

The Role of Stock Market in Economic Growth of India

Dr. KALPANA VERMA

Assistant Professor Department of Commerce (E.A.F.M.) Government Girls College, Ajmer (Raj).

Abstract:

The fundamental reason for this study was to investigate the causal connection between the stock market operation and economic growth and development in terms of an empirical literature framework. Stock market experts have several opinion regarding functions of stock market like improving liquidity position in the economy, amassing and assembling capital, watching supervisors and applying corporate control, giving danger pooling and sharing administrations including speculation levels. The existing literatures argue that stock markets are crucially related to the economic growth and hence a positive relation exists between efficient operation of stock market and economic prosperity of the country by affecting the aggregate quantum of investment.

Introduction

Recent theoretical studies have already commenced the first step to link the financial market and the rate of economic growth; it is proposed that higher per capita income may affect many aspects of the economy and stock market performance. Gurley and Shaw (1955, 1960 and 1967) argued that financial development is a positive function of real income and wealth. This study supports the quantitative work of Goldsmith (1969) who discovered that, in most of the 35 countries investigated, both developed and developing, the ratio of the financial institution to GDP tends to increase with higher real income and wealth. This relationship between growth and financial system size is further supported by more recent evidence from the World Bank (1989).

Much of the research within empirical studies concurs that finance is strongly associated with economic Growth rate.

Financial markets are today classified as bank-based or market-based systems. This division can be further exemplified by the Anglo-Saxon market-based models which are capitalist economies and allow for private investment and private ownership and the other, largely exemplified by Germany, which is the bank-based model that has been practised more widely by Eastern European countries. These latter are centrally planned or, to be politically correct, communist economies (Hall and Soskice, 2001). The UK and US are market-based as these countries have similar long-term growth rates¹. Throughout the world, the type of financial model practised by sovereign countries reflects the type of government as a regime in power. Many, Eastern European, Middle Eastern and African countries, including Libya, have practised socialism for a long time. However in the light of recent trends, and under the direction of the IMF and World Banks, many countries are now reforming their economies and gradually adopting capitalism, largely as a result of the failure of socialism and particularly in order to rescue their economies. In this context, the World Bank (1994, 1989) has argued for the establishment and promotion of stock markets in developing countries in line with those existing in developed countries.

Review of Related Literature

Definition of a Stock Market

A stock market can be a very sophisticated market place, where stocks and shares are the traded commodity. At the same time, it is central to the creation and development of a strong and competitive economy. It is a key to structural transformations in any economy; from traditional, rigid, insecure bank-based to a more flexible, more secure economy that is immune to shocks, fluctuations and lack of investors' confidence (Stapley, 1986). According to Arnold (2004), stock markets are where government and industry can raise long-term capital and investors can purchase and sell securities. Typically, markets, whether they be shares, bonds, cattle or fruit and vegetables, are simply mechanisms to allow the possibility of trade between individuals or organisations. Whilst some markets (e.g. for livestock) are physical where buyers and vendors meet to trade, others (e.g. for foreign currency) are a national network, based on communication using telephone lines and computer links, with no physical meeting place. Additionally, very few stock exchanges around the world still possess a physical location where buyers and sellers meet to trade.

Patrick and Wai (1973) argued that stock markets are those markets that deal with capital, both in the short and long-term, where companies sell stocks in order to generate long-term capital that can be channelled into their profitable options. This is because people would rather invest in winners than losers; buyers hold on to their stocks for future dividend pay outs. The activities of buying and selling stocks and shares on the stock market are extremely significant for the allocation of capital within economies (Pratten, 1993). In addition, transaction prices and quotations provide investors with an indication of the market value of their wealth which may influence their decisions about consumption expenditure (Pratten, 1993). Although, when prices are at historically high levels and/ or rising, this indicates confidence among investors and may affect the confidence of businessmen and, hence, their investment. Furthermore, the stock market is a crucial factor in business investment decisions because the price of shares affects the amount of funds that can be raised by selling newly issued stock to finance investment spending. Johnson (1983:32) suggested that:

“The stock markets are a complex of institutions and mechanisms through which funds for purposes longer than one year are pooled and made available to business, government, and individuals and through which instruments already outstanding are transferred. The stock markets are well organised and are local, regional, national, and world-wide in scope.”

