Empirical Analysis on Indian Capital Market reforms since Globalization

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Abstract

India is presently one of the fastest growing nations in the world. Since the liberalization in the early 1990's, India has proficient nothing short of an economic revolution to become an emerging global economy. An emerging financial market is where a lot of opportunities are available and the market has great potential, but not the capital to achieve it. If capital is infused, a lot of growth is possible. That is exactly what has happened in India since the liberalization in 1991. A lot of money has been flowing into the country from the developed countries. With the stock market tripling in the last 10 years, significant foreign portfolio inflows, including private equity inflows, and a rapidly developing derivative market, the Indian financial system is witnessing an exciting era of transformation. This has also given rise to some very powerful growth stories in the financial services industry. New entrepreneurs in the financial services industry have emerged and within 10-20 years they have become billionaires. This paper discussed the journey and success story in review for Indian Capital Market reforms since Globalization, Liberalization and Privatization.

Introduction

The history of India's economic growth is divided into two phases, the first 43 years (1947-1990) after independence featuring measures of socialism, and the last twenty three years (1991-2013) as a free market economy. During the first 43 years after independence, the government controlled most of the consumer services, and coupled with regulation in the manufacturing sector, India witnessed limited growth. The first three decades of India's policy formulation were marked by socialist policies. Between 1950 and 1980 India grew at an annual rate of 3 to 3.5 percent, which was also referred to as the "Hindu rate of growth." But 1991 saw the nation enter into a new phase of economic policies. For the first time India saw a shift away from its socialist ideologies. The impetus for these reforms started in 1980s when Rajiv Gandhi became the Prime Minister and brought some macro-economic changes. Following the reforms in 1991, the Indian economy has enjoyed a strong capital growth with annual GDP growth exceeding 8 percent since 2003. Private investments have grown extremely fast and constituted 80 percent of the total investments in 2010 11. The poverty ratio went down from 45 percent in 1992-93 to 32 percent in 2009-10. This growth has been accompanied by some structural changes. The share of services in total GDP jumped from 43 percent in 1990-91 to 58 percent in 2010-11, while that of agriculture slipped to 14 percent in 2010-11 from 28 percent in 1990-91. There has been a paradigm shift in the configuration of the economy resulting in increased importance of external trade, foreign capital inflows, and growth of the domestic capital market. In addition, the new liberalization era has convinced the world's investors that India holds great economic promise. The result has been that since liberalization the Indian capital market has been one of the best performing markets in the world. In the past 10 years the stock market has more than tripled in value fuelled by strong economic growth and large inflows from foreign institutional investors. In India, due to socialistic policies of the Government, there were a lot of constraints in the financial markets and hence the development of financial markets was delayed. But once liberalization took place in 1991, reforms took place and the financial markets developed. This directly led to a boost in economic development of the country and it fell in line with the past researches that financial market development precedes economic development and also that financial sector development spurs economic development.

Liberalization in India: 1985 and 1991

Till the mid-1980s India followed a strategy of planned economic development based on import substitution. The 1951 Industrial Development Regulation Act had set out the basic cast and machinery of industrial policy. This involved a comprehensive control over the direction and volume of investment through licenses, a large public sector, and foreign exchange controls. Planned import substitution tilted investment flows initially towards heavy and capital goods industries and later towards chemicals, petroleum and durable consumer goods. It is now universally accepted that this highly regulated and protectionist regime spawned a sluggish and high cost manufacturing system that was also dynamically inefficient (Bhagwati and Desai, 1970; Bhagwati and Srinivasan, 1975; Ahluwalia, 1985). In 1985, the Rajiv Gandhi administration (1984-1991) crystallized the logic for trimming the regulatory system in an effort to rejuvenate industry. These reforms, collectively termed the New Economic Plan, and characterized as liberalization by stealth, eased entry and expansion of incumbent firms by removing license requirements over capacity expansion for many classes of firms: firms with assets below a moderate threshold; those located in "backward" areas; firms in scale-critical industries, and firms that were "modernizing". Modernization was encouraged through relaxing controls on the import of capital equipment and technical know-how. Licenses were "broad banded" to allow enterprises to adjust their product mixes more easily to changing market conditions. There was some relaxation of the restrictions on “monopoly houses” if their expansion were in “priority industries”.

(Government of India, 1985-86; Srivastava, 1996). While these initiatives increased the freedom of incumbent firms to expand, they were less effective in encouraging entry. We might expect freer play of rivalry among incumbents in the period following these reforms. It is likely that among the incumbents, the smaller benefited more from the removal of many restraints. The second phase of reforms, which was part of the substantial structural adjustment programme of 1991, was more radical. New industrial policy lifted the rules of investment licensing. Restrictions on expansion by monopoly houses were relaxed, rules of foreign investment relaxed, and sectors reserved for the public sector were thrown open to private sector entry and competition.2 Procedures for foreign direct investment were simplified and trade tariffs reduced. The maximum import tariff was reduced to 40 percent from 340 percent. Quantitative restrictions were eliminated for capital and intermediate goods. The substantial thrust of 1991 reforms was to expose incumbent firms to greater domestic as well as international competition. Again, one might expect to see an increase in rivalry in the period following these reforms. Larger firms with their greater resources were arguably better placed to respond to the fiercer competition with a range of investments. The relative strengths of the reform episodes of the mid-Eighties and the Nineties and the difference they created in terms of economic growth has been debated. Panagariya (2004) taking issue with DeLong (2004) concludes that the former were “limited in scope and without a clear roadmap”, but they laid the basis for the reforms in the 1990s which were “more systematic and systemic”.

