International Journal of Research in Engineering, Science and Management
Volume-2, Issue-8, August-2019
www.ijresm.com | ISSN (Online): 2581-5792

The Impact of Stock Market on Economic Growth of India

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***Abstract*: The main purpose of this study was to explore the link between stock market performance and the economic growth of India in terms of a simple theoretical literature framework. Indian economy is the third largest economy in the world in terms of purchasing power. It is going to touch new heights in coming years. As predicted by Goldman Sachs, the Global Investment Bank, by 2035 India would be the third largest economy of the world just after US and China. It will grow to 60% of size of the US economy. This booming economy of today has to pass through many phases before it can achieve the current milestone of 9% GDP. Researchers hold diverse opinions regarding the importance of stock markets playing a significant role in economic development performing the following functions: by aggregating and mobilizing capital, profile enhancement, increases companies value, Consumption and the Wealth effect and reducing the cost of capital. The theoretical literature argues that stock markets are crucially linked to economic growth. The findings suggest a positive relationship between stock markets and economic growth, both in short run and long run.**

***Keywords*: Stock market, Economy, Developing country – India, SEBI, Stock exchanges**

1. Introduction

The economic history of India since Indus Valley Civilization to 1700 AD can be said under pre-colonial phase. During Indus Valley Civilization the economy was very well developed. It had very good trade relations with other parts of world, which is evident from the coins of various civilizations found at the site of Indus valley. Then came the phase of Colonization. The arrival of East India Company in India ruined the economy of India. There was a two-way depletion of resources. British used to buy raw materials from India at cheaper rates and finished goods were sold at higher than normal price in Indian markets. During this phase India's share of world income declined from 22.3% in 1700 AD to 3.8% in 1952.

A. Rebuilding the economy of India

After India got independence from this colonial rule in 1947, the process of rebuilding the economy started. For this various policies and schemes were formulated. First five-year plan for the development of the economy came into implementation in 1952. These Five Year Plans, started by Indian government, focused on the needs of the economy. Trade liberalization, financial liberalization, tax reforms and opening up to foreign investments were some of the important steps which also include share market, which helped the economy to gain momentum. The Economic Liberalization introduced by Dr. Manmohan Singh in 1991, then Finance Minister in the government of P. V. Narsimha Rao, proved to be the stepping-stone for Indian economic reform movements.

Stock market is the heart of any economy be it a developing or a developed one. The proposition that a well regulated stock market renders a crucial bundle of economic service is now widely accepted and recognized by various researchers among the various functions of stock exchange, the provision for liquidity of capital and continuous market are considered as prime function from the point of investors. It helps mobilize resources and their allocation in those sectors which use them efficiently. From the point of view of economy in general, a healthy stock market has been considered indispensable for economic growth and is expected to contribute to improvements in productivity. More specifically, the indicators of the stock market operations such as liquidity, capitalization, asset pricing and turn over helps to assess whether the national economy is growing or not. In addition, by ensuring a free and a fair trading of stocks, the stock market can assure and retain a healthy market participation of domestic investors, financial intuitions, foreign investors and high net worth individuals which leads to improving the national economy.

Emerging stock markets have recently been of great importance to the world wide investment community. India is considered as one of the fastest emerging markets in the world. It has a well-established stock market with a long history of organised trading in securities. Over the last few years, there has been a rapid change in the Indian capital market. Advanced technology and online based transactions have modernised the country’s stock exchange. In terms of the number of companies and total market capitalisation, the Indian capital market is considered large relative to country’s stage of economic development.

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, have practised socialism for a long time. However, in the light of recent trends, and under the direction of the IMF and World Bank, 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.

2. Meaning and definition

The word "Stock Exchange" is made from two words 'Stock' and Exchange. Stock means part or fraction of the capital of a company, and Exchange means a transferring the ownership; representing a market for purchasing and selling. Thus, we can describe the stock exchange as a market or a place where different types of securities are bought and sold. Securities traded on a stock exchange include shares issued by companies, unit trusts, derivatives, pooled investment products and bonds. As the stock exchange deals in all types of securities, it is known as 'securities market' or 'securities exchange' also. A stock exchange is a secondary market of securities because the trading happens only for the securities that have already been issued to the public and now being allowed to be traded on the floor of a stock exchange after getting listed with the stock exchange. The initial offering of stocks and bonds to investors is by definition done in the primary market and subsequent trading is done in the secondary market.

