Role of financial markets in a modern economy assignment

Business

Discuss the role of financial markets in a modern market economy. Explain the role and function of the share market and its effect on the economy. The financial market is the most influential sector in a modern market economy. The financial markets provide products to consumers and financial intermediaries allow for the mobilization of money between savers and borrowers. The share market is the financial market in which investors buy and sells shares. The share market's main function in the economy is to allow consumers to attain part-ownership of a company and further their wealth and in effect provide funds for businesses for expansion.

The main effects the share market has on the economy is its ability to reallocate resources and mirror overall economic growth. The financial services industry is one of the largest industries in Australia and its actions influence all other sectors due to its vital role in the economy. Financial markets are so significant as they create products for consumers also serve to provide a return for the producers. In essence, this allows for those who have excess funds to make these funds available to those who need additional money.

Furthermore, the most influential institution in the financial sector are financial intermediaries who are those organizations that allow for the mobilization of money. These firms create a bridge between borrowers and savers in that they receive accumulated funds from individuals or firms and then allow for other firms and individuals to borrow and make use of that money. Financial markets are also the factor markets for capital in the market economy because capital must be acquired by businesses to produce goods and services.

The economy’s productive capacity heavily impacts the ability of the economy to grow in the long term and thus capital investment is vital for the modern market economy. Financial markets provide an efficient process by which income that is not used for consumption can still contribute to aggregate demand. Savings from consumers, businesses and governments can be used for future consumption but also capital investment, which consequently increases the productive capacity of the economy.

The share market is the financial market in which investors buy and sells shares, which are financial assets that give a person part-ownership of a company. The share market plays an important role in the Australian economy because businesses can sell shares in their companies to raise funds needed for growth and to provide individuals with dividends, which contributes to their disposable income. The role and functioning of the share market in the larger modern market can be seen from the perspective of the shareholders and the companies.

For investors, the share market provides the opportunity for consumers to become part-owners of a business and thus are entitled to returns due to the risk they assume by investing in the business, these profits are known as dividends. As the company grows the value of the company increases and thus its share price will consequently increase. In such a situation, shareholders may decide to sell their shares to make a profit which is known as capital gains as they are selling assets at a price above the level originally paid for.

However, the risks of being a shareholder are high as the company may lose money and thus dividends are reduced and the investor will not be able to make capital gains. There is an extremely high level of share ownership by the Australian public which increases the share markets role in the market economy. Currently, many people rely on the profits made from shares as their income and more significantly for their retirement. On the other hand, for a company the share market provides the opportunity for the business to increase its funds to keep as retained profit or allow for the expansion of the business.

When a company first lists its business on the ASX it is called a float. Once the company has been listed it can access further equity funds at any time by issuing an approved prospectus for the release of new shares. However, issuing new shares reduces the control existing shareholders have over the company as they own a smaller proportion. The sale of new share is a primary financial market transaction whilst an existing shareholder selling their shares is a secondary financial market transaction. By allowing both types of share trades the ASX is in effect both a primary and secondary financial market.

Changes in the share market have large impact on the operations of a company. A company’s share price is determined by the price mechanism and thus if demand is low the company’s value will decrease however if demand is high, the company’s value will increase and thus provide benefits to the company itself and its shareholders. When individual businesses prosper it provides greater ability for the Australian economy to grow as it is heavily reliant on the growth of individual businesses to facilitate overall economic growth.

The share market has extensive effects on the economy and it is an indicator of a country’s economic conditions. Rising share prices suggest that the economy is experiencing favourable economic conditions as market prices rise in accordance to better economic prospects for companies. The relationship between general economic conditions and share values can be seen in the following graph which shows that fluctuations in the share market mirror changes in economic growth

A downturn or upturn in the share market can be measured in the All Ordinaries Index, which measures the overall value of companies listed on the ASX. By comparing the AOI with changes in the economy’s growth rate we see that the share market generally rises and falls similarly to economic growth. However, the share market is much less stable and thus small changes in economic growth consequent in much larger changes in share values. The share market also affects the market through its ability to reallocate resources to different sectors in the economy.

Those companies and sectors with the best growth prospects will be able to acquire additional funds most effectively and thus will raise the most funds when floated. In such a way share prices will be higher for firms in industries that shareholders expect will experience growth and thus the share market will raise the medium-term growth prospects of an economy. However, the main issue with using the share market as a guide to the state of the economy is that not all share purchases are based on a rational belief by the shareholder that the industry's future prospects are solid.

Many purchases are speculative, which means that shares are bought with intention of being resold within a short period. These investors are not buying with the intention of long-term capital gain, rather, short-term. The major problem with this sort of investment is that speculators base their investment on the ' hype' of the market, rather than the real profitability of the firm. This has the potential to see share prices that are overvalued, drawing further investment and leading to the misallocation of resources.