According to Tweles and Bradly (1987), the word stock in North American tradition, means ownership or equity. In corporations these stocks are traded in a market called the “stock exchange”. Curry and Winfield (1994:25) offered a brief definition of the stock exchange as: “..... an institution where quoted investments (stocks and shares) may be exchanged between buyers and sellers.” Fabozzi et al. (2002) classified three types of stock market role: first, the interactions of buyers and sellers in a stock market determine the price of the traded asset; second, stock markets provide a mechanism for investors to sell a stock asset; finally, the third economic function of a stock market is that it reduces the cost of transacting. Mishkin and Eakins (2003)

provided that a stock is a security that represents a share of ownership on the earnings and assets of the corporation. The stock market, in which claims of the earnings of corporations (shares of stock) are traded, is the most widely followed market in the American economy. Stock markets can be classified as debt and equity markets, short- term debt instruments (money market) and longer-maturity financial assets (capital markets), including cash or spot market and futures markets, as displayed in Figure 1.



Figure 1. Classification of Stock Markets

Money Market

Since the early history the money market has been a highly active locus where many buyers and sellers enter the market with offers each day. It is based on a 365-day year in the UK and on a 360-day year in the US (Mishkin and Eakins, 2003). Since 1970 it has become more important as interest rates increased dramatically. These rates tend to be very liquid. In the late 1970s and early 1980s the rates rose in the short-term which, coupled with a regulated ceiling on the rate that banks could pay for deposits, resulted in a rapid outflow of funds from financial

institutions. This outflow, in turn, caused many banks, savings and loans to fail. However, the term “money market” actually refers to the markets for financial tools where short-term investment securities of less than one year are traded. It provides an opportunity for borrowers to obtain short term loans. It also provides an opportunity for investors to obtain a high level of security by investing their money in financial assets with high liquidity, as the commercial banks play a critical role in this market’s activity. Money market security has three basic characteristics:

- It has usually sold in large denominations
- It has low default risk
- It matures in one year- instruments mature in less than 120days.

The money market includes a market for short-term treasury securities, particularly treasury bills, having 91-day, 182-day, or 12-month maturities which widely hold liquid, commercial papers, federal- funds, and repurchase agreements. Furthermore, this market includes the bank’s 6-month certificates of deposit and the banker’s acceptances. Finally, from the previous discussion, the most significant advantages of the money market, that is, high flexibility, low risk in terms of money and credit risk, also reduce the cost of transactions to developed secondary markets which have a place for firms or financial institutions to warehouse surplus funds for short periods of time until they are required.

Capital Market

The term “capital” refers to markets for financial instruments of long-term investment tools with maturities of one year or more and where equity instruments are traded. Capital market securities, such as stock and long-term bonds, are often held by financial intermediaries, insurance companies and pension funds, which have little uncertainty about the amount of funds which they will have available to deal with in the future. The most significant chrematistic tools of this market’s shares and bonds in long-term debt are:

- A capital market linked within long-term securities
- An effective role in financing long-term productive projects
- A capital market more structured than other markets because dealers are agent specialists
- Investment in the capital market is far more-risky and bears less liquidity than the money market
- The returns are high on capital compared with investment in other markets.

The capital market is divided according to whether the financial tools contain a promised output of cash flow over time, or offer participation in the future profitability of the company’s chrematistics. They are usually defined as:

Cash or Spot Market

A cash or spot market is a one which deals immediately between buyers and sellers and is divided twofold: primary market; secondary market. These two issues are discussed next.

