Stock Market and Economic Growth

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Abstract

Stock market is a clear indicator of a country's economic progress. Investors may adjust their investments based on their forecasts of the economy's future. It serves as a reflection of a country's economic indicators. Rising stock prices may indicate optimism for future economic expansion and corporate success. Many articles published in various national and international magazines, publications, and websites serve as the foundation for this review paper. Review of articles was conducted, and the review revealed a research gap that concludes inferences based on a literature review. The paper revealed that growth in the stock index is typically regarded as a positive indicator since it shows that investors are optimistic about the state of the economy. A country's stock market performance is positively correlated with its economic factor.

Keywords: *Stock Market, Capital Formation, Investment and Economic Growth*

Introduction

Stock market reflects as a prominent signal of economic development of any nation. Investors' predictions about the future state of the economy may lead them to modify their investments. It acts as the mirror of economic indicator of any nation. For instance, increasing stock prices could be a sign of hope for future business gains and economic growth. The stock market index is taken as a barometer of an economy. Growth in stock index is normally considered as a good sign since it reflects that the investors are confident about the future prospect of economy. A study in the case of India (Salameh & Ahmad, 2022) revealed the fact that the performance of stock market in a nation has a positive correlation to its economic growth.

Initial Public Offerings (IPO) will provide an opportunity to general public to become a shareholder of any company. Many companies in Nepal are trying to issue IPO in Premium or book building way and application in Securities Board of Nepal (SEBON) by them shows that they want to enter in capital market. The market will provide investors strong will to invest in companies or establish companies in any nation. Individuals and companies that own stocks may see a growth in wealth as stock prices rise by daily trading activities in open stock exchange market. Economic growth can benefit from increased consumer spending and investment on the companies that are established in nation. Falling stock prices, on the other hand, may have the reverse impact and lower consumer confidence as well as expenditure. It discourages investment in the financial system. A study in the context of Nepal concludes that development of stock markets and economic growth has favorable long run co-integrating relationship (Bist, 2017).

Stock market keeps the track of ups and down but we should consider that it is normal phenomenon and natural events in stock market. There is always reason for alarm when the stock market index rises quickly. An increase in the index cannot continue if the fundamentals do not support which will eventually lead the index towards collapse, jeopardizing the stability of the financial and economic systems. Hence, it is vital that the policymakers maintain eyes on the stock market development and show readiness to apply appropriate measures. It is necessary to prevent the build-up of bubbles and collapse in the market. Bank credits to the private sector, stock market liquidity, and the overall stock market index are the most representative estimation measures for the development of the financial market (Shrestha & Subedi, 2014).

Literature Review

A study in the case of USA, Jorion and Goetzmann (1999) concluded that U.S. stocks had the largest real return of any country between 1991 and 1996, at 4.3 percent, whereas the median return for other countries was 0.8 percent. A study in the context of Pakistan, Jabeen et al. (2022) concluded that in addition to upsetting the economic circumstances of its victims, the COVID-19 pandemic has presented a serious risk to economies and financial markets around the world. International financial institutions were compelled to lower their projected growth for 2020 and the upcoming years after most global stock markets experienced losses in the trillions of dollars. In the context of India, Srinivasan and Prakasam (2014) reported that market capitalization and turnover ratio, two measures of stock market development positively impact India's economic expansion. Another study in India, Paramati and Gupta (2011) concluded that economic growth has been a significant factor in influencing changes in stock prices. It also tends to encourage and support the growth of the stock market by implementing suitable reallocation of resources.

A study in the context of Nepal, Pradhan and Shyam (1993) reported that larger stocks have higher market value to book value ratios, higher price-earnings ratios, weaker liquidity, worse profitability, and smaller dividends. While market value to book value of equity is more variable for larger businesses, price-earnings and dividend ratios are more variable for smaller stocks. Similarly, another study in the context of Nepal, Shrestha and Subedi (2014) reported that investors in stocks appear to take them as an alternative financial instrument and as a hedge against inflation appeared in economy. Additionally, low interest rates and bank liquidity boost the performance of the stock market of Nepal. More importantly, it has been discovered that the stock market reacts strongly to shifts in the political landscape and Nepal Rastra Bank's policies. Bhattarai et al. (2021) revealed that there is a long-term, unidirectional causal relationship between economic growth and the stock market development index. The size and liquidity of the stock market are important factors that demonstrate the market's capacity to raise capital, diversify risks, and facilitate stock trading. A study in Nepal revealed that there is a significant positive relationship between economic growth and stock market development. The literature indicated that there is positive and coherent relationship between the status of stock market and economic growth of a nation (Baral, 2019).

