

Understanding Stock Market Volatility and Financial Market Stability: Causes and Policy Responses

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Abstract. The stock market is an integral part of the financial market and has significant importance in the process of allocating and financing assets. The price changes are normalization and transmission and that directly affect the current operational order and stability of the financial market. This paper has taken stock market volatility as its research object and in this paper, it has been analyzed the main causes of stock exchange volatility, and some policies are discussed for maintaining stability in stock exchange. Based on literature analysis and theoretical study, this paper analyzes the formation mechanism of stock market volatility from three aspects: macroeconomic factors, policy factors and external factors. It has been discovered that the stock market has a set of factors that impact its fluctuations such as the economy, policies and the external environment. It affects the expectations of the market, the actions of investors and the flow of capital, causing changes in the price of the stocks and increasing the volatility of the market. Based on the above, the paper proposes some countermeasures for maintaining the stability of the market, including improving the regulatory system, improving the structure of investors and strengthening risk prevention ability. The research results can help to better understand the causes of the volatility of the stock market, and give some theoretical support to the stable and healthy development of the stock market.

Keywords: Stock Market, Macroeconomic Factors, Policies, External Factors, Market Stability

1. Introduction

One of the most important subjects of economic sustainability and economic development in the long run is financial market stability. The stock market, one of the financial markets, has made an important contribution to the maintenance of financial stability. It makes financing easier for businesses, which has an impact on the size of the company and innovation. Stock price changes have repercussions on the living standard of the investors and their willingness to spend and save, which, in turn, have consequences for GDP. However, stock prices are constantly changing due to factors such as macroeconomic conditions, including exchange rates and interest rates, policies, and market sentiment [1]. Thus, the stock market is ever-changing. With the present speed of economic development and the globalization of trade, the ripple effects in one market can easily impact other

markets. Thus, it is an issue well worth studying and analyzing the effect of stock market volatility on the stability of the financial market.

The stock market has been more volatile than ever in recent years because of multiple financial crises as well as market turmoil. For instance, the global financial crisis of 2008, because of the US subprime mortgage crisis, and the extensive market volatility during the COVID-19 pandemic are all examples of the growing frequency of stock market volatility. As the price of a stock decreases, not only can the assets and liquidity of financial institutions like investment banks be affected; but the investors can also irrationalize themselves and may even panic sell. This may result in greater uncertainty in financial markets and may cause systemic financial risks. So, the instability in the stock markets can have profound impacts on the economy at large [2]. The effect on financial markets is, however, complicated and volatility is not a one-way bet. The impact of different levels of volatility is different on different stakeholders in different market environments. Therefore, this paper needs to discuss in detail the mechanisms and extent of the impact, and how to maintain stability.

The linkage between the volatility of the stock market and the stability of financial markets has been much discussed so far. There are various studies to show the adverse effects of the volatility of the stock market on the stability of the financial market. Thus, rising stock market volatility could have a negative impact on the performance of financial institutions, especially smaller banks [2]. Market operation as such would be adversely affected by too much volatility, which might lead to less liquidity and normal order in the market. Hence, it's been observed in many studies that stock market volatility is one of the factors that affect the stability of the financial markets. Some studies however do not share the above opinion but believe that the volatilities of stock market don't always have a negative impact on financial market stability, and that suitable volatilities assist the financial markets to appropriately and timely mirror new worth information that improves the effectiveness of the financial markets. There are also scholars who have noted the effect of stock market volatility on financial market stability would be different depending on the market environment, level of regulation, and level of volatility. Some research work has been done in this area, but there are some controversies among different research works and the basic perspectives are limited. Thus, a more systematic and comprehensive analysis is needed of this question.

Keeping the above overview in mind, this study is aimed at the effect of stock market volatility on financial market stability. The study is an attempt to answer the question of what is happening in the stock market and how it can be reduced to mitigate its negative impacts. From the perspective of research methods, this paper mainly used literature analysis and made summarization and generalization of existing relevant research, and on this basis, combined with qualitative analysis methods, explored the stock market volatility and financial market stability from multiple perspectives.

2. Analysis

There are many factors that affect the stock market, all of which are working together to create volatility. There are several studies that identified these factors that influence the results and they are divided into three categories: macro-economic factors, government policies and external economic environment [3, 4]. Hence, from these three angles the salient factors contributing to the volatility of stock market are examined.

