

CHAPTER ONE
INTRODUCTION

UNIVERSITI SAINS ISLAM MALAYSIA
جامعة العلوم الإسلامية الماليزية
ISLAMIC SCIENCE UNIVERSITY OF MALAYSIA

CHAPTER ONE

INTRODUCTION

1.1 RESEARCH BACKGROUND

The financial markets contribute significantly towards guiding the savings and investment flows in the economy. This contribution facilitates the accretion of investment and goods and services production. The arrangement of well-developed financial markets and institutions, as well as different groups of financial tools products serves the needs of borrowers and lenders and, therefore, the overall economic growth. Under these circumstances stock market and economic growth relationship has been a crucial issue around the world.

Stock market is an important part of the country's economy. It helps to improve the growth of the commerce and industry of the country which in the end will affect the country's economy to a significant extent. For this reason the government, industry, commerce and the central bank of the country monitor the development of the stock market. This sector is significant from the industry's and investor's point of view. Since the last few decades, the relationship between the stock market and economic growth has been a debatable issue and is widely discussed around the globe.

The relationship among financial development and economic growth has received a great interest in the empirical growth literature. Economists have four different views about this matter; the first group argued that the stock market has a major role in promoting the economic growth, while the second group believed that there is no significant role played by the stock market. Meanwhile, the third group claimed that there is no relationship at all between these two sectors. Finally, the fourth team considered that there is a bi-directional relationship among them (Mohammad Jamil, 2010).

Many theoretical and empirical studies have been conducted following the work of the pioneering theorist, Schumpeter in 1934. The author argued that growth and

production-accelerating related issues affect the services provided by a developed financial sector. He pointed out that financial intermediaries play a significant role in enhancing technological innovation and economic growth. In addition, they provide essential services such as mobilizing savings, evaluating the projects of the investment, managing risks and facilitating transactions (Christopoulos & Tsionas, 2004).

Meanwhile, Samargandi et al. (2015) examined the relationship between financial development and economic growth in a panel of 52 middle-income countries over the 1980-2008 period, using pooled mean group estimator in a dynamic heterogeneous panel setting. The study showed that financial development does not have a linear positive long-run impact on economic growth. When the study considered a non-linear relationship between financial development and growth, it found an inverted U-shaped relationship between finance and growth in the long run. In the short-run, the relationship is insignificant. Their findings suggested that middle-income countries face a threshold point after which financial development no longer contributes to economic growth.

On the other hand, Ali, A.S et al. (2015) investigated the complex linkages between stock market development and economic growth. The authors employed market capitalization ratio, turnover ratio and total value of shares traded as a percentage of GDP as proxies to stock market development, while GDP per capita and Foreign Direct Investment (FDI) as a percentage of GDP to gauge economic development of BRICS countries (Brazil, Russia, India, China and South Africa) and Turkey. Significant positive links were revealed by the vector autoregression (VAR) results, indicated that stock market development positively and significantly affects the economic growth of Russia, India and China. The Ganger causality test model uncovered that stock market development significantly and robustly influences economic growth for Russia, India, Turkey and South Africa whereas for Brazil and China, it is the economic growth which promotes stock market progress through enhancing liquidity.

Against this backdrop this chapter provides an overview and general background to the research and its motivations, outlining the topic for investigation, the research

objectives, and the associated research questions. It discusses the statement of the problems for the research and provides a comprehensive detail of the structure of the thesis. This study aims to investigate Libya's Stock Market (LSM) contribution towards the economic growth in Libya.

According to the LSM's internal publication entitled "The importance of the stock market to Libyan economy (2009) " the principle function of the capital market is to create the liquidity for financial instruments and create the possibility of providing the means to convert long-term investments to liquid assets. Therefore, it provides an element of confidence in the operations of savings and investment, but at the same time, it should help in determining the suitable areas of investment. It should ensure the quality of the projects invested and also assistance with the allocation of resources. Besides, it also facilitates the deal of securities through continuous provision of liquidity as required by the economic activity. In addition, it mitigates economic fluctuations.

Recently there are many developments in the Libyan economy such as the adoption of privatization policies and the expansion of the ownership based business (Aljbiri, 2008). Therefore, the Libyan economy sought to work for the success of these policies through organizing the work of the listed companies in the LSM and urged them to apply international standards transparency and disclosure, which will lead to increasing the efficiency of the market and attract more investments. However, these objectives will only be achieved by imposing strict regulations. This measure has to achieve the established market for the benefit of the economy.

In order to examine the causal relationship between LSM and economic growth, the present study performed Vector Error Correction Model (VECM) within Granger Causality and co-integration tests using monthly data covering the period of 2008:M4 to 2011:M2. In addition, the study evaluated the roles of LSM in promoting economic growth and its performance and examined the measures taken by its players to attract new investors based on interviews and questionnaires.