Primary Market

The primary market, referred to as “issue market”, issues security stocks, bonds, shares outstanding, and is in businesses that are allowed to issue securities. Jones (1994) suggested that primary markets are completely vital to capitalist economies source from the owners of these sources to those who utilise them to finance productive activities, since they serve to channel funds from savers to borrowers. While business could challenge an initial public offering on their own, many rely on the assistance of investment banks. In fact, the latter represent institutions that specialise in marketing initial ownership shares offered by new business activity which provide shares in the primary market at a slightly higher price.

Secondary Market

The secondary market is where the sale of previously issued securities occurs, because most investors plan to sell long-term bonds before they reach maturity and, eventually, to sell their holdings of stock as well by brokers and intermediaries. Indeed, brokers specialise in secondary markets where they have developed a superior knowledge of the factors that influence risk, costs and returns relating to financial instruments exchanged in these markets. As already indicated, secondary markets are very significant contributors to the efficient performance of primary markets, because the former have the ability to buy or sell previously issued financial instruments, which render these much more liquid than other markets for their investments, enabling them to move quickly, and without substantial loss in market value, from security to cash and from one security to another (Haugen, 2001). There are two types of market in the secondary market for capital securities:

Organised Market

The organised market has a building which is a site for buying and selling securities (including stocks, bonds, options, and futures) and trading with a specific procedure for instruments of securities to be recorded in accordance with the rules and regulations to ensure that they result in competitive trading. Haugen (2001) argued that there are major organised stock markets globally. For instance, the Nikkei in Tokyo is one of the leading active markets internationally. Another of the largest major markets is the New York Stock Exchange (NYSE), in which the shares of approximately 1,600 companies are traded. The second largest stock exchange within the American Stock Exchange (AME) includes the London Stock Exchange (LSE) in the UK, the DAX in Germany and the Toronto Stock Exchange (TSE) in Canada.

Unorganised Market

This is also known as the Over-The-Counter (OTC) market which is not organised in the sense of having a site where unlisted stock is traded. In this market trading operates by using a nationwide network of phone lines and computer links where the price is determined by financial paper negotiations. Haugen (2001) argues that there are two levels of prices i.e. wholesale and retail. Retail prices are offered to individual investors who are usually executing orders via brokers. Wholesale prices are offered to other dealers who wish to alter their inventory positions. Henry (2000) and Elton et al. (2003) have noted the existence of third and fourth markets in the US.

Third Market

The third market involves the trading of listed securities in the OTC market. This market is unregulated and consists of brokerage firms which are not members of the organisation, even though they have the right to deal in securities registered in those markets. Furthermore, these brokerages are willing to buy and sell securities at a greater or lesser amount.

Fourth Market

The fourth market refers to direct trade between institutions without the use of an exchange. This market is intended for major institutions and rich individuals who deal with them in buying and selling securities in large orders, as a strategy to reduce commission paid to brokers and in a strong network of telephones and computers, so that the conclusion of four transactions in the market can happen quickly and at a lower cost.

It can be remarked that Libya solely possesses an organised stock market. There is no definition of the fixed commissions for the transactions dealt in the Libyan stock market, where there is no requirement to create a third or fourth stock market as in the US. According to the Libyan Stock Market Authority (LSMA) regulations, it is not permitted for any brokerage firm to operate in the stock market without registration, which requires a license from the LSMA to operate as a financial intermediary. At the same time, it is not allowed for any deal, either among individual investors, or between institutions to occur without financial intermediaries. This explains why the Libyan stock market does not use the terms of third or fourth markets.

From previous discussion, it can be seen that the capital market has three main instruments: bonds, stocks, and mortgages. Bonds represent borrowing by the issuing firm. Stock represents ownership in the same entity. Mortgages are long-term loans secured by real property. Only corporations and governments can issue bonds, which obtain more funds raised by bonds rather than through stock.

