# STOCK EXCHANGES AND CORPORATE CAPITAL NEEDS

While corporations often raise the funds they need by selling stocks, they do not normally do so through any of the stock exchanges. When new stock is offered by a company, the new issue is usually handled by a special type of bank called an investment bank. In contrast, the stock markets trade exclusively in "secondhand securities"—stocks in the hands of individuals and others who had bought them earlier and who wish to sell them. Therefore, they do not provide funds to corporations that need the financing to expand their productive activities.

Yet stock exchanges have two functions that are of critical importance for the financing of corporations. First, by providing a "secondhand" or secondary market for securities, they make it much less risky for an individual to invest in a company. Investors know that their money is not "locked in." If they need money, they can always sell their stocks to other investors or to the "specialist" or market maker at the price that the market currently offers. This reduction in risk makes it far easier for corporations to issue new stocks.

Second, the stock market determines the current price of the company's stocks. That, in turn, determines whether it will be hard or easy for a corporation to raise money by selling new stocks. For example, suppose a company initially has one million shares and wants to raise $10 million. If the price is $40 per share, an issue of 250,000 shares can bring in the required funds, leaving the original stockholders with four-fifths of the company's ownership. But if the price of the stock is only $20, then 500,000 new shares will have to be issued, cutting the original stockholders back to two-thirds of the ownership of the company. This is a less attractive proposition for existing owners.

Some people believe that the price of a company's stock is closely tied to the efficiency with which its productive activities are conducted, the effectiveness with which it matches its product to consumer demands, and the diligence with which it goes after profitable innovation. In this view, those firms that can make effective use of funds because of their efficiency are precisely the corporations whose stock prices will usually be comparatively high. In this way the stock market tends to channel the economy's investment funds to those firms that can make best use of the money.

If a firm has a promising future, its stock will tend to command a high price on the stock exchanges. The high price of its stock will make it easier for it to raise capital by permitting it to amass a large amount of money through the sale of a comparatively small number of new shares. Thus, the stock market helps to allocate the economy's resources to those firms that can make the best use of the resources.

Suppose you bought 100 shares of Disney stock in the secondary market for $100 today. Next month, since Disney's stock price has risen to $120, you decide to sell all of it. How much money does the Disney Corporation make or lose when you bought and sold Disney stock on the secondary market. Explain your answer.

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