1.2 PROBLEM STATEMENT

The relationship between financial development and economic growth has been an extensive subject of empirical research over past decades. The question of whether financial development causes economic growth or it is a consequence of increased economic activity has been one of the most debated issues in growth development research (Eman. F et al., 2011). Earlier studies focused only on banks and ignored the role of the stock markets. Even though the studies of the role of the stock market have been going on for more than a decade, few studies have been done on Libya. The results from the studies that have been conducted are not conclusive on the causal relationship between stock market development and economic growth. What prompted the current study is that the stock market and economic growth in Libya have both grown in the last decade, leading to questions on whether there is a causal link between the two factors.

In the case of Libya, only two studies have been conducted on this topic. The first was conducted by Masoud. N (2009) on the economic reform programme and the relationship with stock market in a study on 42 countries, including Libya. The second study was undertaken by Aljbiri (2008) examining the importance of financial market in the Libyan economy.

Specifically, the present research will examine the finance-growth nexus in Libya and examine the direction of causality. The aim is to establish whether there is a relationship between stock market development and economic growth. There are several possible outcomes. First, neither variable Granger-causes each other. Second, stock market development Granger-causes economic growth but not vice-versa. Third, economic growth Granger-causes stock market development but not vice versa. Fourth, there is a bi-directional causality between economic growth and stock market development. In short, there could be no causal link, uni-directional or bi-directional relationship between the two variables.

There is a need to re-examine the roles of financial sector as the engine of growth for Libya based on the following observations. Libya witnessed a number of organizational variations following the revolution of 1969 since the Green Book

Theory was introduced, which stated that for a socialist state and state-planned economy, investment was essentially state-driven and trade and price controls, along with subsidies, were widespread. Economic performance was [strictly] constrained by stifling government interference in the economy and an [unfavourable] business climate. Economic conditions began to deteriorate in the mid- 1980s with the fall in world oil prices, and worsened in the 1990s as a result of UN economic sanctions. The authorities were reluctant to initiate any economic reforms [whilst] the country was subject to sanctions. (IMF, 2005:5). The above situation required devising a strategic policy that would seek to achieve sustainable development of the Libyan economy. One approach would be the current official attempts for the restructuring of the Libyan economy via improving the role of private sector and the continuing process the public sector privatization within the country (IMF, 2005). In addition, the Central Intelligence Agency (CIA) in one of its reports, suggested financial resources mobilization to spur economic growth as stated below:

“Libya’s economy is structured primarily around the nation’s energy sector, which generates about 95% of export earnings, 80% of GDP, and 99% of government income. Substantial revenue from the energy sector coupled with a small population give Libya one of the highest per capita GDPs in Africa, but Tripoli largely has not used its significant financial resources to develop national infrastructure or the economy, leaving many citizens poor.”

However, during 1998, a dramatic decline in oil prices reduced its exports and production, which brought Libyan economy to the brink of collapse. This situation led Libyan government in 1999 to introduce the economic reform programme. The reform programme aimed to transform the country’s socialist state-planned economy into one based upon capital to reduce the dependence on the crude oil exports which were considered as the backbone of the Libyan economy.

In spite of that, Libya still depends on the oil sector revenues. Since oil is a non-renewable resources, over-use of this scarce resource may lead to the extermination of oil. Consequently, other alternatives are searched that would support the Libyan economy, for example, encouraging savers to put their savings in the channels of investment and attracting the local and foreign investors to invest in the country. However, it must be realized that the mentioned alternatives will only be achieved through the well establishment of a stock market in Libya. In particular, this market

will not be successful unless it has a strong foundation so that it could play its role effectively.

Therefore, the present study seeks to investigate the extent of the contribution of the Libyan Stock Market (LSM) in economic growth and whether the development in the LSM has an impact on economic growth or otherwise. This impact would be investigated based on qualitative and quantitative approaches.

1.3 RESEARCH OBJECTIVES

This study aims to answer the following objectives:

1. To investigate the roles and causal linkage between Libyan Stock Market (LSM) development and economic growth.
2. To evaluate the performance of LSM as a catalyst of Libya's economic growth.
3. To examine the measures taken by LSM authority to attract local and foreign investors.

1.4 RESEARCH QUESTIONS

According to the stated objectives, the study intends to answer the following research questions:

1. Does LSM development have a role and effect on the economic growth in Libya?
2. What is the extent of LSM performance in terms of its role in the economic growth?
3. What are the measures taken by LSM authority to attract the local and foreign investors?

1.5 SCOPE AND LIMITATIONS OF THE STUDY

If the study eliminates its limitation, this will upgrade the research results. This study investigated the relationship between LSM development and economic growth in a relatively short duration. The study used three years monthly data from year 2008:M4

to year 2011:M2 due the recent establishment of LSM and the war occurrence in 2011. The minimal data limits the analysis of causal trend between LSM development and economic growth. Secondly, various essential data which would facilitate the research were insufficient. In particular, the real gross domestic product (RGDP) data, which is a significant indicator of Libyan economic growth, were unavailable in the local and international reports. Hence, monthly data were interpolated based on some of previous studies that used the same equation of the interpolation.

