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Loosen the Reins on India's Bull Market

By AJIT DAYAL

BOMBAY – "The coffers of the country are empty," said Indian Prime Minister V.P. Singh in his inaugural address to the nation. But judging by the phenomenal growth in investment habits of Indians, the coffers of the citizens of India are far from empty.

Consider the numbers. In 1980, less than Rs. 2 billion (US$251 million) was raised through the Indian stock markets. In 1989, that figure was Rs. 53 billion (US$3.1 billion). In local currency terms, share prices have appreciated by nearly 800% in the 1980s, according to the Bombay Stock Exchange Sensitivity Index of 30 stocks. A study done by Quantum Financial Services, Bombay-based financial consultants, shows that the 10 largest capitalized companies have seen their market capitalization increase by over 12 times in the same period. Even after taking into account the perpetual weakness of the Indian Rupee vis-a-vis the international currencies, share prices have still appreciated by over 500%.

This investment represents just 2% of the nation's household savings; market capitalization has only reached 10% of India's GNP. There is lots of room to grow – if the national government reduces its dominance and takes the necessary steps to make the markets more attractive to small and private investors.

The strong performance of the secondary markets continues to attract local and foreign money. In 1980, only one million Indians invested in the country's financial markets. Today there are about five million Indian investors; even this represents less than 5% of the middle- and upper-class population. As the government finds itself hard-pressed to finance the modernization of the Indian economy, it has begun to let companies tap the deep pockets of investors rather than rely on the state-run development banks. Even the deepest pockets will soon be emptied, however, if the government does not encourage a financial infrastructure that bolsters investor confidence in the integrity of the markets – something that has been lacking in the 110-year history of the Indian stock exchanges.

Spread the Equity Cult

The government should:

- equip and empower the now-dormant Securities and Exchange Board of India to commence its stated objective of developing the capital markets in India;
- force mutual funds to disclose their investments;
- allow private-sector companies to float mutual funds on the same terms and conditions as the government funds;
- force brokers to disclose transaction details and strengthen the capital base of market-makers (jobbers);
- allow foreign financial-services companies to participate in the emerging Indian markets.

Until 1985 there was only one mutual fund manager, the Unit Trust of India, a monopoly government institution licensed to float mutual funds. Today, there are six institutions licensed to manage mutual funds. In addition to the array of domestic mutual funds, a host of offshore funds tailored to meet the needs of global institutional investors have also been successfully launched.

This institutionalization of the market – a necessity for increasing the breadth, depth and resiliency of any stock market – is a welcome step. The creation of mutual funds and the birth of professional investment managers will act as a catalyst to further spread the equity cult.

But a closer look at this growth in numbers indicates that the institutionalization of the market is still limited: The licensed mutual funds all are controlled by the government of India.

Although there is no law specifically barring the participation of the private sector in the mutual fund business, laws limiting intercorporate investments along with the tax disadvantages, waived for the government-controlled funds, prevent the launch of private-sector mutual funds. The liberalization of the Rajiv Gandhi era seems to have bypassed the mutual fund business, where government influence has effectively increased rather than decreased. Although the government claims to have adopted a policy of largely leaving business to business people, in fact it still controls business. If private-sector mutual funds were allowed, the stock markets would be even more buoyant than they are today and would both reflect and enhance the strength of the Indian economy.

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Paradoxically, India's stock-market operations are government-dominated, but probably one of the least controlled in the world. Brokers enjoy a freedom that would make Western brokers blush. The level of information provided to investors on volume and price levels is dismal. Market-makers commonly quote spreads of 10% and clients often complain that brokers seems to be buying at the highest prices and selling at the lowest prices. An investor wishing to check on the authenticity of a trade declared by his broker has no way of doing so. The stock exchange does not even require brokers to indicate the time a transaction took place. The effect is that the broker not only makes the usual commission on the trade executed but also makes an additional profit, or "gala," on the difference between the price reported to the client and the price at which the stock actually was traded. This hardly fosters the concept of equity investment among middle-class Indians.

The offhand treatment of small investors is not limited to the secondary market. Companies raising money in the primary market often paint an exaggerated picture of their future prospects. Advertisements proclaiming "guaranteed returns" and "assured profits" are common fare. Investors lured by the spurting secondary market rushed to subscribe to equity issues in 1985 and 1986. The inevitable shakeout in 1987 and 1988 left many investors holding worthless paper. There are always losers as well as winners in the market, but the important thing is to give small investors the necessary data to make informed choices.

It is precisely this free-wheeling and buccaneering attitude of some private industrialists and brokers that the government uses to justify its decision not to allow private-sector mutual funds. But mature economies have found ways to control this potential misuse, such as insider-trading laws and limits on what mutual funds can or cannot do. The final and exacting judge should be the investor. If, given the appropriate information, an investor believes that a particular mutual fund manager is cheating him of potential returns or simply not doing a good job, he will offload his shares. The driving force will be: perform or perish.

Besides, what guarantees are there that the government-controlled mutual funds will not forego the public interest to please a whim or fancy of the government? The Larsen & Toubro and Reliance scandals, which contributed to the fall of the previous administration, are mute witness to things that can go wrong in a "government-knows-best" environment.

(When business rivals began to target engineering giant Larsen & Toubro for takeover, government institutions, which owned 35% of the shares, off-loaded their shares to the Reliance group without giving anyone else a chance to bid. The deal has been criticized as disregarding the public intererest.)

In a recent editorial, a leading financial magazine, Dalal Street, warned of "the unsettling reports which have poured in over the past few weeks on the operations of [government-controlled] mutual funds [indicating] the need to have more open-ended mutual funds and more effective disclosure of information of their operations. Because the secrecy and confidentiality that their operations enjoy now may veil their deeds from the public eye but the stink which emanates therefrom is not so easily suppressed. On the other hand, if the reports of misdeeds of mutual funds are baseless, they must be exposed as such and not allowed to cloud the investment climate."

The 1990s will be a testing time for administering India's fast emerging financial markets. On the one hand, there is a strong need to regulate and strengthen the broking and market-operations systems. On the other hand, there is a need to allow the broad-based participation of the private sector in financial services on equal terms with the government institutions. To further increase the shareholding population, brokers will need to open full-fledged offices in smaller towns and provide investors with quality service. The active and equity-related participation of the global financial firms will accelerate this trend toward retailing.

Bullish Outlook

India can attract foreign-capital inflows if it can offer quality services to investors. India now attracts just $150 million in project investments; Indonesia attracts $4 billion. Given the ingenuity of Indians and the globalization of finance, there is no reason India cannot bridge the gap.

With a new government in office, investors finally may take note of the stable economy and return to bid up share prices. The long-term outlook for the Indian stock markets is fundamentally bullish. Investors have, by and large, tasted profits from past share investments and would be willing to increase their exposure to financial securities.

But that can only happen if the government begins to create a framework of integrity and stability. Otherwise, the household coffers will find their way into gold, silver, and real estate, India's traditional investment havens. Worse still, the country will end up with a liberalized economy but a nationalized stock market.

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