



How financial markets affect economic performance

INTRODUCTION

By definition the financial markets signify ‘groups’ that facilitate the flow of capital and credit among the various economic agents¹ who participate into the economy, such as companies, individuals, investors, and the public.

In other words, it can be argued that a financial market is the channel that transfers funds from the surplus units² to the deficit units³ of the economy.

It is usual for agents with a surplus of funds to put their funds at the disposal of a financial company, called *financial intermediary*⁴, which in turn transfer the funds to those agents that want additional capital to cover their needs or prospective investments.

FINANCIAL INTERMEDIATION

In their book (Parkin and King 1992) a financial intermediary is defined as ‘a firm that borrows money from households, firms, or other financial intermediaries, and lends money to other households, firms, or other financial intermediaries’.

Undoubtedly, in order to lend the funds in question the financial intermediary requires from the borrower a higher interest rate than that which it will pay to the lender.

¹ Economic agents: Individuals, companies, and the public.

² Surplus units: Agents with surplus funds.

³ Deficit units: Agents who are short of funds.

⁴ For instance: a commercial bank, saving and loans association, or a mutual savings bank.

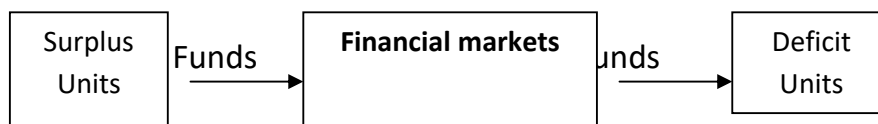
Certainly, the main reason that leads an agent to offer his surplus to a financial intermediary is that he expects to receive an additional income in the form of interest, dividend, and additional value, to mention just a few. In practice, the more the certainty the financial intermediary offers, the less the compensation the agent demands.

On the other hand, there are agents who are interested in borrowing from the financial markets available funds that will enable them to participate partially or in full in investments-projects with higher return than interest rates offer or in other words, to take advantage of productive opportunities.

Another important factor that leads the agents to borrow funds⁵ is their belief for a potential increased income in the future⁶.

The following figure 1 illustrates the process of the *financial intermediation* in which organizations, usually relatively large and secure, borrow funds to lend it to relatively smaller, less safe borrowers (Watkins)⁷.

Figure 1. – Financial Intermediation



We can argue that the actual result of the existence of the financial intermediary is that enables the economic agents to borrow and consequently to partially finance either their investments or their expenditures. The additional amount that an economic agent will borrow and thus will improve its capability to further spending is known as the ***intermediation effect***. Conversely, if we consider the absence of financial markets, we expect smaller amounts to be directed to investments.

⁵ The additional demand for funds will in turn increase the interest rates.

⁶ Based on their forthcoming increased income, they proceed to raise their current spending, and thus their borrowing.

⁷ Thayer Watkins – San Jose State University

FINANCIAL MARKETS and their implications in the Economy

As stated earlier, the financial markets 'transfer' funds from surplus to deficit units in a way desirable to both the participants and profitable to financial institutions.

This is mainly due to the fact that the financial institutions take advantage of scale economies that have succeeded by transferring funds from agents with a surplus of funds to those who are short of funds.

Finally, the financial intermediaries ask for a higher rate of return on their primary security⁸ portfolios than the lending rate they must pay on their own secondary securities⁹. In this respect, we can argue the following factors as the main determinants of the previously mentioned financial intermediaries' characteristics that also represent the major differences between the institutions in question and the individual householders.

Market imperfection. Undoubtedly, the financial intermediaries due to their larger volume of transaction, are able to reduce their average fixed cost and consequently to lessen the exchange cost per unit.

Diversification. Indisputably, we can state that the larger the volume of financial portfolio the greater the diversification¹⁰ that can be achieved, which in turn results in the reduction of risk.

For example, one can put assets in different categories: bonds, stocks, precious metals, and real estate.

Certainly, such a diversification can be much easily achieved from financial intermediaries than from individual householders.

