

3. THE STOCK MARKET, ECONOMIC GROWTH

AND STRUCTURAL CHANGE:

THEORIES AND EVIDENCE¹⁴

Does the structure of the financial system affect industrial performance? Which is the more reliable source of industrial finance for firms—banks or stock markets? In theory, the stock market has a number of distinct functions; it allocates scarce capital among competing users and uses, and provides signals to firms making investment decisions (see Baumol, 1965: 3). How well are these supposed functions actually performed by actual stock markets? Economists have long assumed stock markets fulfill these roles, though they depend on two kinds of market mechanisms: the pricing process and takeover mechanisms (Singh, 1992: 24).

Tobin (1984) distinguishes between two concepts of share price efficiency: ‘fundamental valuation’ efficiency and ‘information arbitrage’ efficiency. The former refers to how well relative share prices of firms reflect their expected profitability. An efficient pricing process will reward well-managed firms by valuing their shares more highly than those of unprofitable firms. ‘Information arbitrage’ refers to how quickly all available information is disseminated throughout the market and incorporated into share prices. According to the efficient market hypothesis, a stock’s price reflect the current market value of its expected future income stream—that is, its fundamental value. If a stock’s price is less than the value of its expected income stream, investors will buy the stock, and the buying pressure will push up its price. It follows that highly profitable firms will have higher stock prices than unprofitable firms.

Steinherr and Huveneers (1990) cite a large number of studies on stock market efficiency; these studies show that the market efficiently reflects publicly available

information, does not directly capitalise current earnings, and does reflect gains from investments and cost reductions (Benston, 1994: 128). Nevertheless, not many studies suggest that share price movements are systematically related to current, past or future underlying performance variables of companies or to long run equilibrium considerations rather than to short run trends (Singh, 1990: 165). If stock prices do not reflect fundamentals, then the stock market will not necessarily perform its allocative function well: an inefficient stock market does not direct investment funds to their best possible uses.

Many empirical studies have shown the domination of stock market prices by short-term considerations.¹⁵ It has been alleged that investment institutions' provision of finance for industry has generally failed to finance the economy's new areas (Coakley and Harris, 1983: 102).¹⁶ Equity financing may therefore be damaging, especially since fund managers are primarily concerned with short-term financial gains as signalled by the vicissitudes of the stock market. Although some fund managers invest for the longer term, most turn over their stock holdings to try to maximise the current value of their investment portfolios, since this is the main criterion against which their own performance is judged. It is alleged that this short-termism results in a reluctance to lend except when returns are more or less assured (Barberis and May, 1993: 47). Keynes expressed his skepticism about the virtues of the stock market in relation to a country's investment needs: 'Speculations may do no harm as bubbles on a steady stream of enterprise. But the position is serious when enterprise becomes the bubble on a whirlpool of speculation. When the capital development of a country becomes a by product of the activities of a casino, the job is likely to be ill-done' (Keynes, 1936: 159).

Besides, not many small companies at the forefront of new industries would issue shares on the stock market. The reason is that to be able to raise funds by selling new shares on the market, a company has to meet various conditions. In addition, share prices of small

companies are highly susceptible to wild fluctuations (Coakley and Harris, 1983: 104). Small companies only issue a small proportion of their shares for sale on the market, and as a result, only a small amount is left over after investment institutions have taken their stakes. If many private investors try to obtain shares, their prices will rise dramatically. Apart from that, the small volume traded also means that when a few investors become pessimistic and sell their shares, their prices may fall dramatically. Indeed, there are many in need of finance who might have no credit access at all if not for the banking system.

'Efficient' prices, in the sense suggested above, are not sufficient for the stock market to perform essential tasks. In addition, sufficiency requires that the 'takeover mechanism' be efficient so that all those companies whose profitability under their existing managements may be lower than it could be under some other management, can be acquired by the latter (Singh, 1992: 27). However, empirical studies of actual takeovers on stock markets do not show that only unprofitable companies are taken over, or conversely, that the greater the profitability or the stock-market valuation of a company, the lower the likelihood of it being acquired. Evidence from a wide range of studies for the United Kingdom, the United States and other industrial countries indicates that takeover selection is based on profitability only to a very limited degree, much more relevant is the size of a company. A large, relatively unprofitable company has a much greater chance of being immune to takeover than a small, but much more profitable company. In fact, in actual stock markets, making an acquisition to increase size might be a tactic to avoid takeover (Singh, 1990: 164).

