

EDRP No. 159

THE ROLE OF A STOCK EXCHANGE IN A DEVELOPING  
ECONOMY

P.D. KARKHANIS

MAKERERE INSTITUTE OF SOCIAL RESEARCH

These papers are prepared as a basis for Seminar discussion.  
They are not publications and are subject to revision.

INSTITUTE  
OF  
DEVELOPMENT

THE ROLE OF STOCK EXCHANGE IN A DEVELOPING  
ECONOMY

What is a Stock Exchange: Stock Exchange may be compared with an ordinary market where people go to buy and sell. It may be considered in its simplest form as a market for the sale and purchase of securities, shares, bonds, etc. The exchange of securities and shares between individuals and institutions is the hub on which the whole business of investments and savings revolves, and must always remain the central part of the business of stock exchange. The fundamental purpose of an organized stock exchange, to quote the preamble of the constitution of the New York Stock Exchange, is to furnish exchange rooms and other facilities for the convenient transaction of their business by its members as brokers, to maintain high standard of commercial honour and integrity among its members and to promote and inculcate just and equitable principles of trade and commerce. Its existence and development plays an indispensable role in the economy of a country particularly so, if it is a developing economy.

Misconception in the minds of people: In most developing countries, the average man has some misconceived ideas about the stock exchange. Very few educated and business-minded people understand the implications and workings of the stock exchange. The majority have some contradictory reactions about stock exchange in their minds. They consider it as a more glamorous version of the football pools. Some even think that it is a Gambling Den or Casino where rich can make easy money and get richer. They further think that stock exchange is purely meant for rich people and that it is beyond the reach of an ordinary individual. This is not true. There may be some unscrupulous speculators who in some isolated cases, may have become rich overnight by spreading rumours or creating artificial scarcity but it may be pertinent to point out that economic forces play a dominant part in the fluctuation of prices on the stock exchange.

Functions and Economic Role of Stock Exchange: By studying the functions and economic role of stock exchanges, one can realise how important they are to the developing countries.

A) Provides and guarantees free and continuous market - Stock exchange provides and guarantees a free and continuous market for

capital already invested by facilitating the exchange of securities with minimum delay and maximum profit. Its continued existence and development plays an indispensable role in a country having Joint Stock Enterprise as its main feature.

B) Helps in the determination of prices - It helps to determine the true prices of shares and securities by constant flow of transactions in particular scrips. In other words, it provides an invaluable service of evaluating the securities at its true worth by the forces of competition.

C) Mobilizes savings and facilitates flow of capital - Since with the aid of stock exchange brokers, new investors can buy shares and securities of their choice, a continuous flow of fresh capital is ensured. This assists mobilization of savings in different sectors of economy.

D) Barometer of business conditions - Stock exchange is a barometer which indicates the general conditions and the atmosphere of business. The trend of values on the market reveals the trend in economic conditions, economic prospects and industrial prospects within the economy. The industrialist, the investor and the student of economics and even the politicians can feel the pulse of the nation by watching and studying the trends of prices on the stock exchange.

E) Ensures mobility of capital - It provides much needed mobility of capital and directs the flow of capital into profitable and more successful industrial enterprises and retards its flow into enterprises with less justification for development. Thus, it brings about a fine balance between demand and supply of capital. A developing country can by proper adjustment make a good deal of use of this weapon to foster justifiable industries. In other words, it equates the flow of savings to economic needs.

F) Grants liquidity to shares and stocks - The stock exchange makes the shares and stocks liquid by making them easily disposable and saleable. Capital once invested cannot be withdrawn from the industry but stock exchange provides the facility for selling the shares to others if they are not wanted by particular individual or individuals.

G) Adds to the collateral value of shares and stocks - If the stocks and shares are quoted on the stock exchange, they are

generally acceptable to the banks or the creditors. If they are not quoted then the banks or creditors would be reluctant to accept them as security for advances. Stock exchange adds to the negotiability of the shares and they become easily acceptable.

H) Infuses sense of confidence - Organized stock exchanges work under certain stringent rules and regulations. The risk of forged securities being traded frequently is to the minimum. It acts as an automatic check. In other words, the collective regulations, standard practices on the stock exchange and the fixed commission charged by the brokers create a sense of confidence in the minds of the investors.

I) Constant quotation service - This service offered by stock exchanges enables the general public, the investors, the industrialists and other interested parties to keep themselves informed of the trends of prices of the shares and securities.

J) Helps to raise new capital - Stock exchange is not a market for new capital but the facility of underwriting new issues which the brokers offer, tends to stimulate and encourage flow of new capital for industrial and other purposes.

