The Stock Market and the Macroeconomy

Most people would agree that movements in the stock market have important effects on the economy. Yet, it is not clear how that changes in stock prices affect the real economy around us. The market goes up and the market goes down, but it is not easy to see how these changes translate into changes in output, employment, and inflation. So, what is the relationship between the stock market and the economy.

To begin with, the stock market is largely a secondary market. It is where corporate stock that has already been issued and sold to the public is traded. In some cases the stock is traded on an exchange – like the Taiwan Stock Exchange. In some cases it is traded over the counter, also called the OTC market. The OTC market is not located in one place. It is spread out among all the securities firms which trade together using computers and telephone lines. There is no exchange and there is no single location. OTC is like exchanging NT dollars for US dollars. You can do it at virtually any bank.

Next, it is important to realize that trading stock merely involves an asset exchange. An existing asset (stock) is being traded for another existing asset (money). No new assets are being created. Just like when you sell your old motorcycle to your friend, no new motorcycle is being produced. You are not making income when you sell your second hand motorcycle...you are only trading one asset (an old motorcycle) for another asset (money). The same is true for stock transactions. No new production has taken place when stock trades hands, except for some commissions made by brokers who help you trade your stock.

Also, unless new shares are being created to finance capital acquisition, buying and selling stock is not investment in the sense of new capital equipment being created. If more stock transactions take place on the TSE, this does not mean that there is more investment in Taiwan. And, if there are less transactions taking place on the stock market, this does not mean that Taiwan or the US is experiencing a fall in investment. Remember that when stock and money trade hands NO NEW CAPITAL IS CREATED. Therefore, no new investment is taking place.

So, how does the stock market affect the economy.

First, when the stock market rises, stockholders feel wealthier. Their income has not changed, but they believe they have more wealth. The same effect happens when you are holding money and the price level falls. The real value of the money becomes larger and you feel wealthier. As the stock prices rise (say faster than the general price level) consumers feel a
real wealth effect and begin to spend more of their unchanged income. They do not feel like they need to save as much out of this unchanged income, since their wealth has increased. The increased spending leads to an increase in aggregate demand and that can boost the growth of output. The stock market has an effect on real economic activity through the real wealth effect. How large is the wealth effect? No one really knows for sure, but many economists would say a $100 increase in wealth raises consumption by 4 or 5 cents. Not a whole lot.

Second, when the stock market rises, business managers may feel that this signals an upturn in the economy. Investors who are more confident about the future will buy stock because they believe companies will make higher profits in the future. So, when the market goes up, it signals better times ahead. Does it do this every time? No of course not. Sometimes the stock market rises only to fall again with the economy. Here is a graph showing the growth of the stock price index in the US compared to (shaded) periods of recession.

**Business Cycles live on**

The USA GDP moves in cycles and Stock Market historically led GDP turning points by many months (graph data till July 1, 2009).

Notice after 1983 the market fell heavily but there was no recession. The same was true in 1967.

Third, when the stock market rises it is easier for firms to finance their purchases of new
capital by issuing more (expensive) stock shares. The higher price of new shares means that the firm will be able to raise money easier than if the market were falling. This encourages greater investment or greater purchases of new plant and equipment. This is also one way for a company to lower its debt. It can issue stock during good times and buy back the loans it took out and the debt which it issued before. Lower debt on the balance sheet can make a company more flexible and dynamic – encouraging its managers to take good business risks that can lead to better market share and higher profits.

Firms must be careful to avoid a bubble in their stock prices. Bubbles occur when most people have the same optimistic view of the market. They expect higher prices and therefore attempt to buy the stock in large amounts. But, since everyone has the same expectations, current holders refuse to sell. The price goes up and everyone feels that their former expectation was justified. This causes a new round of higher expectations. If the general feeling is for higher prices, this can cause the price to rise. If the rise causes higher expectations, then a vicious cycle begins which forces prices up and up. The bubble continues until enough people begin to have pessimistic expectations. At that time, prices plummet and the bubble bursts. A bubble is no time to be engaged in expansionary finance.

Finally, a rising stock market may be bad for some sectors of the economy. Suppose that certain domestic industries are doing very well – like companies involved in domestic real estate. They are making higher profits and therefore these companies have stocks that are rising very fast in price. This attracts foreign money to flow into the stock market and the inflow raises the value of the domestic currency relative to the foreign currency. The appreciation of the currency hurts exports and helps imports. Some get hurt and some get helped.

**Question:** How is the stock market affected by the economy?