Futures Markets

Cuthbertson and Nitzsche (2001) argue that forward and future(s) can be treated in a similar fashion, as Table 1 displays. Usually, forward contracts involve no upfront payment and cash only changes hands at the expiry of a contract, which is negotiated between two parties and is not significant. A future(s) contract is traded in the market and involves a down payment known as the initial margin. This is primarily a deposit to ensure both parties to the contract do not default, which usually earns a competitive interest rate without cost. Typically, a futures contract is a forward agreement that is market to market daily.

Cuthbertson and Nitzsche (2001) explained that, for this privilege, an investor should pay an up-front, non-returnable fee in order to purchase an option contract. This is an option price or premium because future(s) contract does not confer the privilege of walking away from the agreement; it would cost nothing to purchase this type of contract.

The Libyan stock market, upon which this research focuses, can be considered as an auction market, not a negotiated market, where the arena in Libya is concerned with trading stocks of companies listed on the stock exchange, and where all transaction takes place through financial intermediaries called brokerage firms and brokers collect commission for their efforts, and where no type of transaction can occur in the national stock market which involves the dealers directly.

Indeed, the banking sector plays a key role in the stock market in Libya in both the primary and secondary market. In the former, as can be observed, most of the initial public offerings are conducted via the banking sector. They suggest appropriate details to the relevant companies, and all phases of subscription are conducted by banks. For instance, the system in the US differs; commercial, not investment banks are responsible for such transactions. In fact, these banks, not their investment counterparts, are responsible for such transactions and they offer the individual investors financial assistance to purchase securities. They participate in increasing activity by providing more liquidity to investors in the secondary market.

Role and Function of a Stock Market

Stock markets and economic functions may not be distinct to many people but, in fact, they represent a relationship between the disparate sectors in social society between savers and producers as the saving sector needs to employ their savings in more beneficial and ambitious projects. Additionally, the productive sectors always require financial sources to assist them to continue to perform more in function of economy, in which stock market performance and functions of basic economy transfer funds from people who have amassed surplus to those who have a paucity of funds (Henry,1997).

Figure 2 shows that lender-savers must borrow funds from borrower-spenders to finance their spending in two ways. The first is an indirect transfer by financial intermediary institutions, such as banks and other commercial organisations, and the second is a direct transfer where borrowers obtain funds directly from lenders in the sale of financial instruments (security). As the financial intermediary holds the largest part of the investment to reduce the risk to the economy, and low interest rates would lead to increased investment, financial intermediary institutions work on the transfer of funds from lenders to borrowers more efficiently compared with the absence of these institutions. In other words, intermediary institutions have a better incentive to assume the risks resulting from the possession of investment instruments because they have huge financial possibilities allowing them to diversify their portfolios and reduce investment risk rate, which is assisted by the availability of its financial experts. Their specialists take advantage of a rising surplus from the management of purchasing and selling these investment tools.

