Role of Stock Market in the Economy of a Country

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Abstract

Finance is like blood for any organization. If finance is taken out of an organization, whole system will collapse. Stock markets are important in order to increase the investment in any company. The importance of stock market cannot be neglected in the economy of a country. This paper will explain various types of stock markets, how do they operate, and how they impact the economy of a country. There are two types of stock markets in any country, primary markets and secondary markets. The company that is attracting the investors with the first time share issue receives money through Initial Public Offering (IPO). Dealers and brokers are found in a stock market that is important part of stock market operations. Stock market impacts the economy of a country in many ways. The strength of stock market shows the strength of the country's economy. Stock markets make the cash and investments available for the companies. With the availability of investment, corporations perform better and add to the economy of the country. There are certain economic factors that impact the stock market as well. These factors include inflation and interest rates. As a conclusion it can be said that the role of stock market for the betterment of a country's economy can never be ignored.

Keywords: Stock market impacts, investment, Corporations perform, Initial Public Offering (IPO).

INTRODUCTION

There are several financial institutions in a country that help to manage the finance of that country. These financial institutions include banks, stock markets, and other mortgages firms. The importance of stock market cannot be neglected in the economy of a country. This paper will demonstrate the importance and role of stock market in the economy of the country. The paper will also explain that how stock markets work and, then, add in the growth of the economy of a country.

STOCK MARKET

The simplest definition of stock market can be that it is a place where the shares of publicly held corporation are traded. Primarily there are two kinds of stock markets available in any country (Furgang 41).

1. Primary market
2. Secondary market

Primary Market:

In primary market the new shares or issues of a corporation are brought to be traded. For example if a corporation offers new shares then the market where these shares will first be traded will be called primary market The primary market provides the channel for sale of newsecurities. Primary market provides opportunity to issuers of securities; Government as well as corporate to raise resources to meet their requirements of investment and/or discharge some obligation. They may issue the securities at face value, or at a discount/premium and these securities may take a variety of forms such as equity, debt etc. They may issue the securities in domestic market and/or international market

Secondary Market:

Secondary market is those stock markets where the existing or already issued shares of a corporation are traded. The secondary market, also called the aftermarket, is the financial market in which previously issued financial instruments such as stock, bonds, options, and futures are bought and sold. Another frequent usage of "secondary market" is to refer to loans which are sold by a mortgage bank to investors such as Fannie Mae and Freddie Mac.The term "secondary market" is also used to refer to the market for any used goods or assets, or an alternative use for an existing product or asset where the customer base is the second market (for example, corn has been traditionally used primarily for food production and feedstock, but a "second" or "third" market has developed for use in ethanol production).

With primary issuances of securities or financial instruments, or the primary market, investors purchase these securities directly from issuers such as corporations issuing shares in an IPO or private placement, or directly from the federal government in the case of treasuries. After the initial issuance, investors can purchase from other investors in the secondary market.

The secondary market for a variety of assets can vary from loans to stocks, from fragmented to centralized, and from illiquid to very liquid. The major stock exchanges are the most visible example of liquid secondary markets - in this case, for stocks of publicly traded companies. Exchanges such as the New York Stock Exchange, London Stock Exchange and NASDAQ provide a centralized, liquid secondary market for the investors who own stocks that trade on those exchanges. Most bonds and structured products trade “over the counter,” or by phoning the bond desk of one’s broker-dealer. Loans sometimes trade online using a Loan Exchange.

Difference between Primary and Secondary Market

In Primary Market securities are offered to public for subscription for the purpose of raising capital or fund

Secondary Market is an equity trading venue in which already existing/pre-issued securities are traded among investors.

The difference between the primary capital market and the secondary capital market is that in the primary market, investors buy securities directly from the company issuing them, while in the secondary market, investor’s trade securities among themselves, and the company with the security being traded does not participate in the transaction.

When a company publicly sells new stocks and bonds for the first time, it does so on the primary capital market. In many cases, this takes the form of an initial public offering, or IPO. When investors purchase securities on the primary capital market, the company offering the securities has already hired an underwriting firm to review the offering and created a prospectus outlining the price and other details of the securities to be issued.

Companies issuing securities via the primary capital market hire investment bankers to obtain commitments from large institutional investors to purchase the securities when first offered. Small investors are not often able to purchase securities at this point, because the company and its investment bankers seek to sell all of the available securities in a short period of time to meet the required volume and must focus on marketing the sale to large investors who can buy more securities at once. Marketing the sale to investors can often include a "road show" or "dog and pony show," in which investment bankers and the company's leadership travel to meet with potential investors and convince them of the value of the security being issued.

