THE ROLE OF A CAPITAL MARKET IN A MARKET ECONOMY*

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I. INTRODUCTION: THE NEGLECT OF CAPITAL MARKETS IN ECONOMIC THEORY

In economic theory any kind of production can definitely be based on three factors of production, i.e. labor, natural resources and capital. Consequently, these three definite productive factors have been, and still are, subject to research work and thus have emerged into special fields of economic theory, such as labor economics, agricultural economics, theory of capital, etc. The markets of these areas are also considered to be subjects of special research, with the exception of capital markets.

Though capital is one of the key economic problems, even in highly-developed countries there has been until now almost complete neglect of capital market affairs in economic theory. There exist but a few exceptions, such as the lonely works of Goldsmith, Gurley & Shaw, which, in turn, rather more confirm the lack of work undertaken in this field. Realizing this state of affairs, one might ask about its reasons. However, we should refrain from asking questions which might be considered as a special topic.

II. TASKS OF A CAPITAL MARKET

What do we mean by capital markets? When speaking of capital markets we usually mean supply and demand of money liable

* This is a written version of a lecture held.
I am greatly indebted to Mr. and Mrs. Bellmann who helped me to brush up my English. But I insist that any mistakes are purely my responsibility.

to real and monetary investment, including negotiable claims such as bonds and equities. Other possible definitions may rely more on such terms as savings or long-term borrowing.

Though it might not be necessary to go into details at this point and to give sophisticated definitions of terms like capital capital market, long-term borrowing, etc., it is nevertheless appropriate to draw a line between the capital market on one hand and the money market on the other. This means to distinguish between short-term borrowing and lending of money by financial intermediaires (including big firms), which roughly constitutes a money market, as opposed to financial means borrowed and lent on a long-term scale (including sale and purchase of securities) being the essence of a capital market. On practical grounds we have to include the activity of the stock exchange in the capital market, whereas other types of negotiable paper, such as treasury bills, bank obligations, remittances, etc., may be part of the money market if traded on short-term conditions.

Very often definitions are contradictory. This is particularly so with regard to "capital" and consequently even more so in the case of "capital market". So it may be more suitable to give some explanations about the functions of a capital market, instead of giving a proper definition of this market.

Generally speaking, capital markets serve the formation of capital. However, this does not mean that by the process of this market additional capital shall be created, althoug even this could be the result of market actions. Nevertheless, how can a market contribute to capital formation if the capital traded in this market is already available? This can be reached by specific of the market being transformed in different ways and different respects. In fact, a capital market can be explained by the following types of transformation activities:

a. The first of the transformations is the conversion of liquid assets into fixed investments. Usually a saver might be willing to lend his money over a certain period, say half a year or five years, but he would not be inclined to give his money away for fixed and illiquid investments, for instance as direct investment in a factory. A well-organized capital market allows exactly this sort of hitherto incompatible interchange of investment possibilities.

b. The second sort of transformation service can be called the transformation of terms. A capital market is designed to transform relatively short-term lending into possible long-term borrowing. This is possible, for instance, by selling marketable bonds, or any other type of equities, to the lender who, in turn, can sell daily his claims to another investor. Whenever the original lender decides to liquidate his investment he can do so, whereas the borrower has received long-term means available for long-term investment over a definite period of time and under definite arrangement of return and repayment.

c. The third task of a capital market may be seen in the transformation of magnitudes of capital, i.e. the transformation of small- and medium-sized amounts of capital into huge amounts. Normally capital accrues in the way of a piece meal, which means small amounts appearing one after the other. Like a river which cannot be bridged by single stones, but only by a formation of stones, many big investment projects could not be carried out without the accummulative services of a capital market.

d. A fourth type of service rendered by a capital market is the transformation of risks. Each single investment project differs not only with respect to return but also with respect to risk and uncertainty. The risk of investing money means not only the risk with regard to return and repayment, but also the risk of liquidation in the case of the investor wishing to sell his investment. Both sorts of risk can be, and in fact are, reduced by well-organized capital markets. A capital market allows the transformation of risks on different scales into a reasonable and relatively low average risk which is to be considered as normal. This type of service can be compared with risk-sharing offered by insurance companies. Of course, this does not apply to any sort of security and to any sort of investment; however, it is workable in many ways as a matter of principle.

