

## THE EFFECT OF CAPITAL MARKET ON ECONOMIC GROWTH: A LITERATURE REVIEW

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### Abstract

The capital market has a significant role in promoting economic growth through fundraising mechanisms and efficient capital allocation. This study uses the research method. The results show that a developed and liquid capital market provides cheaper and easier access to funding for firms, allowing them to expand and innovate which in turn increases productivity and production capacity. In addition, capital markets also strengthen transparency and corporate governance, which not only increases investor confidence but also maintains overall economic stability. An effective capital market encourages companies to meet higher reporting and auditing standards, which in turn improves their accountability and performance. This allows for a more efficient allocation of resources to sectors with high growth prospects, thereby spurring innovation and value addition in the economy. However, these positive impacts are more pronounced in countries with adequate financial infrastructure and supportive regulations. In developing countries, challenges such as lack of liquidity, information imbalances, and political instability remain major obstacles. In this context, the literature review emphasizes the importance of building strong capital market infrastructure, improving financial literacy, and continuous efforts in strengthening regulations to maximize the contribution of capital markets to economic growth. With the right strategy, capital markets can be an important pillar in promoting sustainable and inclusive economic growth.

**Keywords:** Capital Market, Economic Growth.

### Introduction

Capital markets play a crucial role in the modern economy. Capital markets provide a platform for companies to raise funds by issuing stocks and bonds, and

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provide investment opportunities for individuals and institutions. With an efficient capital market, the allocation of economic resources can run more optimally, supporting overall economic growth. (Fraumeni & Christian, 2020).

Companies can raise funds from public investors without having to rely entirely on bank loans, which often carry higher interest rates and stricter terms. This encourages innovation and accelerates the Company's growth (Huda et al., 2023). In addition, capital markets also serve as an efficient resource allocation mechanism, where funds from investors are allocated to projects or companies that are considered to have high profit potential. This efficiency in resource allocation in turn promotes more stable and sustainable economic growth. (ECHCHARFI, 2024).

On the other hand, the capital market also benefits investors, especially individuals and institutions, by providing a variety of investment instruments that can be selected according to their risk profile. Investment diversification, made possible through participation in the capital market, helps to reduce risk and increase potential returns. (Adamu & Mustafa, 2023). In addition, the transparency required by capital market regulations provides protection to investors and creates a safer investment environment. Overall, capital markets not only increase access to capital but also play an important role in creating a stronger and more stable financial structure, which is critical to the long-term health of the economy (Anderu, 2020). (Anderu, 2020).

Economic growth is often measured through an increase in gross domestic product (GDP) and other economic indicators that reflect an increase in public welfare. One factor that is believed to encourage economic growth is the existence and development of a healthy and efficient capital market. A well-developed capital market not only provides a source of funds for companies but also creates an efficient valuation mechanism as well as better risk distribution. (Eniekezimene & Opuofoni, 2024)..

However, the causal relationship between capital markets and economic growth is not always clear-cut and can be affected by various internal and external factors. Some countries with developed capital markets show rapid economic growth, while others with developed capital markets face structural and regulatory challenges that may hinder the expected economic benefits (Gwaison et al., 2021). (Gwaison et al., 2021)..

On the other hand, there is a debate about the extent to which capital markets affect economic growth. There is a view that capital markets are not always significant in influencing a country's economic growth, especially for developing countries. Factors such as political stability, economic policy, and financial infrastructure also play an important role. (Appiah et al., 2020).

As such, this research focuses on a literature review to analyze and explore the various views and empirical findings on the effect of capital markets on economic growth. This research aims to provide a comprehensive picture of this relationship, as well as identify factors that strengthen or weaken the influence of capital markets on a

country's economic development through a deeper understanding of the existing literature.

## **Research Methods**

The study in this research uses the literature method, which is a data collection and analysis technique that involves searching and reviewing previously published scientific works. This method focuses on collecting relevant information from books, journals, articles, research reports, and other academic sources to understand, analyze, and conclude existing findings. (Barlian, 2018); (Suprayogo & Tobroni, 2003); (Suparlan, 2014).

## **Results and Discussion**

### **Definition of Capital Market**

The capital market is a mechanism or place where various financial instruments, such as stocks, bonds, mutual funds, and other derivatives, are traded between investors and companies or governments that issue these instruments. The capital market serves as a means for mobilizing funds from the public or investors to parties who need capital, as well as providing opportunities for investors to earn profits from their investments. (Yakubu, 2023). It consists of the primary market, where new securities are issued and sold to the public, and the secondary market, where securities that have been issued are traded among investors (Be, 2023). (Be, 2023). As such, capital markets play an important role in supporting economic growth, allocating resources efficiently, and providing a platform for business development.

Capital market components consist of stocks, bonds, and derivative instruments. The capital market consists of various main components that serve as instruments for trading and investment, including stocks, bonds, and derivative instruments. Shares represent ownership of a company and entitle the owner to a portion of the company's profits in the form of dividends as well as voting rights at the General Meeting of Shareholders (GMS). (Olusegun & Ajao, 2024).. Stocks also provide potential gains from rising share prices in the secondary market, although they also pose a risk of loss if the share price falls. Investors can buy and sell shares on the stock exchange, capitalizing on price fluctuations to earn capital gains. (Algaeed, 2020).

Bonds, on the other hand, are debt instruments issued by companies or governments to raise funds from investors. Bondholders are entitled to periodic interest payments and return of principal at maturity. Bonds are considered a safer investment than stocks because the priority of claims on the company's assets is higher in the event of liquidation. Types of bonds include corporate bonds, government bonds, and municipal bonds, each with a different level of risk and yield. (Ahmed & Chowdhury, 2024)..