Capital Formation

One important factor in capital formation is the stock market. Stock markets give businesses a place to issue stocks in order to raise funds. Good and healthy stock market helps to make capital to run large companies. People can easily invest money in stock market. Nepalese stock market can be example of this phenomenon. If any company issues IPO, people give application in huge quantity and lucky draw method is applied to select the investors. Market capitalization significantly boosts economic growth over the long and short terms. It is assumed that inflation has a negative and substantial long and short term effects on Nepal's GDP per capita (Bist, 2017).

It shows that people are ready to invest on the companies. The collected capital can be allocated to ventures, growth and invention. A healthy stock market can support economic growth in emerging nations where capital may be scarce by giving companies the money they need to expand their business. The process of capital formation can be also used in a wrong way by showing fake report to securities board. For example, the hydro sector of Nepal can be taken as one of the leading example of capital formation. They issue IPO, right share and they gather capital but the report that they show to public are vague and polished. Stock manipulation and poor governance can lead them towards business failure. Businesses can raise money by issuing stocks and this money can be utilized for expansion, research, development and investments. A thriving stock market makes it easier for capital to be allocated effectively which can promote economic growth. Most of the stock players who are engaged in companies may dump and pump the stock at the time of unlocking period of promoter share.

A study in the context of USA, Singh (1991) reported that the market for corporate control encourages large companies to expand through takeovers rather than to seek organic growth which promotes economic development. The market indices reflect economic activities of any nation. Economic growth and the stock market are interconnected, as the stock market frequently reflects investors' expectations for the state of the economy going forward but a thorough grasp of economic growth necessitates taking into account a number of variables, such as monetary and fiscal policy, international economic trends and structural features of the economy.

It's critical to understand that there is often more to this link that meets the eye and that correlation does not indicate causation in the case of the stock market and economic growth. Furthermore, the stock market's short-term swings might not always be indicative of the long-term economic fundamentals. Stock market fluctuation helps to predict the future economy. There is importance of financial system for the growth of economy. Nepal government initiated financial sector reform program and has increased the efforts to regularize banking system and the banking system of Nepal can be taken as safe sector which is strictly regulated and directed by Nepal Rastra Bank.

Stock Market for Developing Nation

An active stock market has the potential to help investors create wealth. Stock market provides lots of opportunity for the people to create wealth. People may feel more confident and comfortable about their finances as they invest in equities and see rewards as a compounding return. This may result in higher consumer spending and general economic activity, which would support the growth of the national economy. A study (Durham, 2002) revealed that stock market development has a more positive impact on growth for greater levels of per capita GDP, lower levels of country credit risk, and higher levels of legal development. A well-established stock market can help to raise capital for the company. Foreign capital and expertise may be attracted to companies listed on a transparent and well-regulated stock exchange, making international investors more likely to invest. This financial infusion may support economic expansion and development. Consequently, companies that raise money on the stock market to grow and expand frequently add more jobs. This increase in employment helps to lower unemployment and raise people's standards of life. A strong financial system, regulatory frameworks and technology capabilities are examples of the supporting infrastructure that is frequently needed for the growth and operation of a stock market. The construction and upkeep of this kind of infrastructure may benefit the economy as a whole.

