Growth & Development in the Capital Market: A review of literature

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Abstract

This study aims at looking after the factors that lead to the growth and development of the Indian Economy. In a country like India where the markets are weak in terms of their functioning it is important to identify and look after the factors that can contribute to the healthy growth and development of the capital market. The paper summarizes some of the crucial factors and how do they impact the growth of the markets. The factors identified were economic development, inflation, banking sector, exchange rates, inflation rate. The study helps in understanding the complex capital market and provides scope for further empirical studies in the same direction.

Keywords: Determinants, Capital Market, Market Capitalization

JEL Classification: E44

Introduction

The role and significance of the capital market can be understood from the fact that capital market are considered to be one of the most significance base for the economic development of the economy. Capital markets acts as a platform and helps in the mobilization of savings by the savers or carriers of surplus funds and at the same time help the borrowers of the firms procure funds from the market. They also help in providing the much needed liquidity to the instruments which can be easily sold or disposed in the market when required.

The capital markets can also help in the reduction of the risk not only for the firms and individuals but also for the countries where they could diversify their country wise risk by making diverse investments into different countries. Looking after the importance of the capital markets at such wider scale, the determinants impacting the growth and development of the capital market shall help us understand the complex capital market in a much better manner

There had been a lot of studies being conducted empirically to test the impact of various factors on development of the capital markets but the theoretical landscape for the development has not been looked after in much detail. Hence we take this initiative and through this study we aim to look after the various macro level factors having a direct bearing on the growth & development of the capital markets.

Factors such as Inflation, exchange rate, economic development, interest rates & banking sector were identified as the major macro economic factors with regard to the development of the capital markets. All these factors have been found to impact the development of the capital market in different ways and it was important to see how these factors act under different situations prevailing in the economy.

After the introduction the second section of the study covers the extant review of literature, section three & four deals with the trends & the conclusion part and the last section deals with the references.

Review of literature

The data with regard to the determinants impacting capital markets are not easily available and we had to go through a lot of financial models as well as empirical studies and considerable amount of literature to identify these factors. Based on the extant literature we came across five major determinants which were economic development, inflation rate, interest rates, exchange rate as well as banking sector development. We look at each of these factors in detail to understand the impact they have on the capital market.

Economic Development

The role of economy in uncovering its impact on the financial systems is not well developed in the literature (levine, 1997). In general sense it has been widely accepted fact that the growth in the real income leads to the positive impact on the capital markets and vice versa. The reason for such theory is based on the phenomena of economies of scale. It is believed that the formation of financial systems involves a set of fixed cost based on the services of the financial intermediaries and until and unless the market or the economy reaches a significant level sometimes referred as the threshold level, these fixed costs shall be significantly high. Greenwood & Smith (1997) agrees with this view that once the economic development takes place and reaches a significant level these fixed cost are reduced and the services could be availed at low cost giving a boost to the capital markets. This also helps the investors avail the financial services at low cos (Hicks, 1969; North, 1981; Greenwood and Jovanovic, 1990).

Banking development

The literature available in this domain is largely inconclusive and different proponents have put forth different arguments. One set of authors argue that the banking system act as a substitute to the capital markets whereas another set of studies conclude that both these systems together leads to the overall development of the financial systems and are in fact complementary to each other.

According to Stiglitz (1985) there lies a free rider problem in the capital markets that entails that the information is widely and easily available to the investors regarding the stock markets, especially for the well developed stock markets, and hence there is no motivation for the investors to seek more information for the firms. The free rider problem could be overcome by the banking system which does not divulge this information freely and hence encourages information seeking behavior to promote effective resource allocation.

According to another set of studies the banking as well as capital act as a complementary agents and therefore they must together focus on the overall development of the economy as a whole. Levine (2005) argues that both the banking as well as the financial system can provide growth and enrichment to the economy. They may act as close compliments as there by helping in the growth of both the systems simultaneously. Stock markets can provide the liquidity and the availability of the alternate investment opportunities can prevent the impact of the controlling and influential banks.

Thus we see that both banking as well as capital market can take various forms where the substitution or competitive environment may encourage both the systems to improve the performance or they can together improve the financial mechanisms and systems.

Inflation rates

The literature seems to be inclined towards the fact that higher rate of inflation reduces or negatively impacts the growth of the stock markets. According to Huybens& Smith (1998) a non -linear relationship is found to exist between the inflation rate and the capital market development. With an increase in the inflation rates the rate of returns tends to fall (Boyd et al