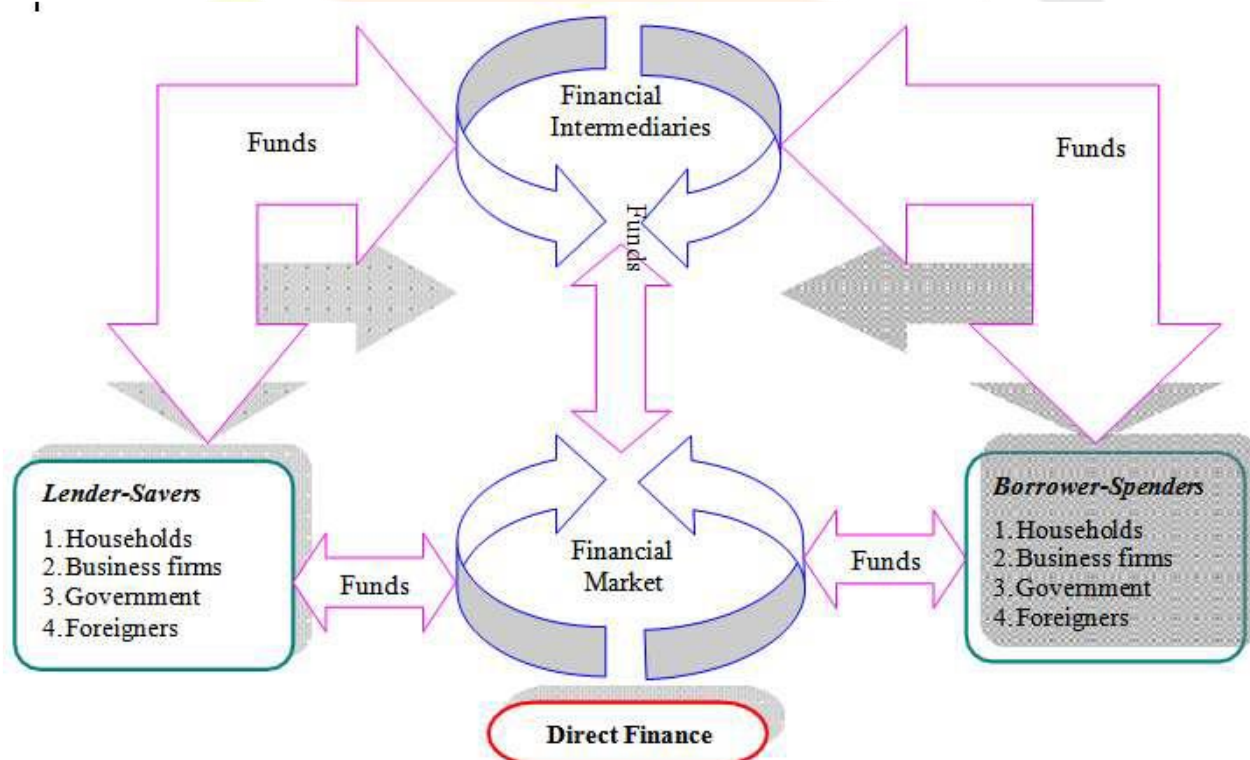


Figure 2. Flows of Funds through the Financial System

Source: Mishkin and Eakins (2003).

In addition to the previous discussion, the economic function of these markets can be identified thus:

1. To provide or increase the amount of financial resource available, as the stock market offers many opportunities for both creditors and civilians via the provision of multiple investment channels.
2. To provide financial information and projects relating to various financial assets available in the stock market, regarding information of the financial situation of companies, thus reducing the cost of access to such information in terms of effort, time and risk.

3. To provide liquidity for owners of various financial assets.
4. To assist in the development of diverse methods of financing (short, medium and long term) for the projects.

In point of fact, it can be observed how important a stock market is for the economy, since it allows movement of funds from persons who possess them and have no investment opportunities to those who enjoy these opportunities, by using the stock market function to increase production and to achieve economic efficiency and improve the level of prosperity in society. Financial intermediaries are determined as being:

commercial banks, savings banks, investment banks and specialised lending institutions, insurance companies, pension funds...etc. These institutions play the crucial role of mediator to transfer funds from lenders to borrowers; the common factor between these intermediaries is the possibility of accessing funds through the creation of the debt on the same (in deposits coffers), then borrowing from the public to invest these funds via the purchase of investment instruments “stocks, bonds”.

Conclusion

The present study represents an attempt to set up the relation between stock market development and economic growth in India, based on annual available data, through different sources. In India, the stock market is in a continuing process of development, but still, there are significant measures that need to be carried out to stimulate its evolution. The study showed that a higher rate of economic growth is definitely stimulated by the real investments, which indirectly generate positive externalities on stock market indicators and in the real sector.

There are many factors which have helped financial markets to gain prominence in many countries of the world, such as increasing the private sector’s role in various economic activities, cutting edge technological advances and the phenomenal speed of access to financial information. There have also been advances in modes of communication and the emergence of new and effective financial tools that guarantees freedom of trade and movement of capital. All of these indicate the significance of stock markets, providing further opportunities for growth

Therefore, the present study recommends that the capital market regulators should implement effective policy frameworks towards the development of Indian stock market in order to substantially enhance the size, depth and liquidity of the Indian stock market which in turn leads to increased economic activities. Further, the government should prioritize the development of the stock market through relaxing laws and of listing requirements for investors so as to encourage more individual market participants than the operators on the stock exchange and thus increases competition and quality of securities investments resulting in a significant influence on economic growth in India.

