

# NEWS ALERT DAILY NEWSLETTER

## DO STOCK MARKETS REFLECT ECONOMIC GROWTH?

The growing importance of stock markets around the world has recently opened up avenues of research into the relationship between financial development and economic growth that primarily focuses on the movement and the consequent development of the stock markets. Various studies across the globe have provided numerous insights on this subject, but none of them has been able to conclusively prove the existence of a definite positive correlation between the two.

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A well functioning stock market may help the development process in an economy through the following channels:

- ◆ Growth of savings
- ◆ Efficient allocation of investment resources
- ◆ Better utilization of the existing resources

**DO STOCK MARKETS AND ECONOMIC REFORMS HAVE AN IMPACT ON ECONOMIC GROWTH? DO STOCK MARKETS AFFECT OVERALL ECONOMIC DEVELOPMENT?**

### THE RATIONALE

**Why stock prices predict economic activity:**

First. Stock prices are the present value of future earnings of companies. So when the stock price rises, people perceive the future earnings of the companies to increase.

Second. The wealth effect is the propensity of people to make more expenditure if they have more assets. Assets include the stocks people own. When the value of equities rises, the notional value of wealth rises too and thus the disposable income. And when the market plunges, people's wealth decreases and they curtail spending.

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Stock markets are "CASINOS"

Some analysts view stock markets as "casinos" that have little positive impact and negative impact on economic growth. According to this view, greater stock market liquidity may hurt economic growth.



What determines stock markets development?

1. Stock market size
2. Liquidity
3. Volatility
4. Concentration
5. Integrity with world capital markets
6. Legal rules, regulation and supervision in the markets

*No definite correlation between GDP and Sensex*  
**One cannot conclusively prove that the stock markets act as a leading indicator to the economic growth.**

### QUESTION OF THE DAY



**What are delta stocks?**

- A ) Highly liquid shares
- B ) Least liquid shares of stock exchange
- C ) Listed but infrequently traded shares

#### POSITIVE EFFECT OF FINANCIAL MARKETS & INTERMEDIARIES ON ECONOMIC GROWTH

**MARKET FRICTIONS**  
 Information costs  
 Transaction costs

**Financial markets & intermediaries**

**Financial Functions**

- ◆ Mobilize savings
- ◆ Allocate resources
- ◆ Exert corporate control
- ◆ Facilitate risk management
- ◆ Ease trading of goods, services and contracts

**Channels to growth**  
 Capital Accumulation  
 Technological innovation

**Growth**