Financial Market Accessibility and Economic Development: Overview of the Evidence

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Theoretical Background

Financial markets improve welfare through:

- Allocating funds to best uses
- Improving risk sharing
- Aggregating dispersed information
- Economizing the deployment of funds

As early as 1873, in *Lombard Street,* Walter Bagehot argued that England's efficient capital markets made the industrial revolution possible.

Governments can help this process by:

- Improving **access** to financial markets
- Increasing **participation** in financial markets
  - Investor protection
  - Fraud prevention
  - Minimizing government financial activity
- Enhancing **competition**
- Improving **information flow**

I survey the empirical findings on:

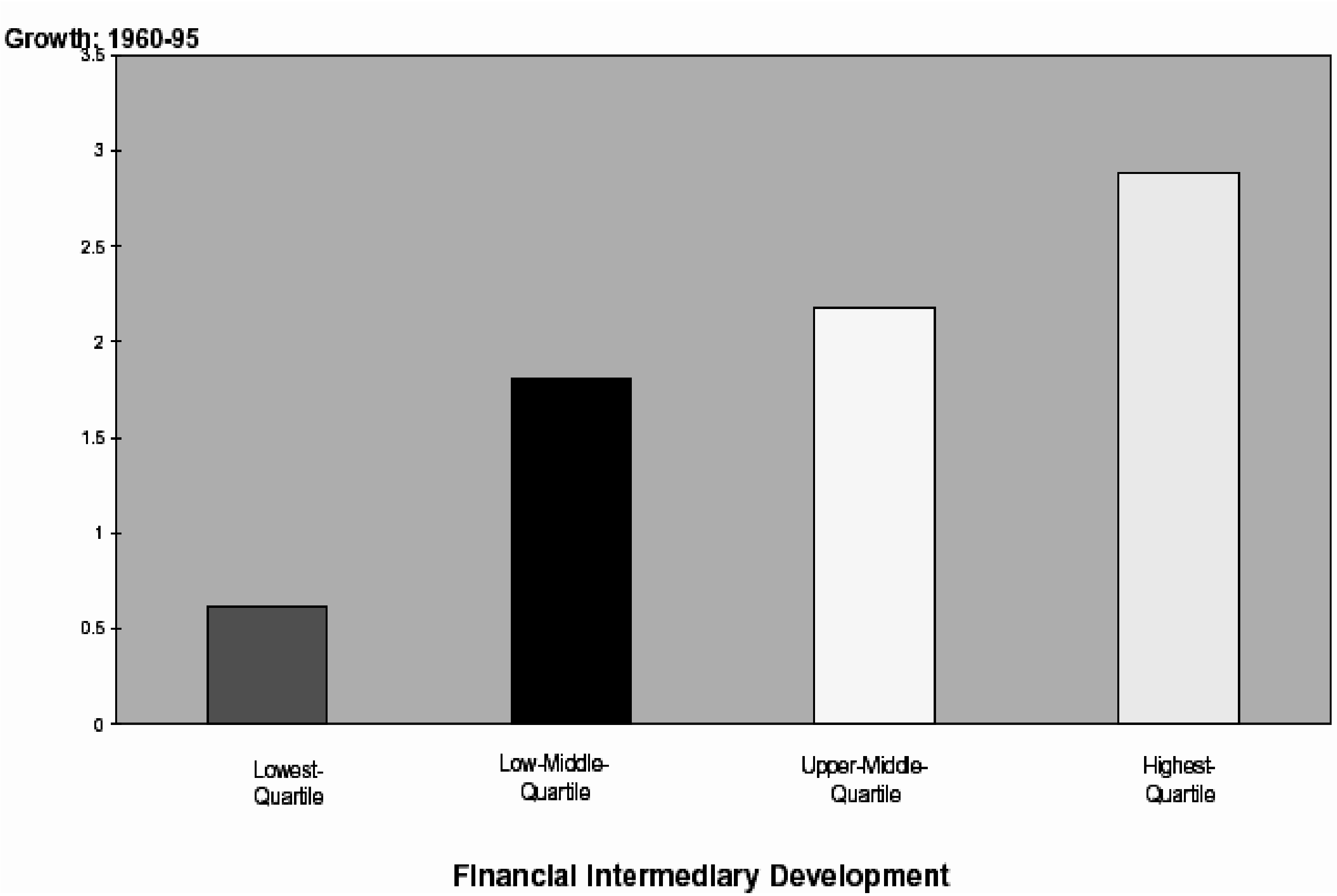
- The role of financial markets in improving economic welfare, and
- The impact of regulations on the efficiency of financial markets.