The Securities Contracts (Regulation) Act, 1956 has defined stock exchange as an "*association, organization or body of individuals, whether incorporated or not, established for the purpose of assisting, regulating and controlling business of buying, selling and dealing in Securities*."

According to Pyle, "*security exchanges are market places where securities that have been listed thereon may be bought and sold for either investment or speculation*".

K.L. Garg has described the stock exchange as "*an association of persons engaged in the buying and selling of stocks, bonds and shares for the public on commission and guided by certain rules and conditions.*"

Johnson 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.*"

What is a Stock Exchange?

We know that companies can raise capital by issuing shares or debentures known as corporate securities and governments also issue bonds and instruments known as government securities to raise funds from the public. Investors hold securities either to earn income by way of interest or dividend or to gain capital appreciation due to increase in the price of the security over time. But investors cannot sell them without finding a buyer for the same. Similarly, people with accumulated savings or the institutions having surplus funds may also like to invest their funds in various securities and they also cannot do that without finding a seller.

Stock exchange is an organization which facilitates this process of buying and selling existing securities by providing a medium for buyers and sellers to interact with each other. As there could be a large number of buyers and sellers who want to trade in a particular security, stock exchanges facilitate arriving at trading price based on supply and demand by providing a medium. They help both buyers and sellers arrive at a mutually satisfactory price.

3. Features of stock exchanges

Based on the above discussion and definitions, given below are the main features of Indian stock exchange:

1. *Organized Market:* Stock exchange is an organized market of securities (shares, debentures, bonds, etc.) where the securities are bought and sold on the floor of a stock exchange. All transactions are regulated by the rules and bye-laws of Securities Exchange Board of India (SEBI).
2. *Formation & Membership:* A stock exchange is generally registered as an association or a society or a company. The membership of the stock exchange is restricted to a certain number, and new members are admitted only when there are vacancies. Every member has to pay the prescribed membership fee.
3. *Only Members Can Trade:* Stock exchange is only open to the members of exchange also known as brokers. Brokers act as an agent of the buyers and sellers of shares, debentures and bonds. In a stock exchange, transactions take place between members or their authorized agents on behalf of the investors.
4. *Listed Securities:* To be able to trade a security on a certain stock exchange, it must be listed on the respective stock exchange as per the guidelines issued by SEBI. The stock exchanges do not allow trading in each and every company's securities. Companies which want their securities to be traded on the floor of a stock exchange have to fulfil certain conditions. The stock exchange satisfies itself about the genuineness and soundness of the company to protect the investors from being cheated. Exchanges maintain records at a central location of such securities but now the trade is increasingly moving from physical places to electronic networks enabling speed and reducing cost.

4. Functions of stock exchanges

Stock exchange is one of the most important financial intermediaries and plays a very important role in the capital formation and economic development of the country. Given below are some important functions of stock exchanges from economic point of view:

1. *Marketability of Securities:* The stock exchange provides for easy marketability of securities as securities can be bought and sold conveniently on the floor of the stock exchange. The Stock Exchange provide companies with the facility to raise capital for expansion through selling shares

to the investing public and on the other hand provides investors with a platform to trade these shares.