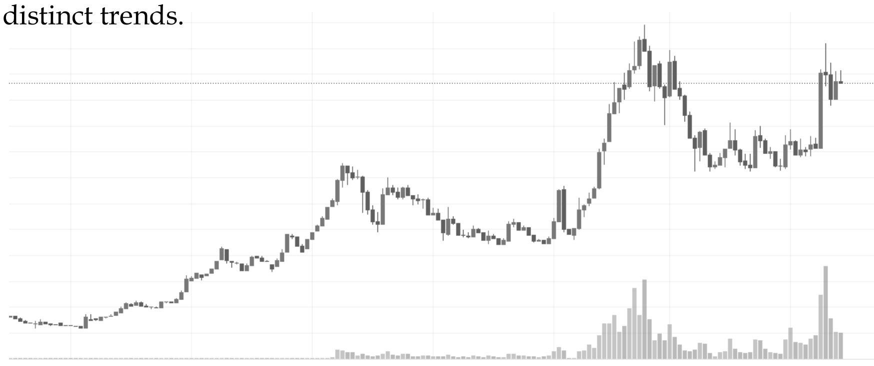
A transparent and well-regulated stock market can encourage improved corporate governance. This is particularly crucial in underdeveloped nations where problems with governance could be more common because publicly traded companies must comply with disclosure regulations, investors find them more appealing since it promotes accountability and openness. In summary, by supplying capital, promoting transparency, drawing in foreign investment, and supporting general economic stability and growth, a healthy stock market can operate as a catalyst for economic development in emerging nations.

Global Trend of Stock Market

The trend of stock market is always in upper side or increasing trend. Although the stock market has typically demonstrated an upward trend over extended periods of time, it's important to realize that the market is volatile and that short-term fluctuations are normal. Many times, the long-term increasing tendency is ascribed to elements like company profitability, economic expansion, technology breakthroughs, and general societal advancement. Application of machine learning or technical analysis techniques and other algorithms tools for stock price analysis and forecasting is an area that can predict the future price and direction of stock (Nti et al., 2020).

The stock market passes through cycles, including bull markets (upward tendencies) and bear markets (downward trends). These cycles are influenced by various elements such as geopolitical events, interest rates, political events and economic situations. Recessions or market corrections may pause the general upward trend. Investor behavior can affect short-term market movements and is driven by emotions such as fear and greed. Fear and greed may dramatically change the emotions that can influence financial wealth of investors (Lo et al., 2005). Market sentiment can contribute to periods of overvaluation or undervaluation. In the case of long run, the market usually reflects the basic principles of the business environment and the economy. Diversity is a common tool used by investors to control risk. Their strategy is to diversify their assets across many asset classes, industries, and geographical areas in order to mitigate the negative effects of a single investment's underperformance on their portfolio as a whole.

Investors must approach the stock market with a long-term outlook and recognize that short-term swings are commonplace. Furthermore, market dynamics can change depending on the state of the economy, specific stocks and industries may see distinct trends.



(The trend of Nepalese stock market from 2012 to 2024)

Investors ought to give serious thought to their time horizon, investing objectives and risk tolerance. Diversification and a disciplined approach to investing can help manage the impact of market volatility on a portfolio. Moreover, consulting with financial experts might yield insightful information customized to specific situations. Global economic conditions, international trade, and geopolitical developments are some of the elements that impact economic growth. Both the stock market and the state of the economy as a whole may be impacted by changes in these variables. Above mentioned chart clearly shows that the trend is always towards upward.

Discussion

With investors' forecasts impacting their investments, the stock market is a vital indicator of a country's economic progress. The growth of stock market index reflects optimism about the state of the economy going forward. In India, economic growth and stock market performance are favorably correlated. Investors can purchase businesses through initial public offerings (IPOs), which increases wealth and boosts consumer spending. On the other hand, declining stock values may deter financial system investment. There is a long-term co-integrating relationship between economic expansion and stock market development. However, if the fundamentals don't support it, sharp rises in the stock market could cause the market to crash. To avoid bubbles and market collapse, policymakers must keep an eye on how the stock market is developing and formulate policies to regulate them. The impact of many factors on the stock market and economic growth is covered in the literature study. Between 1991 and 1996, U.S. stocks had the highest real return of any nation in the USA, at 4.3%. Projected growth for 2020 and the following years world market has been lowered as a result of the COVID-19 pandemic's substantial hazards to global economies and financial systems. Market capitalization and turnover ratio have a favorable effect on economic expansion in India, and economic growth promotes and sustains stock market growth. The market value to book value ratios, price earnings ratios, liquidity, profitability, and dividends are all higher for larger stocks in Nepal.

Conclusion

There are many different economic indicators, governmental regulations, and market dynamics which will play a part in the complex relationship between Nepal's stock market and economic growth. We can focus this relationship into a number of important elements, including the Nepalese stock market's current situation, its effect on economic growth, the market's difficulties, and possible future developments. Market is a wonderful place for capital formation and investment. Stock investors see stocks as a hedge against inflation and an alternative financial instrument.

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