The survey is not intended to be comprehensive.

Rather, I stress the thrust of the main findings and suggests directions for government actions

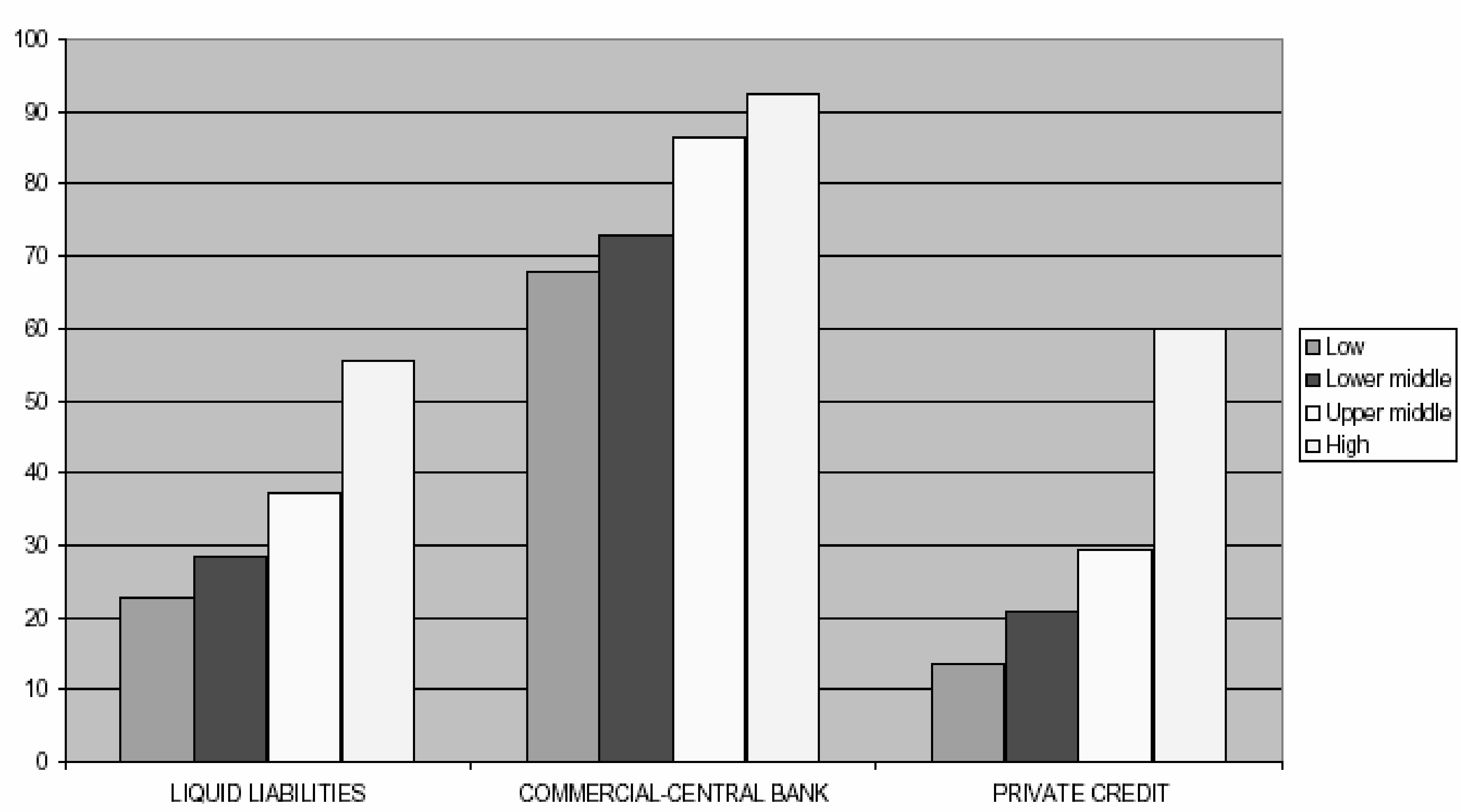
Evidence on Financial Markets' Development & Economic Welfare

Studies document significant correlation between **financial market development** and **GDP growth**:



