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On the causal links between the stock market and the economy of Hong Kong

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Starting from Adam Smith, economists have generally asserted that financial development is an important ingredient for general economic performance. To this end, various empirical papers have examined the causal influence of financial development on economic performance. Hong Kong is one of the economies that have experienced tremendous development in the past three decades. To provide concrete sources of this economic miracle, economists have identified variety of factors. Overall, the role of financial development has been overlooked in most of the studies. However, the stylized fact in support of the positive association between financial development and economic growth remains strong for Hong Kong, especially during the period of substantial economic expansion.

Financial sector is a broad concept encompassing financial intermediaries (banks, insurance companies, and pension funds), and markets (bond and stock markets). In this paper, we depart from the existing studies by concentrating on the role of the financial sector in the growth success of Honk Kong, and particularly narrowing our scope to the stock market. We attempt to find answers to the following question: does the stock market performance influence the performance of the Hong Kong economy? This is important because the stock market of Hong Kong has gained sustain growth over the last three decades both in size and in liquidity. Hence, it may and should have contributed to the economic success of Hong Kong, inasmuch as other aspects of the financial sector may and should have. To further narrow the scope of stock market performance, we decomposed it in terms of three indicators, namely: market capitalisation ratio, turnover ratio, and total value traded ratio.

These indicators measure, respectively, the size of the stock market and the liquidity of the stock market. We define the market capitalisation ratio as the market capitalisation as a percentage of gross domestic product (GDP), turnover ratio as the ratio of the total value of traded shares divided by market capitalisation, and total value traded ratio as the ratio of total value of share traded divided by GDP. We then examine the causal links between each of these components of stock market performance and the performance of the Hong Kong, proxied by real GDP, in an augmented vector autoregressive (VAR) setting, for the period 1986Q2 – 2014Q4. We utilize the Toda-Yamamoto causality test, which is known to be efficient in avoiding pre-testing bias inherent in other competing causality tests. Two main findings emerged from our empirical analysis. There exist bidirectional causal flow between stock market performance, as proxied by market capitalisation ratio and total value traded ratio, and economic performance. There is no causal flow between stock market performance, as proxied by turnover ratio, and economic performance.

These findings suggest that the causal links between stock market performance and economic performance are highly dependent on the proxy of stock market performance, in the case of Hong Kong. Hence, the policymaker should be cautious when gauging the causal influence of the stock market on the economy. Because different measures of stock market performance could produce different policy interpretations.