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Effect of Stock Market Performance in Investment Attraction and Capital Accumulation

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Abstract

Despite the polarization of financial systems of economies in terms of capital concentration, financial market-based financial systems are leading the financial globalization and capital flows by attracting and distributing the investment through stock markets. This article studies the impact of stock markets on attracting investment to economy and capital flows in developing economies.

Keywords: stock market, investment, capital, developing economy, transition economy.

1.Introduction

Financial markets, especially stock markets, have grown considerably in developed and developing countries over the last two decades (Claessens et al, 2001). In developing economies, financial sector is the most progressive and rapidly-changing area of economic reforms. Privatization, economic liberalization and business support policies are key measures to adopt market principles which have the most significant effect in capital circulation and accumulation in a transforming economy. In transition economies privatization policy was the initial step of large-scale economic reforms due to lessen the dominance of public sector in the whole economic system which is seen as the prerequisite of transition to market principles. This systemic reform was conducted with stock market channels by giving the public assets to private hands in multiple ownership forms. As a result, stock market capitalization increased and mobilization of external and internal investment exceeded, and reallocated among different sectors.

An efficiently functioning financial sector is key to achieving a market-based economy for promoting rapid economic development with the private sector as the engine of growth (ADB, 2008). The stock market has an important role in the allocation of resources, both directly as a source of funds and as a determinant of firms' value and borrowing capacity (OECD, 1993). Functioning of a stock market serves as an accumulator of capital and a driver of investment sources. Moreover, stock markets facilitate the smooth integration to global markets with added effects in higher economic growth, more macro stability, structural reforms, and specific policy changes. Stock markets support further capital market development via new financial instruments such as mutual funds and investment vehicles, and encourage national authorities to issue government securities and make use of financial markets as a tool for private sector development and corporate business environment. In the context of developing and transition economies where stock markets are in development phase and partially integrated with the global financial system, domestic stock markets help insulate the domestic economy from much of the impact of external shocks, and hence safeguard the independence of production and foreign trade by injecting the domestic capital and investment to sectors with high market-demand. Stock market attracted domestic and foreign investments enables the full market saturation through import-substitution and market extension through capitalization and reallocation of resources. This article studies the importance of stock market in investment attraction and capital mobility from the perspectives of developing and transition economies, and provides empirically-rooted conclusions and recommendations for transition economies who has completed privatization policy and is actively seeking economic restructuring for adopting market principles.

2. Literature Review

Stock market performance and its impact on investment movement in an economy was a field of comparatively less research interest. Most scientists and policymakers often focused on its impact on entire economy and business environment, but they did not paid sufficient attention to separate impact areas of stock market functioning. After 1980s cross-border capital mobility expanded from developed to developing economies, research focus was directed to investment and stock market linkages and their implications. Tease (1993) examined the relationship between equity prices and business investment, addressing the question of whether investment is influenced by inefficient pricing in equity markets. López-Duarte and García-Canal (2007) tested whether the stock market reaction to investment is dependent not only on the entry mode that the investing firm may have chosen, but also on the interaction between the entry mode and the other FDIs' attributes. Polk and Sapienza (2008) tested a catering theory describing how stock market mispricing might influence individual firms' investment decisions. Claessens et al. (2001) studied the determinants of the growing migration of stock market activity to international financial centers by sample of 77 countries and found that investment is positively correlated with stock market capitalization and value traded.

3. Stock Market and FDI Linkages: Market Performance Effect

Foreign direct investment (FDI) in developing economies has grown rapidly following financial and political transformations. To increase their share of FDI flows, most of the countries ease restrictions on foreign direct investment, strengthened macro stability, privatization of state owned enterprises, domestic financial reforms, capital account liberalization, tax incentives and subsidies have been instituted (Adam and Tweneboah, 2008). FDI has become an increasingly common tool for economic growth in developing economies, as it ensures a room for technological systemic modernization for production and technologies, skills and employment opportunities. Growing body of evidence from international practice shows that ownership adjustment and decentralization of public ownership structure is the key measure for attracting both domestic and foreign investment. In many cases, transition economies transforming the composition and volume of public assets by offering their share to institutional and individual investors. State owned enterprises are going public and sometimes international, and influencing on the whole financial sector by gaining an active position in local or domestic stock markets. There invested amount is accumulated in stock markets and reallocated by production channels to diverse sectors of economy. As seen in practice of many developing economies, (i) domestic added value of financial sector, especially non-bank financial sector increases, (ii) volume of financial assets in economy grows, (iii) cases with of lack-of-funding reduce and (iv) size of financial sector expands.

Figure 1. Investment flows in 2011-2015, billion USD

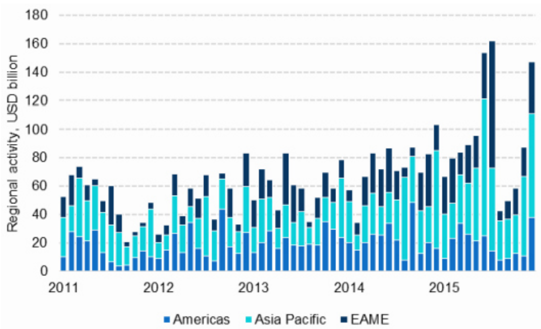
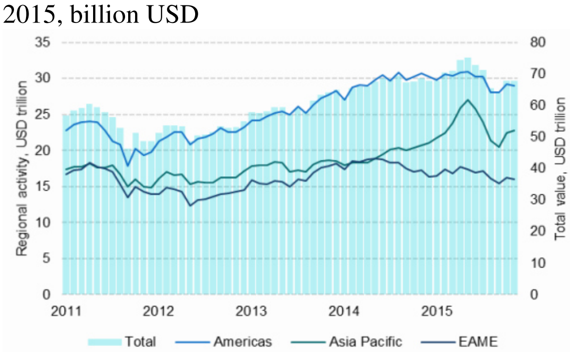


Figure 2. Domestic market capitalization in 2011-2015, billion USD



Source: World Federation of Exchanges, 2016.

