IMPACT OF ECONOMIC GROWTH ON STOCK MARKET PERFORMANCE

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INTRODUCTION

The study will explore the impact of stock market development on the macro economy of the country. It attempts to test the extent to which stock market development affects long term economic growth.

There exist ample literature on economic growth and its determinants. Among the determinants of economic growth, stock market development is increasingly becoming an important factor to impact upon it. The importance of stock markets lies in the contributions of it. Some of the facts in regard to the relationship between financial markets development and economic growth extensively discussed in the literature are as follows. First, at the initial stages of economic development, financial markets are undeveloped and very small in their magnitude. During these stages, financial markets are primarily dominated by banks and other similar types of financial intermediaries. There is almost no role of stock markets or, even if they exist in any form, their size is negligible. Second, when the economy continues to grow, equity markets develop further as well as the banking system. Similarly, other financial intermediaries also develop. Third, researchers recognize the common view that the stock markets appear to develop in a non-monotonic ways. In economies where stock markets are relatively small, capital accumulation seems to be followed by a relative increase in banks’ share in the financial system and in economies where the stock market has already reached a reasonable size, further development of the market causes an increase in the equity markets’ share. In other words, evidence shows that the equity/debt ratio first decreases and, only with further development of the stock market, this ratio increases.

LITERATURE REVIEW

Bencivenga, et. al. and Levine and Renelt (1992) suggested that stock market liquidity plays a major role in economic growth.

Atje and Jovanovich (1993) have concluded that there is strong positive correlation between the level of financial development and stock market development and economic growth.

Levine and Zervos (1996) study of stock market development and economic growth by focusing on India for a ten-year stock market liberalization period.
Levine and Zervos (1998) showed a positive and significant correlation between stock market development and long run economic growth in their study of 47 countries. However, their study relies on a cross-sectional approach with well known empirical limitations.

Tuncer and Alovsat (2001) examined stock market-growth nexus and exhibited positive casual correlation between stock market development and economic activity.

**IMPACT**

Financial development has been observed to follow economic growth in numerous other studies. Macroeconomic forces have systematic influences on the prices of stocks through their influences on expected future cash flows. The relationship between stock prices and macroeconomic variables therefore, has been predominantly investigated assuming that macroeconomic fluctuations are influential on stock prices through their effect on future cash flows and the rate at which they are discounted. The nature of the economy plays a prominent role in determination of stock prices and a complex set of factors are seen to influence the movement of prices at the stock market.

However, even if an economic report is negative, the outcome of the stock market and the financial markets in general may occasionally rise making the stock market perhaps one of the most dynamic components of the world market, alongside other components such as Foreign Exchange market. Stock exchange prices are highly sensitive to some fundamental macroeconomic indicators. It is also noted that as the economy expands, the demand for certain financial instruments increases, leading to the growth of these services and the end result is that the developments in macroeconomic activity influences the stock market performance. The stock market can be vibrant especially with regard to any prospects for potentially positive returns, but generally stock prices and the stock market in general are very volatile. However, it would be wrong to attribute the causes to stock market movements to just the macroeconomic forces, because the financial markets are undisputedly known to be very prone to “noisy” and irrational behavior. The prices of stocks may also move up and down due to other factors such as investors’ perception about the prospects of an individual company, the industry in which it operates. The movement in the price of stocks is also directly affected by the mechanisms of demand and supply in the market. For instance, when more consumers purchase a particular type of stock, its price will consequently increase; and when more traders sell off a stock, its price will tend to fall. This shows the dynamic effects that the forces of demand and supply have on the performance of the stock exchange market.

Dynamic linkages exist between stock markets and macroeconomic variables, but such linkages have been investigated extensively only for the developed markets. This leaves the dynamic linkages in the emerging markets and the less developed countries much more ignored, with only a few exceptions. Reason cited for the lack of extensive literature for the developing economies includes the overwhelming influence of governments in economic activity and that most of the stock markets are at their infancy stages therefore the volume of trade is low and company-specific information is not always timely or of high quality. This therefore leaves the stock markets more prone to influences from economic policy but the relationship is assumed to be unidirectional from macroeconomic variables to stock returns.
REFERENCES


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