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Does capital flows lead to stock market development and economic growth? An enquiry into the existing literature

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Abstract

Role of foreign capital inflows in stock market development and economic growth is a widely debated topic. This paper analyses the existing literature on the long-run short run linkage between stock market development and economic growth via the capital inflows. Equity market development is desirable and necessary for complete financial liberalization. At the same time, foreign investments with flexible exchange rate should be encouraged to foster both stock market and economic growth.

***Keywords**: Capital Flows, stock market, Economic Growth*

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Introduction

Foreign capital inflows (FCI), in any economy, have been considered as the *messiah* for both stock market development and economic growth. The additional capital raised for investing in developed and emerging economies satisfies the much needed resource inflow during financial crunch experienced by these economies. What does the existing literature tell us? Let us take a look at the various studies which focuses on this core theme.

Studies on capital flows, stock market development and economic growth

Gurley and Shaw (1955)[1] opine that as countries develop, self financed capital development will be increasingly replaced by intermediated debt finance and later equity markets for raising external funds emerge and develops. The financial structure i.e. financial intermediaries and markets changes as countries develop. Asli Demirguc Kunt and Ross Levine (1996) have brought out evidences in support of the Gurley and Shaw theory.

In 1970's Mckinnon (1973) [2] and Shaw (1973)[3] studied the relationship between financial development and economic growth. They argued that government manipulation of interest rates and allocation of resources causes distortions in the economy. This in turn leads to negative effect on allocative efficiency and saving

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investment in less developed countries. Hence they point out that financial liberalization is essential for the removal of distortions. But the study fails to incorporate the role of capital markets in the context of liberalization. They also remain silent on the trickledown effect of unplanned and unfocussed liberalization.

Cho (1960)[4] developed the McKinnon Shaw ideology by introducing the role of stock markets. They found that banks fail to achieve efficient capital market allocation due to imperfect credit market information. Equity markets have superior information and hence they fare better than banks in capital allocation. They suggest that equity market development is desirable and necessary for complete financial liberalization. The drawback of the study emerges from the fact that it focuses on the allocative function only and ignores the impact of the financial markets on the real economy.

Mayer (1989)[5] made studies using the corporate balance sheets to examine the amount of funds raised from the securities market and compared it with the internal sources of funds raised by firms .He found that for the developing as well as the developed countries retained earnings are the most dominant source of finance .However there are variations in the retained earnings across countries .He argued that in no countries companies raise substantial amount of finance from the securities market and banks are the main sources of external finance in all countries. Another finding was that the expenditure financed from retentions are inversely proportional to the bank credit. Mayer also pointed out that small and medium sized firms rely more on external finance than large ones. The

World Bank severely criticizes the views of Mayer and says that his views are utopian in nature. One thing is clear he fails to take into account the changing scenario in the financial markets.

Tesar and Werner (1995) [6] and Bohn and Tesar (1996)[7] examine U S equity flows to emerging stock markets in Asia from 1978 to 1991 using descriptive statistics ,cumulated real US net purchases of foreign equity and correlation coefficients . They examined the factors that drive the US portfolio investment into foreign markets and they draw three main conclusions. First despite the recent increase in U S equity investment in emerging stock markets, the U S portfolio remains strongly biased toward domestic equities. Second the fraction of the US portfolio that is allocated to foreign equity investment, the share invested in emerging stock markets is roughly proportional to the share of the emerging stock markets in the global market capitalization value. Third, the volatility of U S transactions in emerging market equities is higher than in other foreign countries.

Haluk AK dogan, (1995)[8] examines the integration of international capital Markets, propelled by the information technology revolution and the creation of variety of new financial instruments which is central to the major economic changes taking place throughout the world. This key issue in global finance is theoretically and empirically addressed in AK dogan's innovative study using asset prizing theories to test the status of international capital market integration. His study differs fundamentally from other studies of integration in two respects.

(i) It is based entirely upon financial theory rather than the pure theory of international trade.

(ii) It develops several different empirical models of capital market integration. These models are empirically tested using the modern capital asset pricing approach and drawing on data taken from 26 stock markets all over the world.