The secondary market is where securities are traded after the company has sold all the stocks and bonds offered on the primary market. Markets such as the New York Stock Exchange (NYSE), London Stock Exchange or NASDAQ are secondary markets. On the secondary market, small investors have a better chance of buying or selling securities, because they are no longer excluded from IPOs due to the small amount of money they represent. Anyone can purchase securities on the secondary market as long as they are willing to pay the price for which the security is being traded.

On the secondary market, an investor requires a broker to purchase the securities on his or her behalf. The price of the security fluctuates with the market, and the cost to the investor includes the commission paid to the broker. The volume of securities sold also varies from day to day, as demand for the security fluctuates. The price paid by the investor is no longer directly related to the initial price of the security as determined by the first issuance, and the company that issued the security is not a party to any sale between two investors. However, the company can engage in a stock buyback on the secondary market.

STOCK MARKET PROCESS

When a company needs to raise capital it offers its company shares in the primary market. This process is called Initial Public Offering (IPO). The price of company's shares is determined based on the worth of the company. The interested buyers of the shares purchase the shares of new offering. The company receives the money only through IPO; the investors keep buying and selling the shares of the company later on. The traders and investors keep buying or selling the shares of a company after its IPO. This is because the perceived value of the company changes over time. If the share price of a company increases over time then more investors are willing to buy the shares to earn more profit. On the other hand if the stock price of a company decreases then the investors are most likely to sell its stock to reduce the potential loss (Schaefer).

So stock market is a place which brings the buyers and sellers of shares together. There are dealers and brokers in stock market. Dealers are those persons who maintain an inventory of shares and are ready to sell the shares at any particular time. On the other hand the brokers do not maintain an inventory of shares rather they bring the buyers and sellers together to make a deal

Some other important functions of stock market include the following:

- It works as an economic barometer
- Stock markets make the transaction of share safe and secure
- It provides liquidity and better allocation of capital
- It promotes the habit of savings and investment
- It contributes to economic development of a country

Importance of Stock Market for Country's Economy:

Studies have shown that stock market growth and the growth of economy are very much related with each other. The liquidity in stock market helps the development of the economy. Stock market provides general idea about the strength of the economy. Countries that have better performing stock markets generally have better performing economies too. The everyday activities in stock market impact the economy of a country. Stock market works as a barometer that explains the health of a country's economy (Boubakari and Jin 18).

The importance of stock market can be understood with this example that in 1929 the stock market crash caused the great depression of 1930. In 1929 there were certain economic imbalances and structural disasters that led to a downfall of stock markets around the globe. As a result of this stock market crash there was a great depression in the economy of whole world.

Corporations add to the economy of a country. If, in any case, the corporations need to raise capital they go to stock market and issue new shares to have more investment and capital. In this way stock markets keep the corporations alive by providing them the fresh capital which makes the corporations capable of keep adding to the economy of the country.

Studies have found that overall growth of the economy depends on the performance and efficiency of stock markets. Stock markets mobilize the savings of individuals to the corporations and corporations then add to the GDP of the economy. So indirectly stock market injects the savings of individuals to the growth of the economy. Rising stock prices create a sense of improvement in the economy and build the confidence of the investors.

Impact of Economic Factors on Stock Markets:

The stock market acts as the reflector of country's economy however there are certain economic factors that affect the stock markets as well. Some of these factors are discussed below.

Inflation is one of the most important economic factors affecting the stock markets. As discussed above individuals invest their savings in the stock market. When there is an increase in the inflation rate the price of products increases and thus there is a reduction in savings for the individuals. Decline in saving leads to decline in the stock market by the individuals.

Interest rate is another economic factor that impacts the performance of stock market of a country. Higher interest rates are certainly beneficial for investors but in this way the cost of borrowing becomes very high for corporations.Avoid more investment from the investors. Thus there is a low supply of shares than the demand which affect the stock market negatively.

CONCLUSION

As a conclusion it can be said that the role of stock market for the betterment of a country's economy can never be ignored. Stock market plays a role of bridge between individual investors and the corporations. Both parties meet and agree on various terms inside a stock market. The impact of stock market on the economy is also considerable. Stock market confirms the availability of liquidity for corporations which can add to economy of the country by producing goods and offering employment opportunities. Thus a country should focus on the stock market in order to strengthen its economy (Burton, Nesiba and Brown 148).

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