(Beck, Levine & Loayza 2000)

This is true both for **public** and **private** financings:



(Beck, Levine & Loayza 2000)

Two potential **causality** directions:

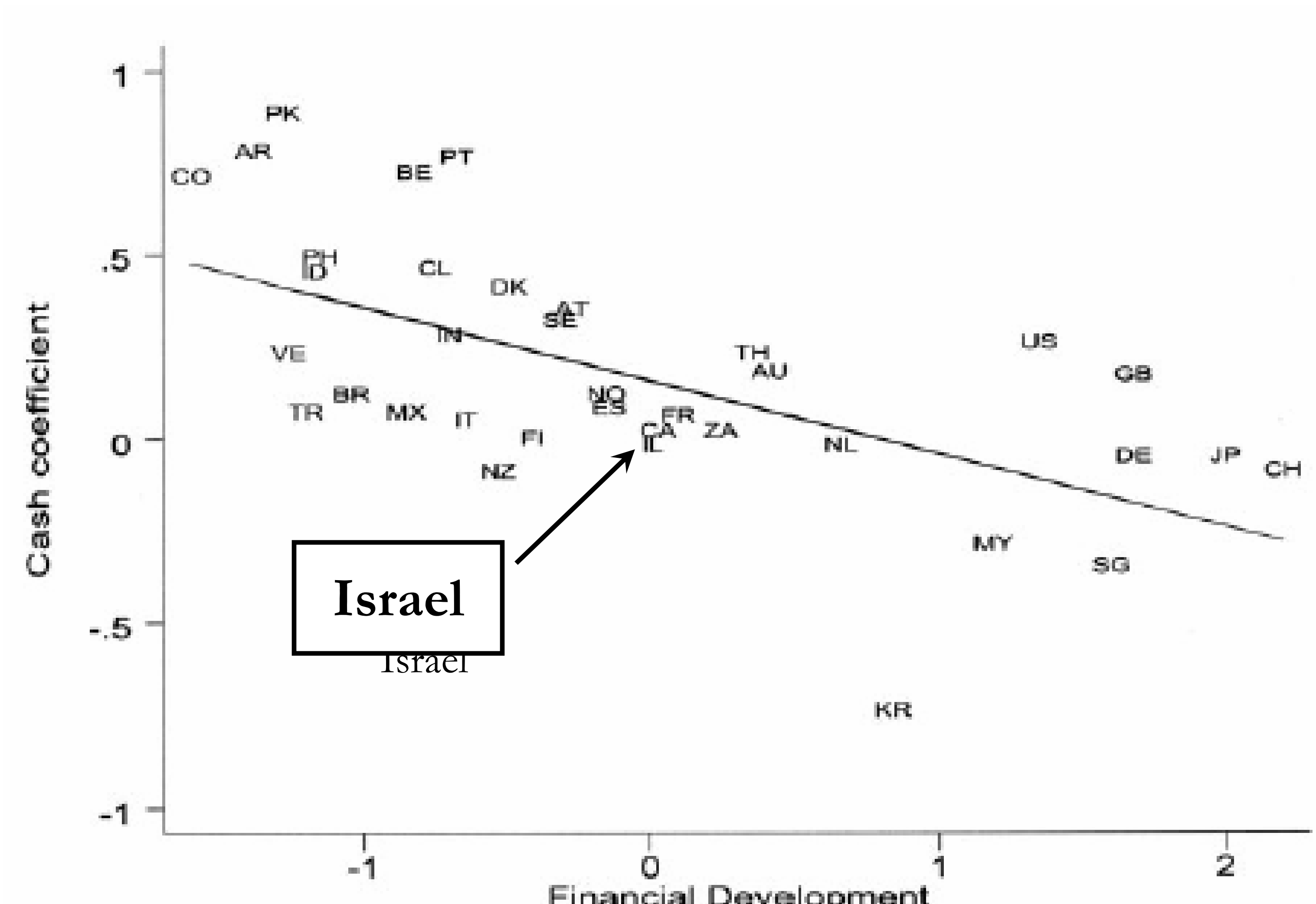
Financial markets' development $\Rightarrow$ growth

Growth $\Rightarrow$ financial markets' development

Empirical evidence:

- **Tests of causality** suggest that financial market development (Granger) cause growth
  (Rousseau & Wachtel 1998)
- **Factor production** (including capital) is correlated with financial development
  (Beck, Levine, and Loayza 2000)