2.1. Macroeconomic factors

One of the most basic and direct factors that can influence the functioning of the stock market is macroeconomic factors [5]. Macroeconomics factors like economic growth, inflation and interest rates have a direct impact on the supply and demand of the stock market, thereby leading to volatility. Firstly, economic growth at a higher rate would lead to higher aggregate production and national income. Increased consumption and investment will lead to higher corporate profits and a more positive outlook for investors and, therefore, higher stock prices. In addition, as the economy does better, investors will have more money to invest and this could include the stock market, causing stock prices to increase. Then in times of inflation, the raw material and labor costs also go up. It also decreases the companies' profit, ultimately reducing the investors' expectations and the share price. Furthermore, when interest rates go up, businesses will have to pay higher interest on loans, which means it will be harder for them to get loans. This will limit their investing and growth, which will result in lower future earnings prospects, and lower stock prices. Meanwhile, the rise in interest rates has an impact on capital flows. Rising interest rates boost the yields of deposits and bonds, making the relative performance of stocks less appealing, encouraging capital outflows from the stock market and a decline in the prices of stocks. Thus, change in interest rate, economic growth and inflation can all be related to fluctuations in the stock market, as all of these could influence businesses, investor expectations, and flows of money into the market [6].

2.2. Policy factors

The political policies also play a significant role that affects the volatility in the stock market. Financial, industry and regulatory policies are directly related to stock market expectations, and their changes will directly affect the level of fluctuations in the short term [7]. Firstly, when central banks put in loose monetary policies, like interest rate cuts, this boosts the general economy and raises the amount of liquidity in the marketplace. More liquidity implies more money will enter the stock market, which will ultimately lead to a higher stock price. Also, if the country's economy is facing too much inflation, banks can increase their interest rate to curb inflation. Thus, a greater share of money could go to savings, resulting in less money in the stock market. Second, there are particular industrial policies that affect the particular industry to a large extent. Prior to a few years, China had enacted several favorable policies to rapidly develop new energy vehicles, such as reducing corporate income tax, and setting aside certain funds for automakers which comply with the policies, making the market optimistic about the prospects of the industry. That attracted a significant capital inflow which in turn led to the corresponding stocks going up. Last, investor confidence in an industry is important, and is basically affected by the rules. As the regulators enhance the control of the market, including combating insider trading and market manipulation, and promoting transparency, investors feel that the market is fairer and the investment environment is better. As such, money could pour into the market, and stock prices could keep going up. Furthermore, regulators can also increase financing requirements and limit trading leverage, which will result in a decline in trading volume and consequently cause market volatility. To conclude, the policy factors are one of the important factors influencing stock market volatility. Market expectations, capital flow, and the investor's behavior can be influenced by policy changes, affecting the stock's price changes. So, stock market changes are frequent when there are changes in policies [8].

2.3. External environmental factors

In this era of globalization of the economy and globalization of financial markets in the world, external factors have become one of the factors influencing the fluctuations of the stock market. Market linkages result in fluctuations in my country's stock market due to external factors like overseas stock markets, international economic situation and geopolitics. One is that the ups and downs on foreign exchanges can affect your stock exchange. This is because the major markets across the world, including the US, European and Asian markets, are highly interlinked and investors are likely to trade across several of these markets. Hence, when overseas stock markets fall short an investor senses that there might be increased financial risk and future uncertainty. As a result, they may be looking to cut back on their stock holdings and move into gold, cash, bonds and other safe haven assets. This leads to a fall in the stock market. In addition, investors can purchase more overseas stocks because of the higher return in overseas markets, which results in capital inflows in overseas markets which, in turn, causes stock prices to decline. In addition, fluctuations in the international economic situation can impact on the stock market. For instance, majority of the companies in the list are manufacturing and foreign trade companies which earn their revenues from the international market. So, with the global economy expanding and export demand going up, corporate profits could be better, and stock prices could be higher. At the same time, risks from the financial markets may be passed on, for instance, financial market risks during the financial crisis in 2008. The economic problem started in the USA and was then passed on to the financial institutions. This resulted in loss of confidence in the market, which in turn led to a stock market crash. Also, geopolitical issues like war, trade friction and international conflicts also have an impact on the stock market. During the period of war when the trade friction becomes stronger, the market becomes unpredictable and its uncertainty grows. This can lead to a drop in investor confidence and consequently a decrease in stock prices. So, in the sense of globalization, the stock market is becoming more and more under the influence of external factors. Changes in global stock markets, global conditions, and geopolitical events can introduce uncertainty and impact investor confidence, market outlook and ultimately stock market volatility.

3. Solutions

Volatility in the stock market is a reflection of different economic and institutional conditions and in order to secure the stability of financial markets, joint regulatory actions as well as rational behaviors by investors and risk management are necessary. Thus, this section suggests some feasible strategies derived from past research and policy experiences.