Derivative instruments are financial contracts whose value depends on the price of an underlying asset, such as a stock, bond, commodity, currency or index. Some types of derivative instruments that are often traded in capital markets include options and futures contracts. Derivatives are used both for hedging purposes, i.e. protecting the value of an asset from price fluctuations, as well as for speculation in order to profit from changes in the price of the underlying asset. (Didier et al., 2020). While offering high potential returns, derivative instruments are also high-risk due to their complexity and high price volatility. Investing in derivatives requires a deep understanding of the market and a sound risk management strategy. (Pokharel, 2020).

### **Economic Growth**

Economic growth is the process of increasing a country's production capacity as reflected in periodic increases in gross domestic product (GDP). This growth includes an increase in the output of goods and services, technological advances, and an increase in the number and quality of labor. (Ritschel, 2023). As a leading indicator of economic performance, economic growth is usually measured by the percentage change in GDP from year to year. A solid economic performance not only indicates that the country is able to produce more goods and services, but it is also often associated with an increase in living standards, a decrease in poverty rates, and a general improvement in people's welfare (Purnama, 2023). (Purnama, 2023).

The factors that drive economic growth can be very diverse. On the one hand, investment, both in physical infrastructure and in human capital, is one of the main drivers. Good infrastructure, such as roads, ports, and communication facilities, provide an important foundation for economic activity. Meanwhile, investments in education and health improve the quality of the workforce, which in turn increases productivity (Kalra et al., 20). (Kalra et al., 2023). Technology and innovation also play a crucial role by enabling greater efficiency and the opening of new market opportunities, both domestically and internationally. These factors work in tandem to create an environment conducive to sustainable economic growth (Khataybeh & Omet, 2021).

However, economic growth is not always equitable and can lead to disparities. In many cases, rapid economic growth benefits only a small proportion of the population, while a large proportion of the population remains living in poverty. This can be due to unequal distribution of wealth and opportunity, as well as limited access to education and health services. (Aniefor & Ndubuisi, 2023). Therefore, it is important for governments and policymakers to ensure that the benefits of economic growth are more equitably disseminated through inclusive and redistributive social policies, such as subsidized education, healthcare, and support for MSMEs (Cynthia et al., 2017). (Cynthia et al., 2021)..

In addition to distributional challenges, economic growth must also be considered in the context of environmental sustainability. Uncontrolled natural

resource exploitation and pollution can cause severe environmental damage and threaten long-term sustainability. (Kicia & Kordela, 2023). Therefore, environmentally sound growth, or "green growth," is increasingly becoming a focus in many countries. This includes more environmentally friendly business practices, investments in renewable energy, and policies that promote resource efficiency. With these measures, it is hoped that economic growth can take place without compromising the environment and future generations. (Eke et al., 2022).

### **Relationship between Capital Market and Economic Growth**

The capital market has a very significant role in driving a country's economic growth. One of the main ways is through allocating resources to productive sectors. By providing a platform for companies to access capital through the issuance of stocks and bonds, capital markets enable companies to fund expansion, innovation, and other development projects. (Osipian, 2023). For example, companies that obtain funds from the sale of stocks or bonds can increase their production capacity, develop new products, or enter new markets. All of this contributes to increased economic output and job creation (Herd, 2020). (Herd, 2020).

In addition, the capital market also serves as an indicator of economic health and investor confidence. When the capital market experiences growth, usually characterized by a rise in major stock indices, it often reflects optimism towards economic prospects and political stability. Conversely, a decline in the capital market may indicate investor uncertainty or concern over economic conditions or government policies. (Ashani & Afsharirad, 2021). This is because investors tend to make a continuous assessment of company performance and the overall economic outlook when making investment decisions. As such, changes in the capital market are often a mirror of broader economic conditions (Aam & Khatoon, 2021). (Aam & Khatoon, 2021)..

Capital markets also support global financial integration which can bring additional benefits to national economic growth. Through capital markets, companies can attract investment from abroad, increase capital inflows, and access various international sources of financing. This can enrich a company's capital structure and enable risk diversification. The invasion of foreign funds is also often accompanied by technology transfer and improved operational efficiency, which in turn contributes to the productivity and competitiveness of the economy as a whole. (Bilgili et al., 2021).

However, the relationship between capital markets and economic growth also involves some challenges and risks. Stock market volatility, for example, can be destabilizing if not managed carefully. Financial crises can also arise when asset bubbles burst, as was the case with the subprime mortgage crisis in 2008. (Degong et al., 2021). Therefore, effective regulation and supervision are essential to ensure that capital markets function in a healthy and stable manner, and protect the interests of investors

and market integrity. With proper regulation and supervision, capital markets can continue to contribute positively to sustainable economic growth.

## Conclusion

Capital markets play a crucial role in a country's economic growth through efficient fundraising and capital allocation mechanisms. Based on various literature reviews, a developed and effective capital market allows firms to obtain funds at a lower cost for expansion and innovation. This, in turn, significantly increases productivity and production capacity. In addition, a liquid capital market provides opportunities for investors to diversify their portfolios, reduce risk, and maximize investment returns.

Furthermore, capital markets also contribute to improved transparency and corporate governance. Companies listed on the stock exchange are required to meet various reporting and auditing standards, which improves their accountability and performance. This not only increases investor confidence, but also strengthens overall economic stability. With a strong capital market, resources can be allocated more efficiently to sectors that have high growth prospects, thereby encouraging innovation and value addition in the economy.

However, it is important to note that the positive influence of capital markets on economic growth is usually more dominant in countries with good financial infrastructure and supportive regulations. In developing countries, capital markets often still face challenges such as lack of liquidity, information imbalance, and political instability. Therefore, to maximize the contribution of capital markets to economic growth, continuous efforts are needed to strengthen regulations, improve financial literacy, and build adequate capital market infrastructure.

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