2. *Price Determination & Continuity:* Since transactions take place regularly on a stock exchange there is continuity in the dealings. Supply and demand in stock markets are driven by various factors and this balance of supply and demand affects the price of stocks. These price gets duly recorded and reported in the newspapers for the benefit of investing public. Besides, stock exchanges have defined rules and regulations to moderate price fluctuations to ensure continuity in buying and selling.
3. *Mobilizing Surplus Savings:* Stock exchange is an integral part of the capital market of a country. When people draw their savings and invest in shares (through an IPO or the issuance of new company shares of an already listed company), this leads mobilization of funds to help companies finance their organizations. They facilitate the process by which the savings from all parts of country gets channelized as investment into industrial and commercial undertakings financing their capital requirements. This promotes business activity resulting in stronger economic growth and higher productivity levels of firms.
4. *Barometer of the Economy:* The share prices fluctuate on stock exchanges as a result of underlying market forces. The intensity of buying and selling of securities and the corresponding rise or fall in the prices of securities reflects the investors' assessment of the economic and business conditions. Share prices tend to rise or remain stable when companies and the economy show signs of stability and growth whereas they might fall sharply at the time of an economic recession, stagnation, depression, or financial crisis. Change in security prices are known to be highly sensitive to changing economic, social and political conditions and hence act as a barometer of economic and business conditions.
5. *Mobility of Capital:* Investing in other businesses require huge capital outlay whereas investing in shares is open to both the large and small stock investors. Stock exchanges furnish an open and continuous market for small investors and their savings that are invested in securities are converted into cash for reinvestment in other securities. Thus, stock exchanges provide mobility to capital and facilitate sound investment. Savings are encouraged when people come to invest in stock exchange.
6. *Profit Sharing & Resource Allocation:* As a result of stock market transactions, funds flow from the less profitable to more profitable enterprises. All type of stock investors whether they are individuals, professional stock investors, institutional investors earn capital gains through dividends and stock price increases. This enables them to share in the wealth of profitable businesses. Industries which have potentials of growth are able to attract the savings of people towards their ventures relatively more than those which have no such prospects. Thus, financial resources of the economy are allocated on a reasonable basis. Unprofitable and troubled businesses may result in capital losses for shareholders.
7. *Speculation:* The stock exchanges are also fashionable places for speculation and bring equilibrium in the prices of securities which are bought and sold by speculators. In a financial context, the terms "speculation" and "investment" are actually quite inter-related because "investment" means the act of placing money in a financial vehicle with the intent of producing returns over a period of time. Speculators generally buy securities in anticipation of rise in the prices. As a result of their buying, prices do not decline as low as might have been the case without their buying and vice versa hence regulating excessive price fluctuations.
8. *Liquidity:* This is the most important function provided by the stock exchanges. The capital investments are generally long term and if shareholder wants their investment back, in a physical scenario, it will result in winding up the company and selling its assets to discharge the money. Investors usually prefer liquidity of their investment. The stock markets facilitate and provide that assurance to investors. These are markets which facilitate buying and selling of securities assuring liquidity of investments which goes to serve the investor's need.
9. *Corporate Governance:* As stock exchanges facilitate ownership of companies to be help by a wide and varied scope of owners, companies generally tend to improve management standards and efficiency to satisfy the demands of these shareholders. To safeguard the interest of investors more stringent rules are imposed by public stock exchanges and the government on public corporations when compared to privately owned enterprises. Every stock exchange defined its own rules and regulations for the control of operations of the exchange. Only members are allowed to deal in securities and make transactions. As the members have to transact their business strictly according to the rules, the investors' interests are safeguarded against dishonesty or malpractices. Traded public companies tend to have better management records than privately held companies.

5. Indian stock market types

Primarily there are two types of stock markets-the primary market and the secondary market. This is true for the Indian stock markets as well. Basically the primary market is the place where the shares are issued for the first time. So when a company is getting listed for the first time at the stock exchange and issuing shares – this process is undertaken at the primary market. That means the process of the Initial Public Offering or IPO and the debentures are controlled at the primary stock market. On the other hand, the secondary market is the stock market where existing stocks are bought and sold by the retail investors through the brokers. It is the secondary market that controls the price of the stocks. Generally, when we speak about investing or trading at the stock market we mean trading at the secondary stock market. It is the secondary market where we can invest and trade in the stocks to get the profit from our investment.

Now these are the broadest classification of the stock markets that is true for any country as well as India. But the Indian stock markets can be divided into further categories depending on various aspects like the mode of operation and the diversification in services. First of the two largest stock exchanges in India can be divided on the basis of operation. While the Bombay stock exchange or BSE is a conventional stock exchange with a trading floor and operating through mostly offline trades, the National Stock Exchange or NSE is a completely online stock exchange and the first of its kind in the country. The trading is carried out at the National Stock Exchange through the electronic limit order book or the LOB. With the immense popularity of the process and online trading facility other exchanges started to take up the online route including the BSE where you can trade online as well. But the BSE is still having the offline trading facility that is carried out at the trading floor of the exchange at its Dalal Street facility.