Specialisation. The operation of the financial intermediaries is entrusted to professional staff with expertise in portfolio management, asset selection, negotiation, and general financial services. On the contrary, it is not anticipated from individuals to have a similar expertise.

⁸ Primary securities are issued by a firm to raise new capital and are exchanged via an underwriter in the primary market.

⁹ Secondary securities are claims against financial intermediaries who are holders of financial assets and are exchanged in the secondary market.

¹⁰ A well-worn adage, states "do not put all your eggs in one basket"

Certainty. Due to their volume of transactions, the financial institutions, as earlier stated, reduce the risk through the diversification and at the same time because of a better scheduling of inflows-outflows, reduce the uncertainty to the individuals.

Miscellaneous services. In addition to their main role in financial intermediation, the financial institutions because of their specialization can offer non-income services tailor made to the specific needs of the ultimate wealth-owners. For example, the financial institutions can offer different types of mutual funds oriented to specific group needs, i.e. age, income, time frame, and tolerance to risk.

FINANCIAL SYSTEM AND ALLOCATION OF CAPITAL

It can be argued, that the diversification – the process of helping reduce risk by investing in several different types of funds or securities – works in hand with the capital allocation. As earlier indicated, the financial markets succeed optimum diversification, which in turn results in an optimum allocation of capital.

In a paper (Wurgler J. 2000) it is stated “Economists have long argued that financial markets can improve the allocation of capital across an economy’s investment opportunities”.

Considering the previously mentioned characteristics of the financial markets we can appreciate that theoretically these institutions can direct the surplus units’ capital to the ‘best’ investment opportunities because of the following:

- Their expertise is the major factor that enables the institution to identify, for instance: a company’s value, its operating performance and consequently, its ability to respond to its obligations and, thus, to lend funds to trustworthy and low risk deficit units.
- It is also the financial institutions expertise that enables them to diversify the yield through allocation of funds into different projects with different risk profiles. The combination of different investments helps them to manage the variability of returns, commonly referred as “market risk”.

Moreover, as stated in an article (Investors group financial services 2005), “Different types of assets do well during different phases of

market cycles". Thus, it is again the specialization of the financial markets that enables them to recognize the cycle's phase and allocate accordingly the capital at hand through a balanced portfolio.

The financial markets optimum allocation of resources is subject to the following preceding conditions:

- Full information.

Everybody has the same information (even though they can not predict the future perfectly). In other words, the concept of the efficient market as defined in their book (Lumby and Jones 1999) exists, when, for example, in the stock market the market price of a company's shares rapidly and correctly reflects all relevant information as it becomes available.

- Known preferences and maximizing behaviour on the part of borrowers and lenders.

Although, as stated by Professor James,¹¹ in practice, different people have different information and this makes them interact in a 'sophisticated' rational way, which is not necessarily rational in the strict "utility-maximizing" sense that is standard in economics and finance. This in turn could lead to a different evaluation of risk.

- Absence of externalities.

It is assumed that there are no significant differences between private and social marginal costs and returns.

FINANCIAL SYSTEM AND ECONOMIC GROWTH

The majority of economists argue that there is a strong positive link between a well-developed financial system and economic growth. They assume that since the financial intermediation leads to the optimal allocation of funds, the anticipated consequence is the direction of the investments across the company's investment profitable opportunities, which in turn results in economic growth.

As stated in an article (Wurgler 2000), "The developed financial markets increase investment in growing industries, and decrease investment in declining industries".

In addition, through the continuously optimal allocation of funds, the restructuring of the economy is attainable in line with the financial environment and thereby the boosting of the economy's growth.

¹¹ Dow James: Professor of Finance - London Business School.

Although the financial system - as a system - is comprised of many subsystems, i.e. financial markets, institutions, instruments, and law, with each one having its own advantages, it can be argued that it will be to the benefit of the economy to have all the system's components (sub-systems) well-organized.

On the contrary, in financially underdeveloped countries, the surplus units instead of placing their savings into financial assets (primary or secondary) prefer to acquire tangible assets, i.e. real estate and precious metals, mainly because of the uncertainty, the limited information, and the traditionally bad experience with inflation.

