CHAPTER I

INTRODUCTION

A. Research Background

It is indeed true that the principal purpose of every nation is to find a good way to obtain (and eventually to keep) a long-term development of its national economy. Economic development is regarded as the most important goal of national policy in any economy (Oke and Adeusi, 2012). Every nation does not stop to seek a way to surpass from the level of undeveloped to the level of developed. For the nations which are already developed, keep a long-run stage of development is the primordial mission of its authorities. According to the Reference Dictionary, the term "developed country" is used to widely describe a country as one that is somewhat self-sustaining. In developed country, the economic statement and government structure are strong enough to provide access to resources and economic opportunities. In contrast, undeveloped or developing nations rely more on support from other nations and agencies to provide necessary resources to their populations. The capacity to produce and the quality of life or the standard of living of its population make the difference between developed and undeveloped country.

The threshold of welfare may vary from country to country, or region to region because it depends on culture, feeling and happiness of each people; but to evaluate the size of economic development of one country, macroeconomics refers to these following indicators: GDP (Gross Domestic Product), GNP (Gross National Product), GDP per capita, economic growth, inequality of wealth, inflation, unemployment, economic structure, demographics. GDP is defined as the sum of goods and services, in term of value, produced by a country within a period generally year. GNP counts the all economic output of a country produced by its citizens inside and outside territory. GNP per capita means GNP of country divided by the number of its population, per capita means per person. Economic growth is measured by the increase of GDP, GNP, GDP per capita, or GNP per capita. Inequality of wealth is the gap existing between a richest and poorest people in a country. Measure of inequality of wealth could be done in many ways, such as comparing the proportion of a country's wealth owned by the richest 20 per cent of population with the proportion owned by the remaining 80 per cent. Inflation measures how much the prices of goods, services and wages increase each year. High inflation could be a bad thing, and notices a government lacks control over the economy. Unemployment is the number of people who would work but cannot get work. Economic structure shows the division of a country's economy between primary, secondary and tertiary industries. Demographics study population growth and structure. Demography compares birth rates to death rates, life expectancy and urban and rural ratios. Many less developed countries have a younger, faster-growing population than the countries economically developed, with more people living in the countryside than in towns.

In 2015, the World Economic Situation and Prospects (WESP) in its annual *statistical countries classification* segregates the whole nations in four categories referring to their gross national income (GNI): high-income, upper middle income, lower middle income and low-income. Countries with less than $1045 GNI per capita are classified as low-income countries. Countries with GNI per capita between $1,046 and $4,125 are classified as low middle income countries. Countries with between $4,126 and $12,745 are classified as upper middle income countries. And countries with incomes of more than $12,746 are classified as high-income countries[1]. The statistical table of WESP revealed that by 159 countries analyzed, 51 countries are high-income, 41 countries are upper middle income, 36 countries are lower middle income, and 31 countries are low-income. Most of the countries with lower income are in Africa, South Asia and East Asia.

As mentioned earlier, every nation always tries to find a means to fight against the poverty; in that fact, many thoughts were posited as a theory of development. Here are some examples of this theory: (1) economic institutions, North (1996) showed that differences in economic institutions are the major sources of cross-country differences in economic growth and prosperity. High quality institutions have a positive influence on the depth and development of the financial sector of nations. (2) Growth theory, Harrold-Domar and Solow-Swan model (1956) explained that capital accumulations, labor, increases in productivity and technological progress are the keys of long-run economic growth. (3) Population Growth, some scholars presented an optimistic outlook on population growth, they consider the growth of population as the basis of wealth and growth. Human can be defined as a set of knowledge, abilities and skills, used in activities, processes and activities, processes

[1] Threshold levels of GNI per capita established by the World Bank

and services that contribute to stimulate economic growth (Neeliah and Seetanah, 2016). (4) Economic policy, economic policy is a decision and action implemented by the government in purpose to influence and improve the national economic situation. John Maynard Keynes, 1939 posited the effectiveness of government's intervention in economic cycle. According to Keynes, Government could push the economic development by increasing the stock of money flowing in economy cycle. (5) Financial sector, the existence of banks, financial institutions, financial market, capital market and insurance companies are also the key of economic growth in Nation. "Finance is, at it were, the stomach of the country, from which all the other organs take their tone" expressed the former British Prime Minister William Gladstone (1958).

Economic leaders of nation (i.e. political holders) ought to choose a good way to develop nation. In this competitive era, each nation vies to obtain the well-being state of its people. All of those thoughts mentioned in precedent paragraph are inarguably effectives. So, government could choose one of those proposed theories to develop the nation.