Allegedly, takeovers provide a mechanism by which capital markets ensure that non-owner managers perform their duties in the interest of shareholders and firms.¹⁷ However, there are several reasons why this has not and is not likely to be an effective control mechanism (see Stiglitz, 1985: 137-9).¹⁸ Even in advanced capitalist economies with highly

organised capital markets, the stock market is a poor disciplinarian of large management-controlled corporations (Singh, 1990: 173)

As far as the savings function is concerned, it turns out that the stock market makes a very limited contribution to social savings, at best. In fact, Mayer (1988) used flow-of-funds accounts to show that between 1970 and 1985, new issues in the two leading stock-market economies of the United Kingdom and the United States made negative contributions to financing capital formation (see Mayer, 1988: 1170-72). As he documents: 'The reason for this is cash expenditure on acquisitions. Repurchases of shares have not until recently been permitted, but the corporate sector as a whole has in effect been buying back shares in the process of making cash financed acquisitions (Mayer, 1988: 1172). Furthermore, there are several factors which explain managements' reluctance to turn to securities markets to source funds (Baumol, 1965: 74-76). In such circumstances, the securities market does not allocate much capital in an economy. Very often, large corporations in capitalist countries finance their investments through retained profits or by borrowing from banks (Singh, 1990: 163).

Besides all the problems faced by well-organised stock markets in advanced countries, research suggests that most third world stock markets have certain negative features. First, stock markets in developing countries exhibit much greater volatility than those in advanced economies. Table 1 shows that during the period 1984-9, the standard deviation of monthly percentage changes in share prices in developing country stock markets tended to be considerably higher than in developed markets.¹⁹ Othman Yong (1993) conducted a study of all stocks traded in the Kuala Lumpur Stock Exchange (KLSE) from January 1977 to May 1985. The result suggested that the path of the price level was usually discontinuous and tended to fluctuate greatly over very short periods (Othman Yong, 1993: 57). A market characterised by a high degree of volatility is inherently more risky. The high degree of

volatility not only makes share prices much less useful as a guide to resources allocation, but also discourages risk-averse savers and investors.

Table 1 Standard deviations of developing and developed-country share price indexes (five years ending December 1989)

Market	Number of months	Standard deviation	Mean of % changes
<u>Latin America</u>			
Argentina	60	37.05	7.14
Brazil	60	21.07	2.51
Chile	60	8.26	3.41
Colombia	60	6.10	1.59
Mexico	60	16.09	4.47
Venezuela	60	11.59	0.29
<u>East Asia</u>			
Korea, Republic of	60	8.16	2.93
Philippines	60	11.15	5.62
Taiwan, Province of China	60	15.15	5.46
<u>South Asia</u>			
India	60	8.76	1.56
Malaysia	60	8.23	1.05
Pakistan	60	2.92	0.33
Thailand	60	7.90	2.69
<u>Europe/Mideast/Africa</u>			
Greece	60	12.39	2.45
Jordan	60	5.41	0.00
Nigeria	60	11.24	-1.00
Portugal ^a	47	18.17	5.53
Turkey ^b	36	23.67	4.90
Zimbabwe	60	8.71	3.39
<u>IFC Regional Indexes</u>			
Composite	60	7.06	2.14
Latin America	60	13.91	2.14
Asia	60	7.98	2.82
<u>Developed Markets</u>			
U.S.A. (S&P 500)	60	5.16	1.39
U.K. (FT-100)	60	5.88	1.31
Japan (Nikkei)	60	4.08	2.17
EAFE	60	5.25	2.61

^a Since January 1986,

^b Since December 1986

Source: Singh, (1993: 19)

In retrospect, the equity market was a much more important source of corporate finance in advanced countries at an earlier stage of development than subsequently. This is reflected in Table 2, which shows the sharp decline in the use of stock issues as a financing source: they remain very low by pre-war standards. One might, therefore, conclude that

equity finance is more important for firm growth in the initial stages of development and hence, developing countries should follow the footsteps of the advanced countries, which is also the conclusion of the World Institute of Development Economic Research (WIDER)²⁰

However, it has been pointed out that:

Research suggests that the greater degree of equity financing in the US at the century does not much indicate the significance of new share issues for financing corporate growth, but rather reflected the gigantic merger movement which swept American industry during that period. The stock market was used by J. P. Morgan and others to float shares to carry out the huge amalgamations of the era. Moreover, in Italy, France, Germany and Japan, even at an earlier stage in the development of these economies, the stock market played a small role in the financing of firm growth: the banks were much more important in this respect. (Singh, 1993: 20)

Table 2 Flow of funds data: proportions of total financing accounted for by particular sources of funds

Period	<u>Total Debt</u>	<u>Long-term Debt</u>	<u>Short-Term Liabilities</u>	<u>Internal Funds</u>	<u>New Stock Issues</u>
	Total Sources	Total Sources	Total Sources	Total Sources	Total Sources
	(1)	(2)	(3)	(4)	(5)
1901-12	.31	.23	.08	.55	.14
1913-22	.29	.12	.17	.60	.11
1923-29	.26	.22	.04	.55	.19
1930-39	negative	negative	negative	1.14	.19
1940-45	.15	negative	.20	.80	.05
1946-59	.30	.16	.14	.64	.05
1960-69	.36	.18	.18	.62	.02
1970-79	.45	.21	.24	.52	.03

Sources: Taggart, Jr., R. A. (1985: 26)