

The Role of Stock Exchanges in Fostering Economic Growth and Sustainable Development



Note

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Preface

Economic growth and development is an aspiration: it is a mechanism to alleviate poverty, to give opportunity to those who do not yet have it, to foster equality, and to create a better society.

Well-functioning exchanges enable economic growth and development by facilitating the mobilisation of financial resources - by bringing together those who need capital to innovate and grow, with those who have resources to invest. They do this within an environment that is regulated, secure, transparent and equitable. Exchanges also seek to promote good corporate governance amongst their listed issuers, encouraging transparency, accountability and respect for the rights of shareholders and key stakeholders.

The number of countries with a stock exchange has grown dramatically over the last 40 years - from just over 50 in 1975 to over 160 in 2015. This increase is partly attributable to a growing consensus about the role of stock exchanges in promoting economic development. However, despite this growth in the number of exchanges, the link between exchanges and economic development is not widely-understood or appreciated. There are several reasons why this might be the case.

First, there is insufficient understanding outside the financial sector and certain policy and aca-

demical arenas, of what exchanges do, and how what they do contributes to positive economic and societal outcomes. Second, while the academic literature is in agreement that there is a positive link between well-functioning financial markets and economic development, there is no blueprint to guide practitioners as to what combination of policies, incentives and structures is required to produce a 'well-functioning market'.

Given the potential of exchanges in contributing to economic development, it is important to not only improve the understanding of the role of exchanges and how they operate, but to work towards the creation of environments that ensure the development of well-functioning exchanges. We believe this joint report with UNCTAD is an important first step in achieving that objective.



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CEO, The World Federation
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Foreword

Our objective with this joint report with the WFE is to engage with the critically important question of how stock exchanges can promote economic development and begin to explore how this can be (and is already being) expanded to address some of the twenty-first century's biggest development challenges.

In 2015, member States of the United Nations launched the Sustainable Development Goals (SDGs). These goals lay out the pathway for the future we all want and include targets like: eliminating poverty, achieving gender equality, addressing climate change, and ensuring inclusive and sustainable economic growth. Achieving these goals is in everyone's interest. Profitable exchanges, investors and companies rely on sustainable, healthy and prosperous societies.

Achieving these goals requires that we all make a contribution to building a better tomorrow. The role of the public sector in this effort is fundamental: we need smart policies, better policy coherence between ministries, and incentive structures that reward investment in sustainable businesses. But none of this will be enough without the private sector's contribution, including stock exchanges and other capital market stakeholders.

Stock exchanges can contribute in two main forms: the first is promoting good governance in business practices and the second is promoting investment in sustainable development.

Good governance in the twenty-first century means good practices on environmental, social and corporate governance issues, what many investors refer to as 'ESG' issues. Policy makers, investors and consumers increasingly demand it. Stock exchanges have a strong role to play in this area. They have traditionally been responsible for helping to form well-regulated markets with transparent, well governed companies. And today stock exchanges are helping companies adopt best practices on ESG issues.

With the right policies in place, exchanges can play an important role in fostering economic development and innovation. This is an important function by itself. However, there is increasing recognition that to address the challenges of the twenty-first century, we need economic development that is sustainable and inclusive. We also need to mobilise significant financing to achieve the SDGs. Meeting the SDGs will require massive injections of investment. In our 2014 *World Investment Report*, we estimate that global investment needs are on the order of \$5 to 7 trillion per year, with about \$3.3 to 4.5 trillion per year in developing countries alone. Much of this is for basic infrastructure, food security, health, education and climate change mitigation and adaptation. Stock exchanges can be instrumental in meeting these investment needs and are recognised as an important element in UNCTAD's *Investment Policy Framework for Sustainable Development*.¹

In addition to their traditional role in contributing to economic development, exchanges are increasingly asked to address these broader issues. Given the size of the challenge it is critically important to have well-functioning exchanges fit for purpose. This paper sets the baseline for future work around policies and processes for maximising the development contribution of stock exchanges. UNCTAD will continue to support stock exchanges, including through the UN Sustainable Stock Exchanges initiative,² to assist exchanges in their endeavours to promote good corporate governance and investment in sustainable development.



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Contents

Note	1
Acknowledgements	1
Preface	2
Foreword	3
Contents	4
Executive Summary	5
1. Stock exchanges and economic development	6
1.1 Overview of the modern-day stock exchange.....	6
1.2 A review of the academic literature.....	6
1.3 Elements of well-functioning markets	9
1.4 Stock exchanges and the real economy	10
2. Stock exchanges and SME development	12
2.1 Importance of SMEs and the financing gap.....	12
2.2 Adapting stock exchanges to serve SMEs.....	12
2.3 The SME platform universe.....	13
2.4 SME listing challenges in developing markets	13
2.5 A review of African SME markets.....	14
3. Stock exchanges and sustainability	16
3.1 Overview of sustainability mechanisms used by exchanges.....	16
3.2 Green bonds, ESG indices and ESG disclosure.....	17
4. Towards a framework for stock exchanges to foster economic growth and sustainable development	19
Notes	20

Executive Summary

This exploratory report by the World Federation of Exchanges (WFE) and the United Nations Conference on Trade and Development (UNCTAD) examines the role of stock exchanges³ in promoting economic growth and sustainable development. It explains why they matter and what can be done to ensure that exchanges make a positive development contribution.