All of those thoughts mentioned are inarguably effectives. But here, this study is more focused on capital market and economic growth, more focused on the causality of capital market to economic growth or vice-versa, economic growth to capital market. Oke and Adeusi (2012) argued that a major engine of economic growth and development of nation is its capital. Thus, from now on, this present study will discuss in depth about capital market, and about economic growth.

In an overview, capital market is the market for long-term securities such as bonds and stocks (Jones, 2010: 619). Capital market is designed to finance long-term investments by businesses, governments, and households (Rose, 2009: 12). Capital market is a financial market including both equity and long-term debt instruments (Teweless, 1992: 530). Capital market is a market like any market where equity and debt instrument are bought and sold. The market of financial asset newly issued is called the primary market. After a period of time, the financial asset is bought and sold (i.e., exchanged or traded) among investors. The market where this activity takes place is referred to as the secondary market (Fabozzi, 1992: 11).

In overview, economic growth is the expansion of economy's production. The economy growth rate is the percentage change in quantity of goods and service produced from one year to the next (Parkin, 2005: 118). Economic growth is an increase in the capacity of an economy to produce goods and services, compared from one period of time to another. Economic growth is measured by the increase of the real GPD. Economic growth helps to understand how much more the economy produces than it did before.

In essence, economic development is resulted by a long-run economy growth. A long-term of expansion of production conducts to sustainable development. Economic development of a one nation is measured by the improvements of the well-being of its citizens, based on their material wealth, a better health care, the quality of life, the education and housing for the most part of people.

Discussing about capital market index and economic growth is worth doing. The research is focusing principally in capital market as a topic because, firstly, nowadays the global market is became more competitive from one country face to another country than ever before. The population of world is increasing, the world is shrinking, and the pace of the world is quickening. So finding a way to remain within the competition of international market is crucial. Global market is worldwide activity of buying and selling goods and service. Capital market is one of the vital key for a good process of networking international exchange. Secondly, capital market is a driver of any economy to growth and development because it is essential for the long term growth capital formation (Oke and Adeusi, 2012). Capital market plays significant role in the intermediation process of economic activities. Capital market ensures the investment in term of funds so that the process of socio-economic development projects is continuous. And lastly, this topic is worth doing because it is crucial to understand the importance of the outcome of the existence of a capital market to an economy growth and development of any nation. Al Faki (2006) stated that capital market is network of specialized financial institutions, series of mechanisms, processes, and infrastructure that, in various way, facilitates the bringing together of suppliers and users of medium to long-term capital for investment in socio-economic developmental projects. Capital markets provide a medium for risk management by allowing diversification of risk in the economy (Haldea, 2010). Nazir et al. (2010) stated that the capital market plays an essential role in the growth of commerce and industry which ultimately affects the economy of the country to a large extent. Hopefully, this research study will add the knowledge of its readers to understand more deeply the advantages resulting from the existence of capital market within economy.

1. Problem formulation

The present research is aimed to investigate the way in which capital market index and variation of GDP are connected and affect one another. Thus, the main problem which is expected to be answered by this research is:

How is the interrelationship between capital market index and economic growth of United-States, England and Japan from the period of 1987 until 2016?

2. Scope of the study

This research is focused to analyze the interrelation between capital market index and economic growth. In order to limit the sphere of study, those following points need to be noticed:

a. Three countries: this study analyzes only the case of United-States, England and Japan. The selection of the countries is based on the fact that these three countries are classified as developed country; therefore we would learn from them and also they are a good model for the others countries.

b. Time series data covering the quarterly of three last decades: from 1987:1 to 2016:4, that is a range of 120 rows, 720 observations. It is quite enough for doing analysis and obtaining a good result.

c. Comparison: the study compares the interrelation of capital market index and economic growth between USA, England, and Japan.

d. The economic growth that is used here is represented by the growth/the changes of gross domestic product rate between two successive periods (one quarter: three months); such as quarterly GDP of USA, quarterly GDP of England and quarterly GDP of Japan.

e. The index of capital market used is represented by the most liquid stock market index of each country concerned, such as S&P 100, FTSE 100 and NIKKEI 225.

3. Motivation of the Research

As mentioned above (and of course we will discuss deeply through theoretical part of the study), capital market is important for the any economy. Unfortunately, still many countries do not yet have stock exchange in their economy. Many of them are in Sub-Sahara Africa (Democratic Republic of Congo, Ethiopia, Gambia, Lesotho, Liberia, Madagascar), an in Asia-pacific (Timor-Leste, Burma, North Korea). According to *investment frontier* website, the biggest reasons why those larger countries (population more than 1 million) do not have stock exchange inside their economics are lack of sufficient capital, lack of expertise, controls and economic growth in order to survive. Governments of those countries are not conscious about the advantage bringing by the existence of capital market. Thus capital and skill are prerequisites for install market of capital in nation. However, the paucity of capital accumulated and the unaware of authorities block the introduction of capital market. The high rate of corruption and the persistence of irregular rules are also might considered as factors that block the efficiency of economic development in those countries.