Evidence suggests that financial development affects growth through cost of capital:



(Hail & Leuz 2003)

Financial development affects cost of capital by:

- Reducing friction
  - Industries that rely heavily on external funding grow fastest in developed financial systems. (Rajan & Zingales 1996)
  - Firms with easy access to financial markets grow faster than firms with limited access. (Kunt & Maksimovic 1996)
- Increasing liquidity
  - Significant correlation between financial market liquidity and growth. (Levine & Zervos 1996)

- Improving risk sharing
- Improving information acquisition
  - Firms that investors know well have easy access to financial markets. (Hubbard & Whited 1995)
- Increasing monitoring
  - Firms that are monitored by investors (e.g., through rating agencies) have easy access to financial markets. (Whited 1992)
- Increasing competition
  - 30% reduction in number of banks in a state (through M&A) increases mortgage rates by 0.1%. (Garmaise & Moskowitz 2003)

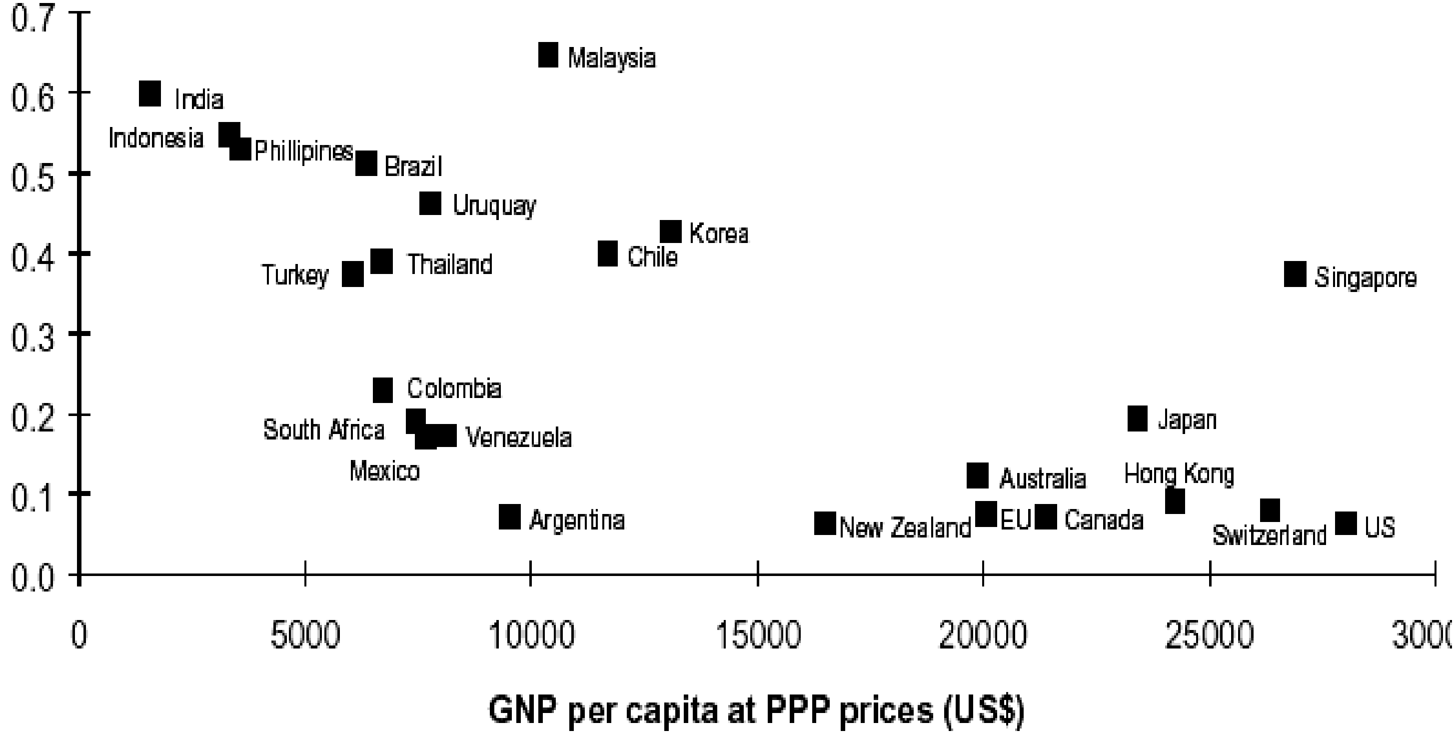
Government Regulation & Financial Market Development