K) Assists Governments to float new issues - By providing the facility of underwriting, publicity amongst the investing public and agreeing to quote the stock on market, the stock exchanges render invaluable service to the Government in successfully floating their large issues for development purposes. Most of the developing countries are in need of money for financing their huge projects. If the stock exchange is existing, it becomes easier to tap the savings in this manner.

Stock Exchange - a must institution in a developing country - It will be observed from the foregoing analysis of the role of the stock exchange that active stock exchange has a vital part to play in the economy of a nation. Firstly, it encourages small savings by the public by giving them incentives to participate in huge trading and industrial concerns. Secondly, active stock market provides much needed finance to the enterprising community for expanding their present activities and/or undertaking new ventures. Another contribution which active stock market makes is that it assists in retaining the money within the boundaries of the country. If investment opportunities are not available, money finds its own way (legal or illegal) elsewhere where investment opportunities

are available. In many industrialised countries, a wide range of industrial investment opportunities are available through the medium of stock exchange. But in developing countries where stock exchange facilities are not available, the genuine investors find difficulties in finding outlets for their savings. So in order to tap the savings, it is very essential to have a stock exchange. Most of the developing countries have large projects of expansion both in the private and public sector. If potential internal savings are tapped through the medium of stock exchange, they will go a long way to meet the capital needs of the country. They will not have to rely entirely on overseas investment. Self-help is the best help.

In developing countries, there has emerged a class of wage-earners - the so called white-collared personnel - whose earning is substantial and whose saving capacity is also substantial. This is apparent, from the increase in the number of houses owned and the increase in the volume of Life Insurance business. This needs to be tapped. If investment opportunities are made available to such local people, large amount of savings could be mobilized. Similarly, if an organized stock exchange is in existence, even the expatriates may invest their savings in some liquid shares and stocks. They could sell their investments at the time of their departure. At present, they are required to keep their savings in banks where they earn very low rate of interest.

In most developing countries, exchange control regulations in respect of remittances overseas are existing. Foreign countries, institutions, private individuals, etc. are, therefore, perforce required to keep their money within the country. Such money is normally invested in low-yielding securities, treasury bills or are deposited in banks. But if the stock exchange facility is available, this money may find its way in the industrial enterprises through the medium of stock exchange.

Further, small savings could be tapped through the medium of investment clubs. Individuals could be members of these clubs and they, in turn, could invest collectively through the club. If a number of clubs are established within the country and if they are given legal recognition and their workings and practices are regulated by law then a large portion of small savings could be mobilized for the benefit of the nation building activities. Private savings can make immense contribution to uplifting the economy of a developing country.

Hitherto, most of the commercial and industrial developments in developing countries depended to a large extent on external source of finance or some family business houses. Little effort was made to tap

public savings by private enterprise. This is undesirable. The developing nations must generate internal saving. This is possible if the facilities of a stock exchange are available so that the Private Limited Companies could go public. This would produce a chain reaction. The economy would get a tremendous boost because if the existing private limited companies go public, their capital resources could be diverted to establishing new industries on joint stock company basis. Thus more and more public participation would be possible and larger resources would be available for new ventures.

What is needed? It is essential that the Governments in developing countries should take active interest in the establishment of stock exchanges by taking following steps.

- (1) Create more investment opportunities
  - (a) By encouraging existing Private Limited Companies to go public. Concessions may be given in payment of Registration and stamp duty fees etc. for such companies.
  - (b) By encouraging Public Company formation for new industries and ventures. This may need a review of the existing legislation and statutory requirements governing public companies and offering them tax-concessions as inducement.
  - (c) By offering similar concessions to foreign owned companies and requiring them to seek local participation upto certain percentage.
- (2) Encourage people to save through the medium of investment clubs or national unit trust by fostering confidence amongst their members with the aid of proper legal protection.
- (3) Require Banks to accept shares quoted on stock exchange as security.
- (4) Channel the issue of new loans or stock through the medium of stock exchanges and entrust the work of conversion of existing loans to Stock exchange
- (5) Encourage para-statal bodies to invite public participation by offering certain percentage of their shares to public. Their policy should be development of Business and Industry and not exclusive business ownership.

(6) Apply greater degree of flexibility in the statutory requirements concerning investments by Insurance Companies, Banks and emigrants.

It may, however, be stated that apart from giving helping hand in respect of the above, the stock Exchange should not have any interference from Government in its day to day operations. It should develop independently and economic forces should play a dominant role in the actual working of the stock exchange.

---

This work is licensed under a  
Creative Commons  
Attribution – NonCommercial - NoDerivs 3.0 Licence.

To view a copy of the licence please see:  
<http://creativecommons.org/licenses/by-nc-nd/3.0/>