In view of this problem, I wish that my research will facilitate the authorities of those nations to obtain a deep understanding about the effectiveness of capital market, and also to make them conscious about the good outcome of the existence of capital market in an economy.

B. Objective Of The Study

This research study is purposed to examine the interrelationship between capital market index and economic growth by doing comparison among United-States, England and Japan.

C. Contribution of the Study

As a contribution, this research study helps three levels of readers: for students, for underdeveloped nations, for investors.

1. For students: who are learning financial management as a concentration will be able to enhance their knowledge on field of capital market, of economic growth, of capital market index, of gross domestic product of, and of economic development.
2. For undeveloped countries: by this research, authorities of those countries will be informed about the importance of the existence of capital market in their economy. Not only, the good importance of capital market in economy but also the key factors and theories of economic development.
3. For investors: investors will be able to add their expertise and acknowledgement of capital market index, and the manner how to evaluate the growth of any economy.

D. Outline of the Study

Chapter 1: Introduction

This first chapter details with the background of the study, the problem formulation, the scope of the study, the motivation of the research, the objective of the study, and the contributions of the study;

Chapter 2: Theoretical Review

The second chapter, theoretical review, is divided into two parts: the first part is about literature review within what the key concepts are explaining; and the second part is about the previous research findings in what the results of precedent researchers are presented.

Chapter 3: Research Methodology

The third chapter is the research methodology. In this chapter, the method of sampling, the type of data and the data gathering are explained. In this third chapter also, the research variables and the period of study are presented in detail. And lastly, this third chapter clarifies plainly the method of analysis.

Chapter 4: Research finding and analysis

The fourth chapter of the study is about research finding and analysis. This fourth chapter presents the way to compile data, the display of data, the tests of data, the presentation of results, and the analysis or discussion of the results.

Chapter 5: Conclusion, limitation and recommendation

The last chapter concludes the results of the study. In this conclusion part, the result of each test will be summarized; the problematic question will be answered. In this fifth part also, the limitations of the study are revealed. The fifth part of study ends with citing the recommendations for readers.

To summarize at one glance the outline of the present study, hereafter a figure that shows briefly the structure of the study. Figure 1 represents the structure of the study by showing clearly the title of each chapter following with its sub-chapters.

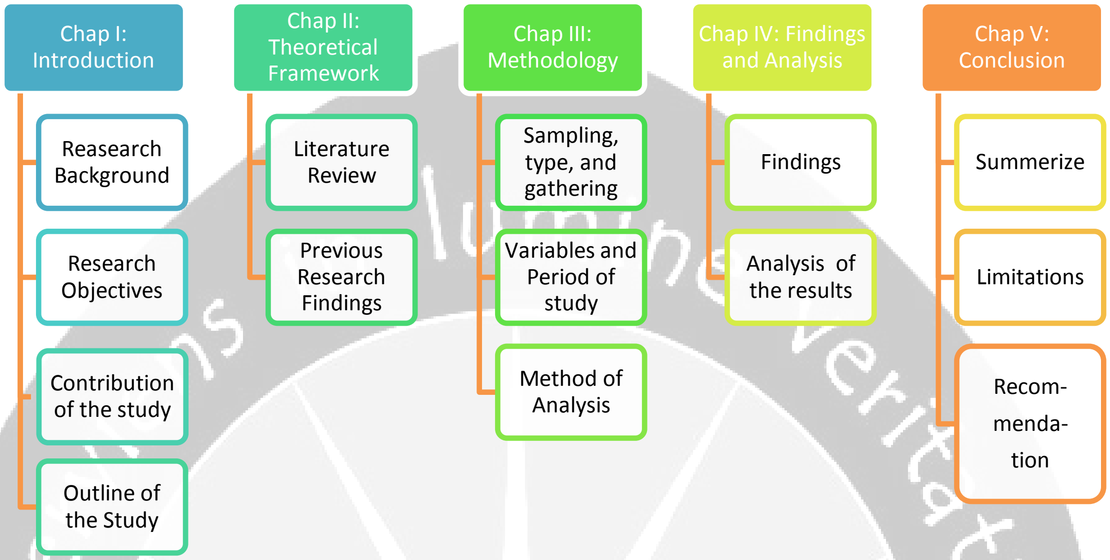

Figure 1: Outline of the Study