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Property rights and the stock market-growth nexus

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ABSTRACT

Using threshold estimation techniques, this study examines whether the growth effect of stock market development differs according to the different levels of property rights and minority shareholders protection in a cross-section of 85 jurisdictions during the post-crisis period. The results demonstrate that the impact of stock market liquidity on growth is positive and significant only in jurisdictions where there is high level of property rights protection. Similar effect is discerned in the case of strong minority shareholders protection. Using the market size as a measure of stock market development, the paper also documents a positive growth effect of market size when property rights and minority shareholders protection are strong. However, there is mixed evidence in the low to medium degrees of protection. Further analyses using other broader governance indicators as threshold variables and instrumental variable threshold regressions reaffirm the main findings. The study upholds the "better finance, more growth" proposition and contributes to the identification of thresholds above which institutional quality can positively shape the impact of stock market on economic growth.

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1. Introduction

The importance of financial development as a catalyst for long-term economic growth is an issue that has received intense discussion in recent years. It is generally viewed that well-developed financial markets and financial intermediaries facilitate the allocation of capital to the corporate sector, enhance resource allocation, and enable firms to raise capital essential to long-term investment, and consequently bring positive ramifications on economic growth (King & Levine, 1993; Levine, 1997; Beck, Levine, & Loayza, 2000; Wurgler, 2000). Despite extensive early cross-country evidence establishing positive contributions of finance to economic growth, country-specific studies have noted vast variations in the finance-growth causal nexus.

In recent years, two trends of studies have emerged. First, concerns over financial systems in some countries being too large vis-à-vis the size of the economy and being a drag on growth have reignited the interest of policymakers and academics to reexamine whether too much finance is growth-impeding. Research at the Bank for International Settlements (BIS) and the International Monetary Fund (IMF) suggests that financial development may only be good up to a certain level, after which it becomes a drag on growth (Arcand, Berkes, & Panizza, 2012; Cecchetti & Kharroubi, 2012). A more recent research by Law and Singh (2014) also reinforces these findings on the importance of having an optimal level of financial development in order to spur growth.

Second, the recent recurrences of financial crises and economic meltdowns have called into question whether finance is necessarily growth-enhancing. These developments have prompted the inclusion of policy conditionality such as inflation, income and institutional quality to complement the study of the finance-growth nexus. For example, high and volatile inflation distorts the ability of financial development in efficiently allocating capital, thereby reducing the positive effects of finance on economic growth (Huang, Lin, Kim, & Yeh, 2010). Evidence on the relationship between financial development and growth becomes mixed when income level is used as a policy condition. While Deidda and Fattouh (2002) find evidence of a significant and positive relationship between financial development and growth in high-income countries, Huang and Lin (2009) demonstrate that the positive effect is larger in the low-income countries.

Particularly relevant to the restoration of trust and confidence in the financial system is the role of institutional quality as a necessary enabler of a positive finance-growth relation. In the presence of strong institutions and good governance that protects investors' rights and attract investment, financial development can efficiently allocate capital to productive use in the economy as evidenced in several empirical studies. Arestis and Demetriades (1999) suggested that the presence or absence of good governance is likely to affect the causal relationship between financial 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 a weak regulatory environment that hampers the efficiency of financial institutions in the allocation of their resources (Al-Yousif, 2002). Building on the idea by Arestis and Demetriades (1997) and Demetriades and Andrianova (2004), empirical works such as Demetriades and Law (2006) show that financial 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. In a more recent study, using in a cross-country analysis for 85 countries, Law, Azman-Saini, and Ibrahim (2013) reaffirm the importance of institutions in shaping the relations between financial development and economic growth. Specifically, they find that the growth effect of banking sector development is contingent on formal institutional qualities such as control of corruption, rule of law, bureaucratic quality or government effectiveness. According to their results, banking sector development exerts positive influences on real growth only when these institutional quality indicators exceed certain thresholds.

All the aforementioned studies suggest that "better finance, more growth" has become the more appropriate proposition than "more finance, more growth". The former is grounded on the notion that a financial system entrenched in a sound institutional framework promotes economic growth. Where such institutions are in place, the financial system can play a pivotal role in the optimization of resource allocation. It is therefore the quality rather than the quantity of finance that matters more to

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