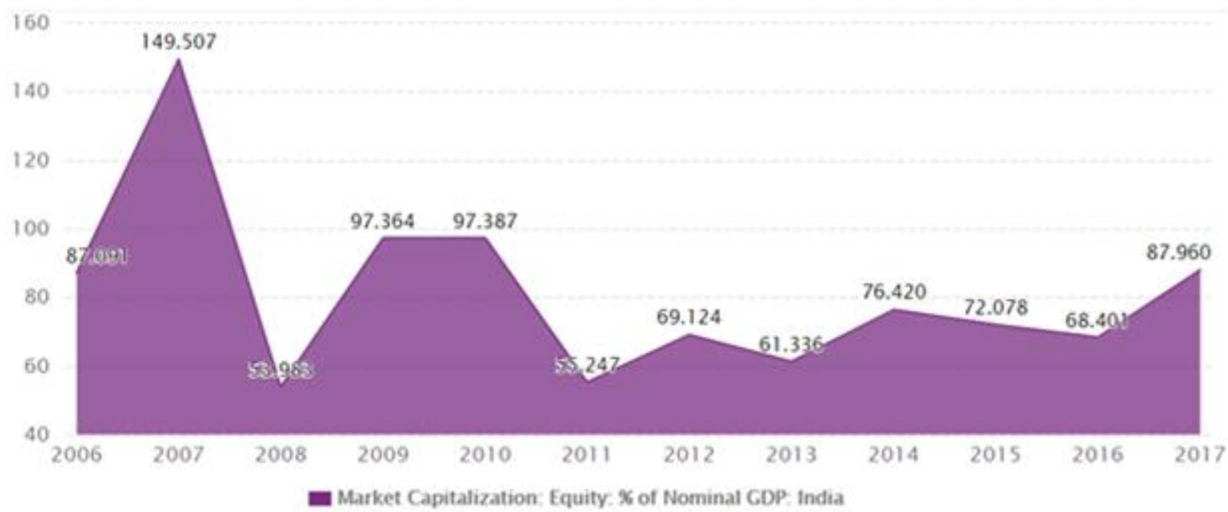
2001), such that this would reduce the incentive of the lenders to lend money and thus there are very bleak chances of such funds reaching the capital market leading to reduced performance and deterioration, it also causes credit market friction leading to rationing of funds (Huybens& Smith 1998; Choi et.al 1996).

Interest Rates

Interest rates are considered to be one of the most important ingredients for the development of the stock market. The level of interest rates prevalent in the economy provides a set of incentives both for the borrowers as well as lenders differently. Interest rates could affect the capital markets for endogenous reasons (Cooley and Smith ,1992).This represents a case where the economic growth rate is higher than the interest rates available in the markets. In cases where the rate of interests are quite low it is beneficial for the lenders such that they can invest in the capital markets, but at the same time this might lead to borrowers becoming nonexistent from the markets. Thus it replicates a situation of having excess supply from the markets but no demand for the same.

Exchange Rate

The literature with respect to the exchange rate movements are very significant and conclusive in terms of the established relationship between the capital market and the exchange rates in the economy (Dornbusch and Fisher,1980). As per the financial models propounded by the Dornbusch and Fisher (1980),the exchange rate plays a very crucial role in determining the international competitiveness of the economies. The exchange rate affects the exports and imports of the countries which in turn affects their balance of payments account. The real output of the economies, purchasing power, real income all these elements are based on the exchange rate mechanisms. They will direct bearing on the capital market of the country since the income levels and the availability of funds with the firms and other individuals are affected. Also the exchange rates movements create a sense of panic as well as volatility attack in the investors mind in terms of their real income and thus the impact is possibly negative in nature.



Source: www.ceicdata.com Fig.1

Trends in the growth of the Indian Capital Market

The above (Figure 1) clearly shows the market capitalization of India in terms of the equity percentage of the nominal gdp from the period 2006-2017. We can see the maximum decline in the year 2008 caused by the impact of the major US financial crisis and then the growth has never ever reached the same peak as it was before the financial crisis. Over the years the growth in the capital market development has been more or less stagnant with not many changes and has been close to 90%.

Conclusion and Policy Recommendations

In this study after going through the extant literature available with respect to the growth and development of the capital markets we came across five macroeconomic factors and thus these factors tell us a lot in detail about the course of action required for the policy makers to look after these aspects carefully such that they can boost the development of the capital markets.

Firstly economic growth and development is considered to positively affect the capital market hence all those incentives that help in economic development must be initiated by the government. Secondly it was propounded that banking system development can take two forms one acting as a substitute to the capital markets and other to support and complement the capital markets. In both the scenarios the focus shall be to enhance the overall efficiency as well as productivity of the financial systems. Thirdly Inflation rates are understood to negatively impacts the capital market development hence the government as well as the reserve bank of India shall focus on keeping the inflation level under control. Fourthly the impact of interest rates can be both positive as well as negative depending upon its relationship between the growth rate, thus the policy makers shall indulge into such measures that shall give a positive push to the capital markets. Lastly the exchange rates movements are found to be negatively impacting the growth since these movements usually impact the real income as well as the international competitiveness thus making it risky for investors to invest in capital markets. Thus government shall try to control the exchange rates in a certain range in order to provide stability.

In a nutshell it can be understood that these factors together play a significant role in development of the capital market hence the policy makers shall consider the impact of each of these agents and frame policies accordingly. Also for future studies a financial model could be developed to empirically test the validity and impact of such agents together on the development of the capital market.

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