Stock market financing

Stock markets – or equity markets – are networks of economic transactions, in which shares and derivatives of companies are issued and traded at an agreed price. Such transactions take place either through stock exchanges or over-the-counter negotiations. In the former case, stocks are listed and traded on stock exchanges. In the latter case, trading is done directly between the parties, without supervision of a stock exchange. Market participants range from small individual retail investors to large organizations, such as mutual funds, banks, hedge funds, insurance companies, as well as corporations trading their own shares. Trades in stock markets occur without restrictions of geographic locality.

Stock markets are vital for an important group of firms, providing them with access to capital from investors who are seizing profits from potential gains of firms' future performance by purchasing ownership shares of the company. Similarly substantial sources of financing are frequently not accessible via other means.

These financial institutions also help producing and spreading information about markets and behaviour of agents. Ideally, stock markets would provide symmetric information for anyone willing to invest. This, however, requires limited opportunistic behaviour on the part of inventors and will critically depend on the importance of good governance in managing stock markets and transparency in reporting information from firms which shares are traded. Furthermore, the prices of derivative markets are stated in terms of notional values rather than actual market price – consequently, the total price of world derivatives is much higher than the size of the world economy.

It is often argued that stock markets lead firms to stray away from investing in innovation as those investments are riskier and will only have payoffs in the longer run. This view is based on the observation that markets are often more prone to react positively to immediate earnings, rather than to uncertain and long-term pay-offs. This is related to the relationship between corporate governance and innovation. It is often argued that stock-price performance follows the principle that corporations should maximize shareholder value and, though innovation could maximize returns in the long run, executives might aim short-term rewards from speculation.

Others argue that smooth functioning stock markets appreciate innovation projects, as these projects generate higher future market returns From that perspective stock markets could provide necessary resources to finance innovation responding to needed funding for innovation. The valuation of firms by stock markets affects resource allocation in the economy; and studies have proven that the effect of innovation on market valuation is robust, although intensity varies considerably across firms, sectors and countries. Studies suggested that firms with high market shares that are successful in generating innovation get a higher valuation on stock markets than the non-innovative ones.

The relationship between innovation and stock markets can vary deeply according to policy settings. There is no pattern both on how innovative dynamics of firms happen and on how stock markets perceive and rewards their innovative performance. The key lesson for policy-making here is that one size does not fit all the important actors and, consequently, policies should take heterogeneity into account. Relevant policy measures to improve contributions include fostering transparency and setting long-term goals for technological development. Some authors also suggest that linking financial soundness to 'rating' devices should be exchanged to more complex assessment tools, improving how information about investment opportunities for long-term development is provided by stock markets.

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