, 2005; Osamwonyi & Kasimu, 2013); however, these studies are not rich enough to address the dynamics associated with panel datasets. The sparse nature of studies in this area on Africa may be because most countries introduced stock markets in the 1990s and therefore sufficiently long time series may not be available for meaningful analysis. In addition, the number of countries which have stock markets has increased in the 1990s and therefore good quality panel datasets were not available until recently when such datasets became available. It is in the view of these gaps in the literature that we conduct a cross country analysis targeting the African region. This may help to understand whether or not Africa is different.

The rest of the paper is organised as follows: Section 1.1 discusses the evolution of stock market indicators and economic growth in Africa. Section 2 presents the model and discusses the factors that explain growth. It also discusses the concept of causality between the stock market development and economic growth. Section 3 discusses the empirical findings while Section 4 concludes.

1.1. Evolution of stock market development and economic growth in Africa

The level of stock market development varies greatly in Africa as shown in Fig. 1. Based on the data on the market capitalisation to GDP for 2010, it is found that during this time, the market capitalisation to GDP was highest in South Africa at 278 percent. The rest of the countries have ratios that were far below that posted by South Africa. For example, Morocco had 75.8 percent followed closely by Mauritius at 66.8 percent and Kenya at 46.4 percent. During this time Uganda, Tanzania and Swaziland had the lowest ratios amongst the countries surveyed.