There are still other services of a capital market to be mentioned. They differ from the before mentioned a., b., c., d., in that they cannot be classified as tasks of transformation but rather as means for more effectiveness. Let me mention just two more.

e. A properly-working capital market helps to streamline most transfers and activities in the field of saving and investment. This can be achieved by a variety of standardized securities or offers and investment possibilities such as shares, mortgage bonds, state bonds, bank certificates, investment certificates, etc. Normally, the lender does not have to worry about receiving his dividends or interests, nor about repayment, or the exact date of payment. Even cash dividends and interests and the administration of a portfolio can be, and in fact is, mostly managed by banks or similar institutions on behalf of the customer.

f. One of the most remarkable effects of a proper capital market is to be seen in the improved transparence and review in respect of supply and demand. Suppliers, as well as demanders, are better informed and can more easily have access to additional information through the market as compared with a situation of very isolated individual and sporadic capital transactions. More transparence and information does not only help the participants in such a market, but contributes decisively more to the effectiveness of a nation's economic resources.

Apart from the six services mentioned above, some others are left which might be considered as collateral and therefore could to some extent be included later on when speaking of the specific functions of a capital market in a market economy. Some of these functions have already been indicated.

III. PRECONDITIONS

(1) Apart from the suppositions mentioned above, some preconditions for the development of capital markets have to be observed. Ihe first has to be seen in the organization of the society. Clearly socialized economies scarcely need institutions such as stock exchanges and would normally not allow capital markets in a customary way. History of the development of stock exchanges inevitably

shows that capital markets have emerged under conditions of free bargaing and free enterprise and even without any government interference. Since policies for industrialization and development are usually combined with some dirigism, there may arise certain obstacles with respect to the growth of a free capital market.

Objections could be made on pure logical bases. It may be argued that bonds can be issued, and in fact have been offered, from government institutions even in socialist countries, thus establishing the core of a capital market. However, as long as private ownership of means of production is principally not possible and as long as interest rates do not correspond in any way to returns of real investment the capital market cannot work in the same way and cannot exert the same functions as in capitalistic countries. If there is agreement of the consequences of the price mechanism, particularly in the field of factor prices, there is no parallel between capital markets in the two different social systems mentioned. Consequently, there should be a minimum of free market conditions to enable a capital market to play its proper role.

(2) Similar considerations are applicable to some leagal conditions Trade and financial relations depend basically on social order and minimum standards of safe conduct. For instance, it is well know that dealing at the stock exchange means to keep one's word. In case of failing there must be reliance on legal institutions. Swiss banking is not only famous for its domestic currency but also for its trustworhyness and safety even vis-a-vis the state and political pressures from outside. What counts here is the belief that one can rely on it.

To be more analytical and accurate we may determine two main conditions for the development and existence of capital markets. The first is to be seen in a liberal and promotive framework of laws, which leaves sufficient opportunities for financial activities and at the same time protects existing contratcs and acts as a safeguard to any possible financial agreement within the limits of the law. The second one is a minimum of good conduct and business moral within the field of finance, without which even good laws and effective jurisdiction cannot succeed. Licenses and strong rules of permission for such financial activities as banking, dealing at the stock exchange, issuing bonds, etc., may be adequate.

(3) Another form of stability refers to the society as a whole. Monetary history shows that saving and capital formation is also a function of political stability. Though this is true not only for developing countries, it seems to be a prerequsite particularly essential for those countries whose savings are poor and who could loose their scarce resources of capital by a flight of capital or by domestic hoarding instead of having it invested.

(4) Furthermore, stability has to be mentioned as an essential condition with respect to total economic activity and inflation. Whereas inflation induces investment, it discriminates, at the same time, money savings. Permanent losses in purchasing-power of money destroy a currency's function as a store of value. If inflation is accompanied by income taxation or property taxation, it aggravates the situation. Even if the rate of taxation is compensated by correspondingly high interest rates, it might be difficult to convince a saver that it is still worthwile to continue ta save. Assuming the official rate of inflation is 13 per cent p.a. — however computed — and the effective interest rate on bonds reaches 16 per cent, this would scarcely be an attraction for savers to purchase bonds. Risks of further changes, incompetence of price-indices for different income groups and, consequently, misguidance of rates of inflation, may attribute towards an attitude of reluctance, suspision and high propensity to consume, as well as hoarding goods, instead of saving money. In either case, a capital market cannot develop. Thus, a minimum of monetary stability and a clima of confidence is necessary for domestic saving and the supply of capital.