This report is set out as follows. Chapter 1 begins with a description of a modern-day stock exchange and the framework within which it operates. It then summarises debates within economic theory about stock exchanges and economic development. It notes both the positive role of stock markets in promoting economic development, as well as some of the shortcomings and common criticisms of markets. Next the report describes functionally what an exchange does and how this translates into economic impact. The report then provides an overview of exchange activity around the world.

Because the growth of small and medium enterprises (SMEs) is an important element in the overall development of an economy and the creation of jobs, Chapter 2 of the report looks at exchange initiatives to enhance SME access to capital market finance.

Chapter 3 of the report looks at efforts by exchanges to promote sustainable development. Recent years have seen many exchanges around the world adopting various initiatives and tools to promote improved environmental, social and governance disclosure and performance among issuers. This includes involvement in the development of new ESG-themed financial products and information services such as green bonds and ESG indices.

The report identifies two main mechanisms through which stock exchanges can contribute to development:

- 1) Mobilising resources for sustainable economic growth and development:
 - a) Well-functioning exchanges facilitate the mobilisation of domestic resources and foreign portfolio flows.
 - b) Exchanges around the world are increasingly focused on improving SME access to finance, as evidenced by the dramatic growth in the number of dedicated SME markets.
 - c) A number of exchanges offer sustainability-themed products and services, from ESG-themed indices and funds to green bonds. These assist in promoting companies that better manage ESG issues and mobilising funds towards addressing sustainability challenges.
- 2) Promoting good governance in business practices:
 - a) Many exchanges are promoting greater ESG disclosure among listed companies via voluntary guidance, listing rules, and training activities.
 - b) SME development is about more than access to finance. Some stock exchanges have introduced programmes to help SMEs to develop their management capacity, strengthen their governance structures and innovate and grow.

These findings highlight just some of the roles that exchanges play in contributing to broad and sustainable economic development. The ability of exchanges to perform these roles is dependent on the existence of a combination of relevant enabling policies, processes and institutional structures. The exact nature of these would vary across jurisdictions. The report sets out initial thoughts on key elements of a framework to maximise the role of stock exchanges in promoting development in the final chapter.

1. Stock exchanges and economic development

1.1 Overview of the modern-day stock exchange

A stock exchange is an organised marketplace, licensed by a relevant regulatory body, where ownership stakes (shares) in companies are listed and traded. Listing happens in the so-called 'primary market', where a portion of a company's shares are made available to the public. The company often uses the listing to raise funds through issuing new equity shares (an initial public offering or IPO). Investors can then buy and sell these listed shares in the so-called 'secondary market'. While listing in the primary market may result in a flow of funds from investors to the firm, the trading between investors in the secondary market does not.

The activity in both the primary and secondary market occurs within a framework of laws, rules and regulations, aimed at ensuring the existence of fair, transparent and orderly markets. To achieve these objectives, these rules and regulations will typically provide for the protection of investor assets, the process for transferring ownership of shares, the requirements with which companies that are listed on markets must comply, and processes for ensuring settlement of disputes. Exchanges also ensure that trading occurs according to predefined, public rules and that information about the prices at which investors are willing to buy and sell, and the prices at which instruments have sold (pre- and post-trade transparency) are publicly available.

models of who is responsible for what element of market regulation. All markets with an exchange will stipulate:

- The listings requirements (the requirements that companies wishing to list on the exchange must meet initially and on an ongoing basis, and the information they are required to disclose to the public);
- The membership requirements (the financial, educational, conduct and other requirements that the entities who trade on the exchange on behalf of investors must meet);
- The trading rules (the rules according to which, for example, buy-and-sell orders are matched, the price determination process, what happens in the event of errors, the moment at which a binding transaction is concluded); and
- The process for clearing and settlement of transactions (e.g. how the transfer of ownership of shares and cash is effected, over what time period, and how defaults are managed).

Regardless of the specific regulatory structure, all exchanges will have some responsibility for ensuring compliance with these aspects of market regulation and engaging in some level of market surveillance.

1.2 A review of the academic literature

Questions about the impact and role of financial markets in promoting long-run economic growth and development have occupied development economists, academics and policy-makers for decades. While the research focused initially on the banking sector it later expanded to include

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