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Equity markets and growth: Cross-country evidence on timing and outcomes, 1980–1995

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Abstract

The rapid expansion of organized equity exchanges in both emerging and developed markets has prompted policymakers to raise important questions about their macroeconomic impact, yet the need to focus on recent data poses implementation difficulties for econometric studies of dynamic interactions between stock markets and economic performance in individual countries. This paper overcomes some of these difficulties by applying recent developments in the analysis of panels with a small time dimension to estimate vector autoregressions for a set of 47 countries with annual data for 1980–1995. After describing recent theories on the role of stock markets in growth and considering a pure cross-sectional empirical approach, our panel VARs show leading roles for stock market liquidity and the intensity of activity in traditional financial intermediaries on per capita output. The findings underscore the potential gains associated with developing deep and liquid financial markets in an increasingly global economy. © 2000 Elsevier Science B.V. All rights reserved.

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1. Introduction

The explosive growth of organized equity exchanges in emerging and developed markets in recent years, especially in light of events in the East Asian economies, has prompted policymakers to raise important questions about their macroeconomic impact. [1] The relative brevity of this global expansion, however, poses implementation difficulties for dynamic studies of the effects of growth in equity markets within individual countries. At the same time, advances in the analysis of panel data have made it possible to explore dynamic links between stock markets and growth in a cross-country framework. This investigation applies one such technique to annual data from 1980 to 1995 (i.e., the eve of the East Asian financial crises) for 47 countries and finds strong support for the notion that deep and liquid equity markets have had a significant and persistent impact on economic performance.

Specifically, we examine the relationship between equity markets and economic growth with panel data vector autoregressions that apply the generalized method of moments techniques developed by Holtz-Eakin et al. (1988) and Arellano and Bond (1991). Our dynamic panels, which are the first to our knowledge to apply VAR estimation with annual data to a cross-country context, allow us to explore the directions of causality between the growth of stock markets and economic outcomes. The size of equity market effects on output are then assessed with the use of impulse response functions. The VARs include measures of activity for traditional intermediaries, such as banks, as well as for organized exchanges in an attempt both to distinguish stock market effects from those attributable to the financial sector generally and to characterize their interactions.

We explore the effects of two aspects of stock market development: the size of the market as indicated by total market capitalization and a combination of size and liquidity in the market as indicated by the volume of trading activity. In both instances, the measures of stock market activity will increase when local share prices increase as a consequence of expected profitability or some other reason. For this reason, and in order to focus on market development, we deflate the measures of market activity for each country with its index of local share prices. To the extent that share prices in an efficient equity market incorporate current information about future economic prospects, this deflation cleanses our measures of market activity of any "forward-looking" component that is directly related to stock prices. Even after applying these adjustments,

[1] Increases in the market value of outstanding equity among exchange-listed companies in 33 emerging markets from $238 billion in 1986 to over $1.8 trillion in 1995 reflect the size of the expansion. Market capitalization also rose from $6.2 trillion to $15.8 trillion in 23 developed markets over the same period (International Finance Corporation, 1998, pp. 16–17).

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