Apart from these classifications there are also different types of stock market in India and the classification is made on the type of instrument that is being traded at the market. Both the Bombay Stock Exchange and the National Stock Exchange have these types of stock markets.

1. *Equity market or the cash segment:* The first type of market is the equity market or the cash segment where stocks are traded. In this type of trading the buyers of the stocks book a buying order with a bid price and the order is executed through the broker at a negotiated ask price offered by the sellers at the market. In most cases the deal is closed or the stocks are brought at the best available ask price. In this type of trading the buyer pays the entire amount of the value of the stocks that is determined by multiplying the number stocks with the current price of the stock. Once the buyer pays the entire amount along with the brokerage and taxes of the transaction the stocks are deposited to the DP account of the buyer.
2. *Derivatives Market:* In the derivative market trading is done mainly through two instruments – the Future contract and the Option contract. In both these types of contracts the stocks are bought and sold in lot. The number of stocks for each lot depends on the valuation of the stock and the valuation of the lot is determined by the number of the stocks in a lot multiplied with the current market price of the stock. For trading in derivative market you have to buy either the future contract or the option contract. In a future contract you are bound to close the deal within a specific time and at a fixed rate. While in case of option contract you can also choose to ignore the contract.

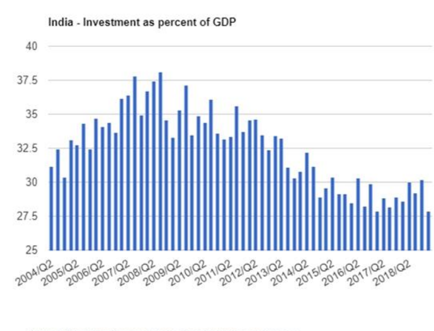
6. Stock market role in economic development

The role of stock markets as a source of economic growth has been widely debated. It is well recognized that stock markets influence economic activity through the creation of liquidity. Liquid financial market was an important enabling factor behind most of the early innovations that characterized the early phases of the Industrial Revolution.

Recent advances in this area reveal that stock markets remain an important conduit for enhancing development. Many profitable investments necessitate a long-term commitment of capital, but investors might be reluctant to relinquish control of their savings for long periods. Liquid equity markets make investments less risky and more attractive.

Here below are some of the ways of how stock exchange benefits the economy.

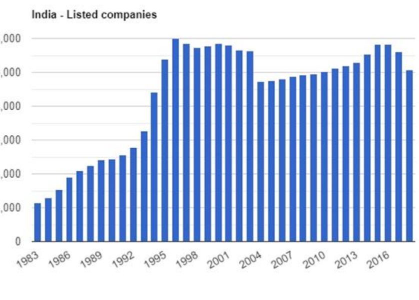
1. *Aggregating investments and mobilizing capital:* Stock exchanges provide companies the ability to raise capital to expand their businesses. When a company needs to raise money they can sell shares of the company to the public. They accomplish this by listing their shares on a stock exchange. Investors are able to buy shares of public offerings and the money that is raised from the investors is used by the company to expand operations, buy another company or hire additional workers. All of this leads to increased economic activity which helps drive the economy.TheGlobalEconomy.com provides data for India from Q2 of 2004 to Q1 of 2019 for investments made. The average value for India during that period was 32.51 percent with a minimum of 27.85 percent in Q1 of 2017 and a maximum of 38.14 percent in Q3 of 2008.