(5) Another prerequisite of a capital market is to be seen in an adequate institutional framework. Without an infrastructure of a banking system, of security regulations, stock exchanges, specific types of financial intermediaries such as savings banks, mortgage banks, insurance corporations, investment funds, etc. a capital market can neither develop nor survive. For countries like Turkey, I guess this is a matter of development in itself which shall promote and sustain the development of a capital market as a con-

sequence. Confidence in those institutions and permanent information of savers should be considered as necessary conditions.

Summarizing the preconditions we may repeat that amongst the basic needs of a capital market the following ranks first:

i) A minimum of free market conditions,
ii) minimum standards of private law and safe conduct,
iii) a fair degree of political and social stability,
iv) relative monetary stability,
v) a basic framework for monetary institutions and intermediaries.

Role of Capital Markets in Industrialized and Developing Countries

In general, capital markets contribute to
a) promote capital formation,
b) link saving and investment,
c) increase effectiveness of available capital.

In the first case a capital market may help to raise savings and to make those savings available. In the second case these savings have to be channeled and transformed into investment by standardized offers and by a streamlined system of contracting. In the third case a capital markets deserve more detailed treatment.

Ad a) : Amongst the basic necessities of most countries is economic growth. Since there is no economic growth without investment, we may say that capital formation — apart from foreign aid — is one of the key problems. Capital formation requires savings. Leaving aside the controversial view of ex ante saving versus forced saving by credit expansion, we may concentrate here on voluntary savings.

No doubt, well-organized capital markets can advance both the creation of savings and the readiness of lending. The choice open to a person as well as to a society is between present consumption on one hand and capital formation or saving on the other. This is equally true for poor persons and nations as well as for rich ones. As it is more attractive to release resources from consumption in favor of investment, if savings provide fair interest returns and additional safety in the future by means of an increased stock of value, free capital markets can favor these conditions. In other words, free interest rates and competitive demand for savings normally provide more attractive alternatives to the saver than otherwise might prevail. Since more savings allow additional investments, it follows that a capital market can encourage capital formation and economic growth.

Ad b) : Another advantage of capital market is to be seen in linking saving and investment in a better way than otherwise possible. Normally, suppliers of capital tend to produce, individually, small amounts and expect at the same time high returns at low risks and at the most liquid form of investment. The demand side usually requires capital in large portions at fixed long-term conditions and at costs of borrowing as low as possible. The market has to interlock these opposing ends in the best possible way. Operating to these ends, a capital market has to transform — i) small amounts into large ones; ii) liquid assets into fixed investment and at the same time iii) short-term preferences into long-term claims; finally iv) different risks into an intermix of risks on different scales.

A well-developed capital market succeeds in performing these different kinds of transformation by a variety of financial intermediaires as well as by different forms of investment opportunities. Actually, the pattern of monetary investment offers a wide range of forms of securities reaching from near money certificates on one hand to more direct forms of investment, relatively illiquid, on the other. The fact that bonds and equities can be easily sold and are regularly quoted at the stock exchange, indicates that opposing interests between suppy and demand — as indicated above — nevertheles allow for useful compromise and reasonable solutions. Thus, a capital market achieves the maintaining of individual preferences to a relatively high degree and, at the same time, succeeds in linking saving and investment, despite contradicting interests on both sides.

Ad c) : A third achievement of capital markets is derived from the allocation effect of a free market. Since all investment projects compete vis-a-vis the available capital there exists a mechanism of automatic selection amongst these projects which operates in favor of the most profitable ones. Therefore, free interest rates and fair competition tend to use the available capital in the most productive way. Since not only in developing countries but also in the most developed ones, capital is amongst the most short factors of production, it should be understood that any improvements of efficiency of this scarce factor helps to augment economic growth. This is even more so as the transparence of a faily well-organized capital market avoids privileging single regional investment projects in favor of others elsewhere hitherto omitted.

What has been said in the three preceeding paragraphs has been argued on purely theoretical grounds. It would be unrealistic to neglect the deficiencies of free market conditions and, particularly, to abstain from the special difficulties of developing countries. For instance, if the shortage of capital would lead to extremely high interest rates — even in the absence of inflation — it might be quite understandable to try to bring the level down to a somewhat normal niveau for social and other reasons. However, since this could cause a deviation from an equilibrium position it might produce excess demand. As, under these conditions, black markets can grow out of disequilibrium, it may even worsen the situation and cause the supply side to run dry.

