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The impact of institutional investors on equity markets and their liquidity

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Chapter 2

The role of capital markets

Part I

2.1 Introduction

Capital markets, market liquidity and the impact of institutional investors

the financial system.¹ Its fundamental aim is to have to reduce it to the other. Furthermore, we look at the factors that have an influence on the development of capital markets, such as the legal environment, privatization and pension system reform.² These factors may be responsible for structural weaknesses relating to the development of capital markets and the demand financing needs by firms. Privatization and the pension reform have a particular influence on the design and development of capital markets in transition economies. We briefly discuss the role of capital markets in these economies at the end of the chapter.

We can distinguish at least four strands of literature that deal with the theory of capital markets. First, the theory of financial intermediation provides many implications for the role of capital markets relative to financial intermediaries.³ Second, the theory of corporate finance provides insights that are relevant to the role of capital markets. Most of them follow from the analysis of financing decisions by firms. The emerging research on the design of financial systems and on financial architecture represents a new class of

¹ A capital market is a market where debt and equity are traded. The term financial market is often used to encompass the capital market. However, some authors view financial market more broadly to encompass the capital market and money market. Here we do not consider money market as the distinction between money and capital markets will be used as synonymous.

² Although we do not deal with debt markets in this dissertation, most of the literature in this chapter concerns both debt and equity markets. This makes the discussion more general.

³ See Grossman and Stiglitz (1980) for an overview of the theory of financial intermediation.