Well-organized FDI and stock market interaction resulted in economic development in many developing and emerging economies. Stock market-led FDI served as the main tool for economic diversification, modernization and, finally, growth. Nowadays, FDI stocks are changing by sector, geography and mode of entry due to changing business environment and different development orientation of host and home economies (Figure 1 and Figure 2).

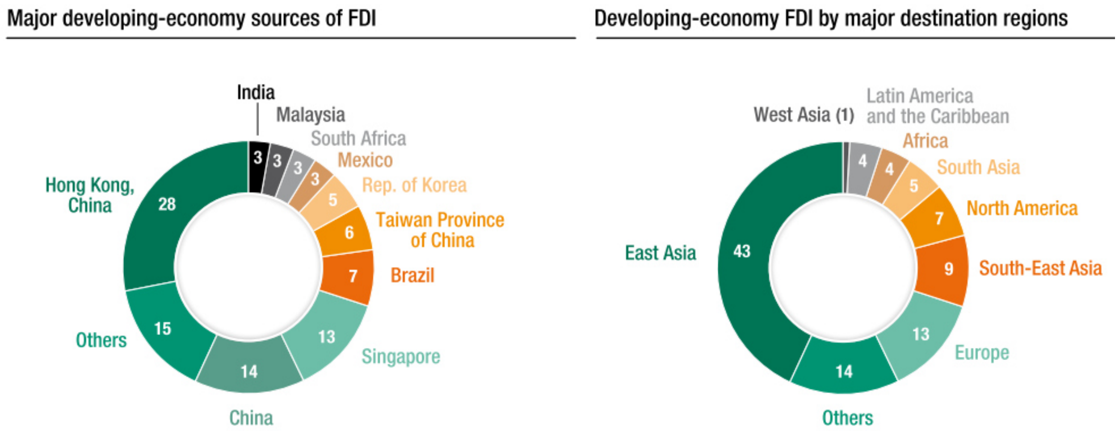
As seen in Figure 1 and 2, Asia Pacific region, which consists of mainly developing economies, was main destination of stock market-led investment. India, China, Malaysia, Hong Kong SAR, Kazakhstan, Uzbekistan, Vietnam, Azerbaijan and other Asian developing economies piled the investment stocks in financial markets. Domestic market is developing via large flow of capital to different unrestricted investment-available fields and sectors.

4. Stock Market Development, Investment and Economic Growth in Developing and Transition Economies

A well organized and managed stock market encourage investment by identifying and supporting that productive projects that will ultimately lead to economic development (Raza et al, 2012). Since there are several contrasting literature which reject or support the positive effect of stock market attracted investment in economic growth, practical evidence and experience of emerging economies reflects the importance of stock market extension and its role in attracting investments to boost economic growth. In 1980s they increased efforts to attract more FDI and take the advantage of its several positive effects which include productivity gains, technology transfers, introduction of new processes to the domestic market, managerial skills and know-how, employee training, international production networks, and access to markets, and eventually their status altered from developing to emerging economy. India, China, Indonesia, Russia and Brazil developed the investment policy in parallel with stock market development actions. As a result, financial sector held a considerable importance in national output and share in economic development.

Particular differences in economic sector-stock market relations exist in developing economies. In transition economies, this difference is even bigger, and sometimes it is observed that there is a huge gap in activeness of an entire industry in financial markets. Developing and transition economies are always in need of external capital to improve any sector or industry due to comparatively low income level or inadequate level of technological or financial capacity. Therefore, attracting foreign investment and offering the public shares to foreign investors have a doubled effect both for industrial and financial sector development. Publicly offered shares of state-owned enterprises and IPOs of newly established enterprises are initially traded in local stock markets. Turnover effect of stock markets increases as trade volume rises, which eventually leads to wider capital circulation and reallocation of investments among promising industries in consistent with market demand and changes in local business environment.

Figure 3. Share of host and home developing economies for FDI stock, %



Source: UNCTAD, 2015.

Landscape of financial market attracted FDI changed after global financial crisis. Nowadays host-home principles are polarized in destination of FDI (Figure 3). Till global financial crisis in 2008, developed economies were main investors and key players in financial markets of developing economies by holding a large share of foreign capital and properties. After a painful hit of the crisis, developing economies became the major investors to developing counterparts. China, India, Russia and Malaysia injected their investment and hold a considerable share in local financial markets of any developing economies.

5. Conclusion

In modern economy period, financial markets are seen as the driving force of economic soundness and development. Foreign trade and cross-border capital mobility have already created a web of interdependent economic linkages which make every economy to develop collectively, not individually. The global trend of financial system formation is going on the way of transition to bank-based to financial market-based financial system. It proves that financial markets gains the central role in capital formation, accumulation, distribution and economy-wide circulation in any economy. Economic growth channels unavoidably cross the financial market channels to progress. Therefore, stock markets of both developed and developing economies, as accumulators of investment, are required to fully integrate to global financial environment and to keep updated with developments international economic community. In the context of developing and transition economies, as outlined above, stock markets bring not only the capital to fulcrum industries, but also international best practices. Considering the comparatively less developed financial market infrastructure in developing and transition economies, following recommendations are proposed:

1. Easing the market access and listing requirements;
2. Simplifying the listing procedure and avoidance from too much formalities;

3. Stimulating the foreign shareholders to be active in financial market operations;
4. Regularly issuing the stock market performance reports and reviews.

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