Instead of a laissez-faire policy, the interest rates may be administered, i.e., prevented from being too high, whereas the supply of capital and credits have to be rationed. Governmental controls take the place of selection by the free market mechanism. Though the chances of regaining free interest rates cannot be treated here at lenght, it still might remain a goal to be aimed at if otherwise the benefits of a capital market are to be considered desirable any longer.

Other deficiencies of a free market can easily be mentioned. There are, for instance, many complaints about the fact that even higly-developed capital markets fail to provide equal conditions for big business on one hand and small business on the other. No doubt, capital markets favor wellknown enterprises and, in particular, big firms. Lack of information of smaller firms often prevent those enterprises from the possibility of easy-way financing by means of issuing bonds or equities. There cooperative forms of financing can be taken into consideration or otherwise special banks an financial intermediaries help to overcome those deficiencies. These special institutions can supply handicrafts and small business with money ready for investment. This can be financed by way of bonds or other securities issued by those special institutions. In fact, many countries make use of similar organizations and institutions.

Another point can be seen particularly regarding the priority of investments in a developing economy. Priorities, well understood, may not be in complete accordance with profitability. In as much as investments are profitable on private grounds, but less desirable from the point of view of economic development, the government might intervene. Interventions may take the form of excise taxation on those less desirable goods or carried through in another indirect way rather than by any form of direct action or dirigism on the capital market.

In general, it might be more reasonable to make use of regular interest rates which signalize the degree of shortage of capital and thereby reduce investments at a feasible level than to induce investment projects of any sort by a low level of interest. As the problem of development is mainly a problem of increased capital formation on one hand and more productive investment on the other, it should be understood that the good services of a capital market can only be rendered in full if interest rates are in accordance with actual supply and demand.

Let me summarize by asking again : What is the proper place of a capital market in a market economy?

Very briefly, it is the full application of the market principle in the field of saving and investment. This is in a way no less essential and no less effective than the application of the market principle in other fields of the economy. A capital market ensures that incentives given by the notes of the consumer shall be signalized to producers in the most rapid and effective way. Thus, a capital market is a perfection or rather more a necessary completion of a market economy if otherwise the effectiveness of such an economy shall not be reduced. However, we might consider a market economy not only from the point of view of effectiveness (growth, investment rates, system devoted to consumers, etc.) but also regarding distribution of income and wealth other social implications.

Again, a capital market could and in fact usually would contribute to less concentration of income and wealth. The reasons for this are:

a) Higher interest rates or returns to the savers, particularly to small savers and income earnings.

b) A capital market offers more direct forms of investment than otherwise possible. More ownership instead of monetary claims. The saver becomes more the quality and the reward of an investor.

c) It dimishes social tensions means of more widespread ownership of private capital.

d) It renders the chance of more direct taxation i.e, more equal taxation. In most cases interests, dividends and other capital returns can easily be taxed at the source.

Having enumerated so many positive effects of a capital market, I should at least mention that there is nearly nothing in the world without a reverse side.

I have already touched the question of whether a capital market favors concentration. In fact it can do so although there are also opposing forces. The immanent tendency towards concentration favors in particular financial institutions such as banks, insurance companies and others. Here, state regulations and adequate laws can be used without doing considerable damage to the capital market itself.

Another black spot in the field is speculation. I am not going to say that speculation should generally be prevented or is to be considered as an evil from the very beginning .On the contrary, it would normally help to smoothen abrupt and sudden movements by anticipations and careful judgements. However, there are quite a few examples where pure speculation has caused considerable damage to special markets if not for an economy as a whole. For that we can only hope that wise governmental actions succeed to prevent Black Fridays or similar events.

Many other points could be made. Besides, this very rough enumeration of aspects as given before is far from being complete. For instance, nothing has been said on the effects of central banking on capital markets, nothing on the interrelations between monetary and fiscal policies; not to mention the influence of taxation and the interdependence between domestic and international markets. We took no recognition of special policy measures such as subsidies, tax allowances or any other protective actions, and regulations regarding interest, saving and investment, etc. Again, this indicates the tremendous lack of knowledge and research in this field ,as mentioned initially.