2. *Profile Enhancement:* Companies which are listed on stock exchange are more recognizable than their privately-held counterparts. The increased visibility might come with being on the exchange market which includes the attraction of investors and also attracting attention that might be somehow difficult and expensive for a company to draw on itself. The stock exchanges provide order and regulation to the process of stock trading. Without the regulations and the shareholder protections that the stock exchanges provide few people would be willing to invest in stocks. Because of the oversight of the stock exchanges the average person has the confidence to invest in stocks and this leads to more people become a part of the investor class. The investors' wealth grows over time, which allows them to contribute more to the economy. The World Bank provides data for the companies listed on the exchanges in India from 1983 to

International Journal of Research in Engineering, Science and Management
Volume-2, Issue-8, August-2019
www.ijresm.com | ISSN (Online): 2581-5792

2018. The average value for India during that period was 4370 companies with a minimum of 1151 companies in 1983 and a maximum of 5999 companies in 1996.



Source: TheGlobalEconomy.com, The World Bank

The number of listed companies on the stock exchange in India is an indicator of the development of the stock market. A higher number means that more companies use equity financing in their business. Of course, the number of listed companies in India and other countries also reflects the size of the economy: larger economies have more firms.

3. *Consumption and the Wealth effect:* When stock prices rise and there is a bull market, people are more confident in the market conditions, and their investment increases. They tend to spend more on expensive items such as houses and cars. This is also known as the wealth effect which is how a change in a person's income affects their spending habits and eventually leads to growth in the economy. In the case of a bear market or a fall in stock prices, there is a negative wealth effect. It creates an environment of uncertainty among consumers and a fall in the value of their investment portfolios decreases spending on goods and services. This affects economic growth as consumer spending is a major component of Gross Domestic Product. A common situation of the wealth effect was during the US housing market crash of 2008, which had a large negative impact on consumer's wealth.
4. *Increased Value traded:* Companies mostly listed on stock exchanges are much valued higher compared to their privately-held counterparts. This higher, although harnessed valuation can also have companies allowed to offer more flexible share options to the public. Stock exchanges allow any person to invest in the greatest companies in the world. Investors, both large and small, use the stock exchanges to buy into a company's future. Investing would not be possible for the average person if there was not a centralized place to trade stocks. The ability for the average person to invest in these companies leads to increased wealth for the investors. This increased wealth then leads to additional economic activity when the investors spend their money. The World Federation of Exchanges provides data for the stock value traded in India from 2003 to 2017. The average value for India during that period was 52.89 percent with a minimum of 28.96 percent in 2013 and a maximum of 93.97 percent in 2007.

Source: TheGlobalEconomy.com, The World Federation of Exchanges

The value of shares traded is the total number of shares traded, both domestic and foreign, multiplied by their respective matching prices. Figures are single counted (only one side of the transaction is considered). Companies admitted to listing and admitted to trading are included in the data. Data are end of year values.

5. *Reducing the cost of capital:* India is currently the fastest-growing major economy in the world, which is no small matter. The question is whether the current growth rate is enough to create quality jobs for a growing population. The experience of the two previous economic booms—in the mid-1990s and in the years before the global meltdown of 2008—is that a shift in trend growth requires an investment boom led by the private sector. One of the requirements for that is competitive cost of capital. There are three ways to think about this challenge. First, the direct tax system has to be overhauled. The indirect tax system has already been transformed with the introduction of the goods and services tax (GST), albeit in a messy form. Second, the cost of borrowing in India is too high. One important reason is that India has been an inflation outlier compared to the rest of the world. Sustained low inflation should help bring down the cost of borrowing. Third, investment activity quickens when the relative cost of intermediate goods falls. In other words, machinery has to be competitively accessed. Prices of machinery and equipment have been falling relative to overall prices for decades, thanks to rising trade and sweeping technological improvements that led to more efficient production of capital goods.
6. *Other factors:* The stock market also affects the bond market and pension funds. A large part of pension funds are invested in the stock market and a decrease in the price of shares will lower the value of the fund and affect future pension payments. This can lower economic growth as people who depend on pension income will tend to save more and this lowers spending and eventually the GDP. While a fall in share prices has a negative impact on economic growth and GDP of a nation, it has a positive effect on the bond market. When there is a depression in the stock market, people look for other assets to invest their money in such as bonds or gold. They often provide a better return on investment than shares in the stock market.

International Journal of Research in Engineering, Science and Management
Volume-2, Issue-8, August-2019
www.ijresm.com | ISSN (Online): 2581-5792

7. 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.

8. 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.

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