The study fails to draw attention on the spillover effects of international capital market integration. Dogan remains silent on this crucial issue which is very essential for policy formulation

Razia and Sadka (2000)[9] combine elements from the seemingly disjoint parts of economies and presents them in a consistent analytical framework. It lays the ground work for the integration of capital, labor and finance into a unified treatment of globalization. Using the growth theories and empirical models of international factor movements they argue that it is essential to develop an integrated framework for all these variables. They say that if this does not happen then economies will remain isolated sectors unable to reap the benefits of globalization.

CharlesOman (1984)[10]researches on new forms of investment in developing countries. He draws to a considerable extend on his research carried out in 1980-82 on the basis of collaborative agreements with researchers and their institutes in 10 developing host countries. He concludes that the emerging markets in these countries (Philippines, Thailand etc), are becoming more and more diversified. New debt instruments are floated and considerable public interest is generated .He fails to account for the impact of these instruments in a long run perspective on the investment and saving in the economy.

Bruno Solnik (1991)[11] presents the international environment and provides both a theoretical and empirical analysis of the basic economic aspects of the international capital markets. He also analyses the international investment's pros and cons, the major investment vehicles, the instruments, the markets as well as the concepts and the techniques used to analyze those investments. He provides a detailed account of the international capital account pricing theory and how it is used in evaluating the securities. He also tests for the co movement between the interest rate and securities market performance. He concludes by saying that the capital markets – both bond and equity – show high degree of correlation with the US interest rates.

Kenneth Midgley and Ronald Burns (1977)[12] examine the role of the capital market, different classes of security and reasons for their issue. The requirements and circumstances of various fund raisers, including public corporations and government as well as private industry are analyzed with regard to the personal factor institutional investors, loans and specialist suppliers, such as Finance for Industry. Factors influencing the demand for capital are technological innovations, spread of equity cult, favorable industrial environment, relaxation of tax rates and tax concessions. His explanation of procedure and means of regulation within the capital market, criticisms on the working of the capital market, its effectiveness and adaptability cannot be applied in a highly globalized environment.

E. Victor Morgan and Richard Harrington. (1977)[13] present the findings of their study on Capital Markets in the EEC (1950-1975) by covering the volume of saving and investment in relation to National Income for individual countries in the EEC .They use a series of comparative studies among these countries to deal with major issue of public interest. Using the descriptive statistics, capital market turnover, market capitalization, volatility and liquidity the capital markets are analyzed and found that the

capital markets of these countries need a revision of policies and instruments to function effectively.

Brain Scott Quinn (1975)[14] sets the markets in a theoretical frame work and looks at the question of currency of denomination of Eurobonds and the relationship of this to the interest rate – a question of practical importance yet one which has not previously been dealt with any depth. He makes a study of the borrowers in the markets in preference to domestic markets and how the different features of the Eurobonds and Euro currency markets might lead a particular borrower to use one rather than the other. He finds that when the interest rates are high in the bond market external borrowers prefer euro currencies as debt instruments. His study however fails to give empirical evidence in support of his arguments.

Jan Mossin (1973)[15] provides a unified theoretical framework, based on general equilibrium theory, for the analysis of valuation of securities, the financing and investment decisions of a firm and the competitive financial markets distributing investment capital among firms and in allocating the risk of return among investors. He places special emphasis on the normative aspects of capital market theory. The price earnings ratio, asset valuation, interest rate spread etc are explained in detail. He thus presents the various methods for understanding the capital market functioning.

James A. Hanson and Sanjay Kathuria (Ed) (1999)[16] analyse the new dilemmas arising from the expanded role of the financial sector, and proposals for the second phase of reforms. It deals with complex international problems and provides international comparison of capital markets. Two broad themes emerge from the discussions. An improved incentive framework, prudential regulation and supervisors are needed to deal with the increasing complexity of finance while discouraging excessive risk taking.

Branson (1968)[17] examined the case where traders were assumed to operate simultaneously as arbitrageurs, hedgers, and speculators. He concluded that an increase in the foreign interest rate (generating a shift in the arbitrage schedule) would cause a decrease in the forward foreign exchange rate but that the direction of induced capital movements could not be determined. This unusual result is contradicted by the empirical work, which clearly supports the conventional view that an increase in a given country's interest rate will have a positive effect on the short term capital inflow.

Conclusion

The studies cited here investigate the causality between stock market development and economic growth. Granger causality test and other empirical analysis used in the research papers reveal stock market development boosts economic growth. These studies also bring to light the fact that if these inflows can be used positively through a well administered policy net they could bring in the much needed economic growth.

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