3.1. Regulatory system in the stock market

Government can minimize the abnormal fluctuation in the stock market by enhancing the regulatory framework of stock market [9]. First, abnormal movements in stock prices are partly caused by insider trading, market manipulation, as well as by malicious speculation. All of these can decrease the equitability of deals, resulting in unusual price swings, incorrect investor estimates and, in the end, greater market volatility. The government can make illegal activities and illegal acts expensive and impose higher penalties on such acts to deter illegal and irregular activities. The greater the costs of law breaking, the less likely it is that insider trading and market manipulation will occur. This can help preserve the fairness of the market, and consequently, stabilize market operations. Secondly, due to imperfect information, investors may misestimate the price of a company, and this

can result in mispricing the market and heightening the volatility of the stock markets. Government can enhance transparency by requiring that listed companies report the key events promptly and enhance the transparency of the financial reports. This will make the investors' decisions more accurate, minimizing the irrational fluctuations and making the market more stable. Last, but not least, there are also hidden risks which are hard for the investor to see or, in some cases, are seen too late. This enables risks to build up until they result in abnormal stock price movements. So, the regulators can identify issues in advance and act upon them by real-time identification of abnormal market action, monitoring leverage and monitoring concentrated inflows and outflows of money, which helps in preventing the irrational investment behavior of panic selling and stabilization of the stock prices. If, for instance, regulators notice that there is a large amount of turnover or trading volume happening in the stock price, then it could mean the stock price is about to hit a continuous rally or a plunge. Hence, they could see in advance which to intervene in and which to avoid preventing the market from being shaken. Therefore, it is essential to enhance the regulatory system of stock exchange, which is an essential step to achieve stability in the financial markets. Continuing to improve information disclosure, strictly punish illegal acts like market manipulation and set up the market early warning mechanism of risk to stabilize market expectations, promote the market efficiency, reduce the risk of an abnormal fluctuation and promote the financial market to be well developed.

3.2. Rational investment

Investors are often not 100% rational. Their emotions may get impacted due to the market movements or policy changes, which may result in panic trading and higher volatility [10]. This means that government can make the investor structure optimal and rational investment direction. First, retail investors account for a significant share of the stock markets, and they are more easily swayed by emotions as compared to financial institutions. For instance, as the market goes up, they may become more emotional and follow the trend, thereby adding to the volatility of the market. To boost the institutional investors' participation in the market, long-term funds like pension funds and social security funds can be further developed and mutual fund market can be encouraged. Institutional investors have more professional analytical skills and have a long-term investment horizon compared to individual investors. So, they can lessen the sentiment changes in the market and irrational behavior and hence increase market stability. Then, we can further improve investor education. Most investors are not well-versed in the market, have limited understanding of risks, and are liable to follow the herd, resulting in panic trading and speculation. If the government propagates basic investment knowledge and risk education, and seriously promotes long-term investment concepts, it will help the investors to rationally analyze the market and prevent them from following the tide. Due to this, the volatility in the market sentiment has been reduced and the stability in the stock market has increased. Thus, optimizing the investor structure and performing rational investment guidance are important to enhance market stability. It can improve the quality of investors, reduce irrational trading and market sentiment fluctuations by cultivating institutional investors and promote the healthy development of the financial market through investor education.

3.3. Financial institutions risk management

Financial institutions are one of the major players in the stock market and they can lessen the impact of stock market fluctuations if they have better risk resistance capabilities [11]. First, the government can provide directions to financial institutions to enhance stock investment risk

management system. Many times, the financial institutions are not able to identify, assess and control risks in time and suffer huge losses in terms of money in the event of a stock market crash. With a more comprehensive risk management system, financial institutions can anticipate and estimate the risks and implement preventive measures to minimize losses. Moreover, institutional risk can increase even more because of the "over-concentrated" assets of institutions, for example, the high concentration of investments in one industry. During the downfall in the market, financial institutions undergo a sharp rise in losses. Hence it is important to promote the diversification of financial institutions' investment portfolio and rational investment in assets and equity in the spirit of risk mitigation. This can help to mitigate market shocks and stabilize market conditions. To conclude, it is important to reinforce risk management in financial institutions as it is a key element in the stability of the financial system. Effectively increasing ability to deal with the market fluctuation and preventing the occurrence of systemic financial risks can be achieved by improving the ability to identify the risk and diversify the asset [12].

4. Conclusion

Literature analysis and theoretical analysis methods are used in this paper; the object of research is stock market volatility. It studies in detail the causes of stock market volatility from three aspects macro-economic factors, political factors and external factors and how to prevent stock market volatility and maintaining the stability of financial markets. The study has revealed that the stock market volatility is determined by a range of factors. Among them, the macroeconomic aspects are basic because economic growth influences the profits of companies and the confidence in the market. The investor expectation is affected by policy changes and political events, and the capital flow is affected by changes in the interest rate or inflation rate. External economic conditions and unexpected events can lead to the volatility of the market, and the financial risk in the international market can be transferred and affect the domestic market. Hence, the government should enhance the stock market control mechanism for better regularization of the stock market. It also needs to optimize the investor structure, guide rational investment, and improve the information disclosure system to enhance the market transparency and financial market stability. This paper is mostly theoretical and is not backed up by data. In the future, the study could be carried out by combining certain case studies with statistical data, so as to conduct more in-depth research on the impact of different factors on the stability of financial markets, and provide more comprehensive theoretical basis for the stable development of the stock market.

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