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Banking industry volatility and economic growth

Fariborz Moshirian^a, Qiongbing Wu^{b,*}

^a Australian School of Business, The University of New South Wales, Sydney, NSW 2052, Australia

^b School of Business, The University of Western Sydney, Locked Bag 1797, Penrith South DC, NSW 1791, Australia

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ABSTRACT

Utilizing the recent dynamic panel GMM estimation techniques for 36 markets, this research investigates the relationship between banking industry volatility and future economic growth, and provides empirical evidence complementary to Cole et al. (2008) who examine the finance-growth nexus from a unique asset pricing theory perspective and document a positive relationship between bank stock returns and future economic growth that is significantly influenced by a series of country-specific and banking institutional characteristics. We find that the negative link between banking industry volatility and future economic growth is significantly affected by government ownership of banks, the enforcement of the insider trading law, systemic banking crises, and bank accounting disclosure standards, while the impact of financial development is ambiguous. The significant results are primarily driven by the data from emerging markets.

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1. Introduction

Previous empirical studies have strongly supported the theoretical proposition that the banking system is an essential determinant of a country's economic development.¹ A well-functioning banking system significantly promotes a country's economic growth; while a banking crisis, resulting from malfunction of the banking system, exerts an independent negative real effect (Dell'Aricca et al., 2008; Campello et al., 2010), and causes serious disruptions of a country's economic activities (Hoggarth et al., 2002; Boyd et al., 2005; Hutchison and Noy, 2005; Serwa, 2010). The recent banking crises triggered by the subprime mortgage crisis in the U.S. have caused a contagious chaos in the global

* Corresponding author. Tel.: +61 2 96859151; fax: +61 2 96859105.

E-mail address: q.wu@uws.edu.au (Q. Wu).

¹ See Levine (2005) and Cole et al. (2007) for the review on the literature.

financial markets and have subsequently led to a global economic recession. Empirical research also suggests that the performance of banks and the impact of the banking system on economic growth are significantly influenced by a country's institutional framework, such as government ownership of banks (La Porta et al., 2002; Micco et al., 2007; Cornett et al., 2010) and institutional environment (Naceur and Ghazouani, 2007).

Following a number of studies (e.g., Levine and Zervos, 1998; Beck et al., 2000; Levine et al., 2000; Beck and Levine, 2004) which demonstrated that a sound banking system promotes better economic growth, Cole et al. (2008) investigate the relationship between banks and economic growth from the unique view points of market efficiency and asset pricing theory. Publicly traded banks are broadly representative of a country's banking sector. In an efficient market, banks' stock prices will reflect their expected future cashflows, which in turn depend on the performance of the projects they financed. Therefore, banking industry stock returns will broadly reflect the performance of a country's banking sector. Since banks have played such an important role in promoting economic growth, there should be a relationship between bank stock prices and future economic growth. Not surprisingly, using the data from eighteen developed and eighteen emerging markets, they find a positive and significant relationship between bank excess return and short-term future economic growth that is independent of the market excess return, and this relationship is significantly affected by a series of country-specific and banking institutional characteristics.

In this paper, we extend the work of Cole et al. (2008) and examine the relationship of bank stock prices and economic growth from a different angle. Bank excess return reflects the performance of a country's banking sector, while bank volatility may indicate the stability of bank performance. A certain degree of volatility is desirable since it reflects information flows in the efficient market, while "excessive" changes of stock prices may signify uncertainty of the future economic state. Naes et al. (2011) observe that stock volatility increases prior to economic recession. Moshirian and Wu (2009) find that banking industry volatility is a good predictor of a country's banking crises. The recent global economic recession had seen the global financial turmoil led by extreme volatility of banking industry stocks. Therefore, it is worthwhile to extend Cole et al.'s (2008) research and examine whether banking industry volatility contains information about future economic growth, and how those country-specific and banking institutional characteristics that affect the relationship between bank excess return and future economic growth influence the relationship between bank volatility and future economic growth.

We address the issue using the recent generalized-method-of-moments (GMM) techniques for dynamic panel estimations. We first construct the portfolios of banks listed in domestic stock exchanges for 36 markets, including 18 developed markets and 18 emerging markets. We utilize the disaggregated approach from Campbell et al. (2001) to measure banking industry idiosyncratic volatility. This approach enables us to extract the banking industrial shock from the market and take into account the market capitalization of the components and the variations of all individual bank stock prices *within* the period rather than between the periods. We then examine the relationship between bank volatility and future economic growth for the panel data using dynamic panel GMM techniques, and investigate the impact of country-specific and banking institutional characteristics on the relationship between bank volatility and economic growth. We analyze the panel data for the full sample of all markets and the subsamples of developed markets and emerging markets respectively. We also run fixed-effect OLS panel estimations to check for robustness.

This research extends the literature on banks and economic growth, and is related to the literature on stock markets and growth.² Most of the empirical studies on the relationship between stock markets and short-term economic growth focus on stock market returns, which emerge from the asset pricing literature with the initial purpose of examining the sources of variation in stock returns (Fama, 1981, 1990; Schwert, 1990; Liew and Vassalou, 2000). Empirical research on stock market volatility and economic growth is relatively sparse. In the cross-country studies, Levine and Zervos (1998) show that the initial level of stock market volatility is not robustly associated with long-run economic growth using data from 47 countries over the period from 1976 to 1993. By utilizing the vector autoregression (VAR) methodology, Arestis et al. (2001) find that the link between stock market volatility and future

² The detailed review of these two strands of literature can be found in Cole et al. (2007).

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