Suggestions

Stock market performance and the economic growth are just like the two sides of a fair coin. As stock market increases economy, is also fast in growth on the other hand downfall in the market means slowdown in the economy growth. Both are related to each other so we could create to maintain growth of the market, savings and investments. There is a need for economic growth in India that’s why emphasis should be more on the smooth functioning of the stock markets.

References

1. Arnold, H. (2004), Schumpeter and Methodological Individualism. *Journal of Evolutionary Economics*, 14(2),153-156.
2. Bencivenga, V.R., Smith, B.D. (1991), Financial Intermediation and Endogenous Growth. *Review of Economic Studies Limited*, 58, 195-209.
3. Boyle, G., Peterson, J. (1995), Monterey Policy, Aggregate Uncertainty, and Stock Market. *Journal of Money, Credit and Banking*, 27(1),570-582.
4. Pratten, C. (1993), The Stock Market. Department of Applied Economics, University of Cambridge. Romer, D. (1993), Credit Channel or Credit Action? An Interpretation of the Post-war Transmission
5. Cottle, S., Dodd, D.L., Graham, B. (1962), Security Analysis. New York: McGraw.
6. Curry, S.J., Winfield, R.G. (1994), Success in Investment. London: John Murray Publishers Ltd. Cuthbertson, K., Nitzsche, D. (2001), Financial Engineering Derivatives and Risk Management. Australia: John Wiley and Sons, LTD.
7. Fabozzi, J., Modigliani, F., Jones, F., Ferri, M. (2002), Foundations of Financial Markets and Institutions. (3rd ed.) Pearson Education LTD.
8. Goldsmith, R.W. (1969), Financial Structure and Development. New York: Yale University Press. Greenwood, J., Smith, B. (1997),
9. Gurley, J.G., Shaw, E.S. (1960), Money in a Theory of Finance. Washington D.C.: The Brookings Institution.

10. Handay, E.M. (1997), Securities and Capital Market. Alexandria: Monshat Almarf, Egypt (in Arabic). Haugen, R.A. (2001), Modern Investment Theory. (5th ed.) Great Britain: Upper Saddle River, NJ. Henry, P. (2000), Stock market Liberalisation, Economic Reform, and Emerging Market Equity Prices. *Journal of Finance*, 55(2), 529-564.
11. Johnson, T.E. (1983), Investment Principles. New Jersey: Printice-Hall, Inc.
12. Mishkin, F.S., Eakins, S.G. (2003), Financial Markets in Institutions. (4th ed.) New York: Boston San Francisco.
13. Mullin, J. (1993), Emerging Equity Markets in the Global Economy. *Quarterly Review*, 54-83.
14. Patrick, H.T., Wai, U. (1973), Stock and Bond Issues and Capital Markets in Less Developed Countries. International Monetary Fund, Staff Papers, World Bank, Washington, D.C.
15. Singh, A. (1999), Should Africa Promote Stock Market Capitalism?. *Journal of Informational Development*, 11, 343-365.
16. Standard and Poor's (2007), Public Finance Criteria. New York.
17. Stapley, N.F. (1986), The Stock Market: A Guide for the Private Investors. London: Woodhead- Faulkner in Association with Laing and Cruickshank Investment Management Services.
18. Tobin, J. (1969), A General Equilibrium Approach to Monetary Theory. *Journal of Money, Credit, and Banking*, 1(1), 15-29.
19. Tweles, R.J., Bradly, E.S. (1987), The Stock Market. New York: John and Sons, Inc.
20. World Bank (1994), Philippines Private Sector Assessment. World Bank, Washington, D.C.