Governments impact financial markets by

- Protecting investor rights
  - Countries with strong shareholder protection have developed financial markets. (La Porta, Lopez-de-Silanes, Shleifer & Vishny 1997)
  - Countries with strong creditor protection have developed financial markets. (Levine 1999)
  - Countries with strong investor protection better finance high-growth firms. (Demirguc-Kunt & Maksimovic 1998)

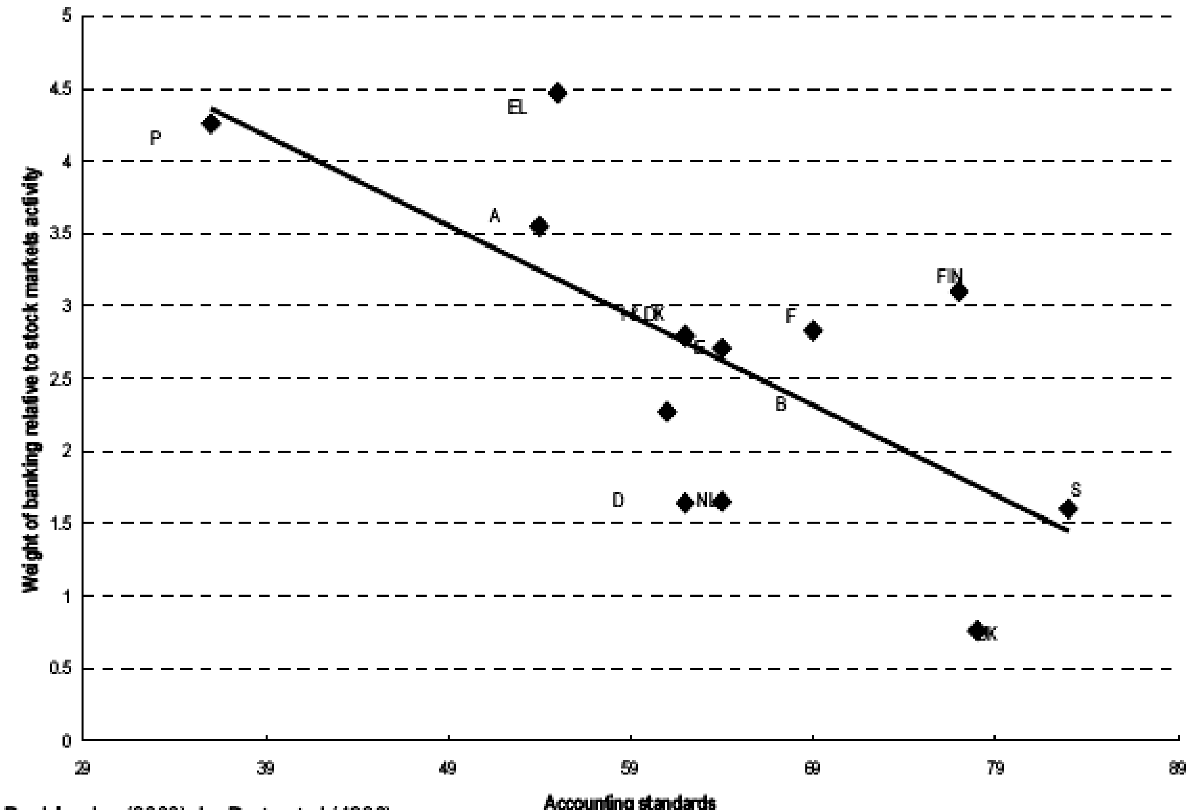
- Facilitating competition
  - Countries with protected financial markets have lower productivity:

Figure 1 Foreign Restrictiveness Index in Banking and GNP per capita at PPP prices (1996)



(Findlay & Warren 2001)

- Enforcing disclosure
  - Improving the transparency of the financial reporting significantly reduces the cost of capital in the country. (Chen, Chen & Wei 2003)



Source: Beck/Levine (2000), La Porta et al (1998).

Summary

Financial market development fosters growth by improving utilization of capital.

Governments can help development of financial markets by:

- Protecting investor rights
- Facilitating competition
- Enforcing disclosure