Capital markets as a tool of finance for development

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One of the primary objectives of any nation is ensuring socioeconomic development of its citizens, especially if the objective can be sustained overtime. According to a recent World Bank Report, an estimated $4 trillion in annual investment is required for developing countries to achieve the Sustainable Development Goals (SDGs) by 2030.

In light of the investment requirement, there is a greater need to develop and strengthen capital markets in order to mobilisee domestic savings for commercial and development financing. The role that capital markets have in financing infrastructure development, large enterprises, and Small and Medium Enterprises (SMEs), and the links with economic growth, are increasingly being highlighted.

Economists traditionally have looked to factors such as capital, labour and technology as the major factors affecting economic growth. The functioning of capital markets has received special attention in recent years. A vibrant and well-functioning capital market, as part of the financial system, permits an economy to fully exploit its growth potential, as it ensures that the best investment opportunities receive the necessary funding, while the inferior opportunities are either denied capital or access lesser and expensive sources of capital; in this regard, the role that capital markets play in economic development should be reconsidered and attention be played. And so, to start with, what are capital markets?

Capital markets are a general category of markets that facilitate the buying and selling of securities/ financial instruments which are of medium-term and long-term maturity nature, i.e. of one year or more. Capital markets channel savings and investment between suppliers of capital and users of capital through intermediaries. Examples of key players in the capital market's process are: (a) suppliers of capital - also known as surplus units, these suppliers receive more money than they spend or do not have immediate use for - they also termed as investors and they provide their net savings to the financial markets for a return on the capital provided. Examples include retail investors (private individuals) who may have savings and institutional investors (corporate entities, pension funds, insurance companies and other such entities) who may have surplus profits or are used as investment vehicles by individuals; (b) financial intermediaries: these are financial institutions or individuals that serves as middleman among diverse parties in order to facilitate financial transactions. Common types include commercial banks, investment banks, stockbrokers, fund managers, and stock exchanges; then (c) users of capital -- also known as deficit units, users of capital spend more money than they receive or need funds for investments or development, they are also termed as borrowers. They access funds from the capital markets. Examples include business enterprises (of any type and size), governments (central or local), and individuals.

Products in the capital markets are also referred to as capital market securities or financial instruments. These are debt securities (also referred as bonds), with a maturity of more than one year, and equity securities (also referred as shares): (a) **Bonds:** These are medium to long-term debt securities issued by corporates and governments to raise large amounts of funds. Bonds are differentiated by the issuer and can be classified as Treasury bonds (if issued by the central government), municipal bonds (if issued by municipals and local governments), or corporate bonds (if issued by corporate enterprises); (b) **Equity Securities:** an equity security represents ownership interest held by shareholders in an entity realized in the form of shares of the capital stock of the company, which includes shares of both common and preferred stocks. Shares are classified as capital market securities because they have no maturity and therefore serve as a long-term source of funds.

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Funds received from these products (bonds and equity/shares) are mostly used to purchase capital assets, such as buildings, equipment, machinery. For financial institutions such funds can be used for on-lending to long term borrowers. These funds are sometimes raised to enable the company to engage in strategic corporate finance transactions such as mergers, or acquisitions of new entities for the purpose of their growth and expansion to new geographical locations.

How can capital markets facilitate economic development?

Capital markets are a network of specialized financial institutions, series of mechanism, processes and infrastructure that in various ways facilitate the bringing together of suppliers and users of medium to long-term capital.

Capital markets connect the monetary sector with the real sector, which is the sector of the economy concerned with the production of goods and services. Considering this role in the economy, the capital markets play an important role in economic development as they facilitate growth in the real sector by giving producers of goods and services, and entities tasked with infrastructure development access to long-term financing.

The fundamental channels through which capital markets are connected to the economy, economic growth and development can be outlined as follows:

(a) Creating a bridge between suppliers of capital and users - the contact between agents with a monetary deficit and the ones with monetary surplus can take place directly through direct financing, but also through a financial intermediary in form of indirect financing, which is a situation whereby specific operators facilitate the connection between the real economy and the financial market. In this case, the financial intermediaries could be banks, investment funds, pension funds, insurance companies, or other non bank financial institutions;

(b) Promoting saving and investments: capital markets increase the proportion of long-term savings (pensions, life insurance covers, etc.) that is channelled to long-term investment. Capital markets also enables the contractual savings (pension and provident funds, insurance companies, medical insurance schemes, collective investment schemes, etc.) to mobilize long-term savings from small individual household and channel them into long-term investments. It fulfils the transfer of current purchasing power, in monetary form from surplus sectors to deficit sectors, in exchange for reimbursing a greater purchasing power in the future. This way, the capital markets enable corporations to raise funds to finance their investments in production activities. The implication will be an increase in productivity within the economy leading to more employment, increase in aggregate consumption and hence growth and development. It also helps in diffusing stress on the banking system by matching long-term investments with long-term capital. It encourages broader ownership of productive assets by small savers and hence facilitate implementation of inclusive economic empowerment and financial inclusion policies. It enables citizens to benefit from economic growth and wealth distribution, and provides avenues for investment opportunities that encourage a thrift culture critical in increasing domestic savings and investments that translate to economic growth. ***(To be continued...)***

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