As a result, the economic units, especially the young and growing ones, are lacking of more 'innovative' kinds of finance, such as equity finance. On the other hand, the predominant financial intermediary – the banking system – may be reluctant to provide loans due to the greater exposure that it takes when it finances such young companies or requires from the firms such 'costly' guarantees that make the deficit economic agents unwilling to take the loan since due to the loans cost, they consider unprofitable the anticipated return.

Certainly, government intervention can support the early stage of private financial intermediation's development by offering 'guarantees' that will reduce the private subjective risk. For example, government guarantees of primary securities issued by high-priority investors and government insurance of the indirect debt of private financial institution.

Undoubtedly, nowadays, such a rudimentary financial system keeps a low capital formation, and, consequently, does not significantly aid the boost of the economy's growth.

FINANCIAL SYSTEM AND FINANCIAL STABILITY

Undeniably, the word 'stability' in the economy is of huge importance when considering investments, employment and consequently economic development.

Considering the previously analyzed concept of ‘capital allocation’, it can be argued that financial stability occurs when the financial system allocates the capital in hand in an efficient way, even in the case of unpleasant phases of the economy.

The financial system in order to perform its role successfully, which is the maintenance of financial stability has to take into consideration the following indicators and factors:

- The phase of the economic cycle.
- The country’s financial interrelation ratio (FIR)¹².
- The expansionary movements.
- The government debt.
- The monetary developments.
- The price changes.

In other words, two questions have to be posed: firstly, what are the potential risks for the country, and secondly, what are the necessary precautionary measures that have to be taken in order to avoid a possible crisis in the financial system?

CONCLUDING REMARKS

In this paper we initially described the financial markets’ characteristics and the way the financial system contributes to financial intermediation. Then, we formed an opinion about financial markets and their implication in the economy’s performance making reference to the financial system’s ‘link’ with first, the allocation of capital, second, the economy’s growth, and third, the economy’s stability.

Finally, we concluded – as many economists have long believed – that there is a positive link between the financial system¹³ and the economic growth or in other words, between the development of financial markets and economic performance.

The former British Prime Minister William Gladstone expressed the importance of finance for the economy in 1858 as follows: “Finance is, as

¹² The financial interrelation ratio (FIR) has been calculated by the Raymond Goldsmith (Belgian born economist 1904-1988) and measures the ratio of financial assets to real tangible assets. As regards the developed countries, the rate is only rarely below 0,5, while ratio’s rates above 1,5 are found only in countries with large dead-weight government debt.

¹³ Financial system is a system that comprises all financial markets, instruments and institutions.

it were, the stomach of the country, from which all the other organs take their tone”.

It is also stated (Goldsmith 1969) that “The development in financial intermediation accelerates economic growth and performance to the extent that it facilitates the migration of funds to the best users”.

The financial market –because of its existence – is one of the reasons that leads the agents to postpone current consumption and therefore to save. In addition, the financial intermediaries through their expertise and specialization transfer the capital to the most profitable investment opportunities by exploiting the ideal relation between risk and expected return each time. Thus, they contribute to the country’s economic stability and development.

In his paper (Wurgler 2000), he presents evidence from 65 countries, which suggests that financial markets do, indeed, play a crucial role in the capital allocation process. His research proved that in developed financial markets, investment increases more in growing industries, and decreases more in declining industries, than occurs in financially underdeveloped countries.

A well-developed financial system offers a variety of financial instruments to the deficit units enabling each agent to make use of the most ‘suitable’ type of finance, i.e. the less costly one, in order to cover its needs.

Moreover, they offer to the country’s economy and/or the county’s companies a comparative advantage that is of huge importance in today’s environment. Those companies with a lack of innovation in their production procedure will, sooner or later disappear from the economy. In his speech (Duisenberg 2001) states, “Equity is essential for the emergence and growth of innovative firms. Today's young innovative high-technology firms will be the main drivers of future structural change essential for maintaining a country's long-term growth potential. The contribution of financial markets in this area is a necessity for maintaining the competitiveness of an economy today given the strongly increased international competition, rapid technological progress and the increased role of innovation for growth performance”.