However, previous study on the finance-growth nexus utilizing interpolation method suggest that the causality analysis performed is adequate. For example, similar problem of lack the availability of long period data was suffered by Al-Bazai (1999) when he investigated the roles of the money in Saudi Arabia using VAR model. Due to the lack of data, he interpolated annual data to quarterly data to improve the analysis by increasing the number of observations. Ihsan et al., (2007) used the same method in their study of Karachi Stock Exchange.

Another limitation of the research is the declining number of investors in the stock market, especially in Benghazi, due to the political turmoil and Arab Spring Revolution that took place in 2011. Absence these unforeseen events, the researchers could have distributed more questionnaires and schedule more interviews.

Another important limitation of this study is due to the fact that RGDP is available and could be collected for a longer period of time, while data for LSM is only recently available. This is because Libya is an emerging economy and recorded data are not available. In addition, since the LSM was only recently established in 2006, its volatility is more rapid than that in RGDP. Therefore, the present study would contribute significantly to the literature by examining the nascent operation of LSM and its contribution to the economic growth.

1.6 SIGNIFICANCE OF THE STUDY

The LSM is one of the emerging markets in the world. It was established in 2006 as the Libyan government believed that they have to look for other alternatives for their income sources. This point led to the idea of the establishment of the LSM. The

market promotes the investment channels by encouraging the local and foreign savers to invest their savings in the local market, which will eventually lead to the rise of the national economic growth.

Many changes need to be introduced to improve the operation of the newly established exchange. This study is a scientific research that could be used by the regulators to move forward since it has little experience as compared to other markets in the other countries. The results of this research, especially on the development measures taken by LSM, are expected to provide more confidence to the investors that would encourage them to invest in the stock market in Libya.

In addition to that, very few studies have been conducted to examine the prospects and performance of LSM. Hence this study would provide the stakeholders of LSM with the information from the analyses on the market such as on its performance and prospects that will be of assistance to them to make future investment decisions. Moreover, this study employs a more comprehensive technique¹ to evaluate the case study. In particular, it combines qualitative (interviews) and quantitative (questionnaires, Vector Error Correction Model within Granger causality test and

¹ Advantages of combining two methods: i) logic of triangulation (the findings from the qualitative investigation could be against the findings deriving from a quantitative study).ii) Structure & Process (quantitative study is very efficient at capturing the structural features of social life while qualitative research is stronger on process aspects).iii)Facilitate the interpretation of relationships between variables (quantitative research allows to establish relationships among variables, but weak in discovering the reasons for the relationships. A qualitative study can be used to explain the factors' relationships). iv) A qualitative research facilitates quantitative research (qualitative study help to provide background information on the subjects matter and acts as a source of hypotheses). V) Provide a general picture (quantitative research reduces the gaps arises in a qualitative study, for instance, the researcher cannot be in more than one place at the same time.vi) Problem of generality (quantitative methods may help generalizability). Vii) Relationship between macro and micro levels (employing quantitative and qualitative technique provide tools of rounding between the macro-micro. Qualitative research can help of tap large-scale structural features of sociality. While qualitative research addresses small-scale behavioural aspects).

cointegration test) methods. This thesis will add to the current body of literature regarding development and application of stock market performance and economic growth in emerging Arab economies.

1.7 ORGANIZATION OF THE STUDY

This research is divided into six chapters. Chapter one is an Introduction chapter. It provides the background of the study and its problem statement, followed by the objectives and questions of the research. At the end of the chapter, the study provided its limitation, scope and its significance.

The Second Chapter contains discussions on the Libyan economy and the discussion on financial market and stock market, as well as their significance for economic growth. It focuses on LSM development, its recent activities which encompass the formation of new listed companies and financial institutions and broker companies. Additionally it depicts the affirmative impacts taken by LSM that can be seen in the area of finance and investments.

Chapter Three is the literature review chapter that discusses previous studies in the area of stock market development and economic growth. This chapter expands discussion according to former researches on finance and growth interconnection in developing countries, finance and growth linkage in developing countries, financial and growth relationship in African stock markets, and financial and growth relationship in Arab stock markets.

Chapter Four emphasises on the research methodology employed in this study, with the explaining of the measurable design particularly on the nexus and effect between LSM development and economic growth. Moreover, it delineates the measurements, variables and models of the study. In addition, this chapter explains the analysis of data, the methods of executing the research as well as the design and assumptions of the study. Chapter Five provides the analysis and discussion of the study results; it contains two sections: qualitative and quantitative analysis and discussions.

Chapter Six is the conclusion chapter. It provides the summary of the study results. It also includes the study's contributions and recommendations to the stakeholders of

this research. Finally, it offers a discussion on the areas of future studies that other researchers may undertake related to stock market development and economic growth. For more explanation see Appendix (1.1).

1.8 SUMMARY OF THE CHAPTER

This chapter focused on the research problem by emphasizing on the role of the Libyan Stock Market (LSM) in promoting economic growth, the development of its performance and the procedures taken to attract local and foreign investors. The chapter also includes research objectives, questions, scope, limitations and significance of study. Finally, the organization of the study that provides the structure of the research presented.