Role and Importance of Capital Market in India

Capital market has a crucial significance to capital formation. For a speedy economic development adequate capital formation is necessary. The significance of capital market in economic development is explained below:-

1. Mobilization of Savings and Acceleration of Capital Formation

In developing countries like India the importance of capital market is self-evident. In this market, various types of securities help to mobilize savings from various sectors of population. The twin features of reasonable return and liquidity in stock exchange are definite incentives to the people to invest in securities. This accelerates the capital formation in the country.

2. Raising Long - Term Capital

The existence of a stock exchange enables companies to raise permanent capital. The investors cannot commit their funds for a permanent period but companies require funds permanently. The stock exchange resolves this dash of interests by offering an opportunity to investors to buy or sell their securities, while permanent capital with the company remains unaffected.

3. Promotion of Industrial Growth

The stock exchange is a central market through which resources are transferred to the industrial sector of the economy. The existence of such an institution encourages people to invest in productive channels. Thus it stimulates industrial growth and economic development of the country by mobilizing funds for investment in the corporate securities.

4. Ready and Continuous Market

The stock exchange provides a central convenient place where buyers and sellers can easily purchase and sell securities. Easy marketability makes investment in securities more liquid as compared to other assets.

5. Technical Assistance

An important shortage faced by entrepreneurs in developing countries is technical assistance. By offering advisory services relating to preparation of feasibility reports, identifying growth potential and training entrepreneurs in project management, the financial intermediaries in capital market play an important role.

6. Reliable Guide to Performance

The capital market serves as a reliable guide to the performance and financial position of corporate, and thereby promotes efficiency.

7. Proper Channelization of Funds

The prevailing market price of a security and relative yield are the guiding factors for the people to channelize their funds in a particular company. This ensures effective utilization of funds in the public interest.

8. Provision of Variety of Services

The financial institutions functioning in the capital market provide a variety of services such as grant of long term and medium term loans to entrepreneurs, provision of underwriting facilities, assistance in promotion of companies, participation in equity capital, giving expert advice etc.

9. Development of Backward Areas

Capital Markets provide funds for projects in backward areas. This facilitates economic development of backward areas. Long term funds are also provided for development projects in backward and rural areas.

10. Foreign Capital

Capital markets makes possible to generate foreign capital. Indian firms are able to generate capital funds from overseas markets by way of bonds and other securities. Government has liberalized Foreign Direct Investment (FDI) in the country. This not only brings in foreign capital but also foreign technology which is important for economic development of the country.

11. Easy Liquidity

With the help of secondary market investors can sell off their holdings and convert them into liquid cash. Commercial banks also allow investors to withdraw their deposits, as and when they are in need of funds.

12. Revival of Sick Units

The Commercial and Financial Institutions provide timely financial assistance to viable sick units to overcome their industrial sickness. To help the weak units to overcome their financial industrial sickness banks and FIs may write off a part of their loan.

Pre-Liberalization Scenario

After independence, India was under immense financial hardships. Especially in the 1950's and 1960's India saw a number of bank failures. The private commercial banks were unable to fulfill the social and development goals of banking. Hence, to better align the banking system to the needs of the economic policy in India, the Government of India issued an ordinance in 1969, which led to the nationalization of India's 14 largest commercial banks. This event shaped the philosophy of financial sector reforms over the next 15 years. Successively, in 1972 the insurance sector was nationalized. By 1980, six more banks had been nationalized by the Government of India controlling almost 91 percent of the banking business in India. Nationalization enabled the banking system to quickly expand in the rural areas. Population per bank office came down from 65,000 in 1969 to 14,000 in 1990. Increased branches also gave rise to higher domestic savings. In terms of financial markets, the bond market and FOREX market were limited. The call money rate was controlled. But the stock market was an exception as India had one of the oldest stock exchanges in Asia, the Bombay Stock Exchange (BSE). Yet it also had a lot of controls on the floatation of new issues by the Controller of Capital Issues (COCI). Finally, India's economic model was based on the policy of "self-reliance". Hence, most of the investments were financed by domestic savings and there was reluctance to permit foreign investments. In 1990-91 when trade imbalances were accompanied by a fall in private remittances, the current account deficit widened to 3.2 percent of the GDP. With the Gulf crisis happening at the same time, capital inflows dried up and India pledged gold to the Bank of England to escape a default. Overall by1991, the government had built up a big banking network, boosting growth and savings, but also giving rise to numerous problems and inefficiencies. Based on government policies the nationalized banks gave enormous loans to small-scale industries and sectors such as agriculture. However, banks struggled to recover loans and non-performing loans increased. Labor productivity and efficiency came down. It was clear that the financial sector needed to be liberalized for a higher growth trajectory.

Post Liberalization Scenario

With liberalization taking place in early 1990's, India's financial markets began their transformation path. Financial liberalization was part of greater reliance on the private sector after the 1991 foreign exchange crisis. After the 1991 capital markets crisis, regulations were strengthened, listings were liberalized, foreign investors were allowed in, and infrastructure was substantially improved. (Shah and Thomas 1999; Nayak 1999)

Banking Reforms: Banking reforms came in two sets, both chaired by M. Narasihman.

The first report: Narasihman Committee I took place in 1991 and was primarily devoted to giving operational freedom to banks. The second report came in 1998 and was called Narasihman Committee II, which focused on stability issues and prudential regulations.

Opening up of Indian capital markets, a case for development

Both academics and skeptics would agree that the health of an economy is reflected in the performance of its capital market. Currently, India's economic growth is second only to China but unfortunately the phenomenal growth rate has not reflected in the performance of its capital market. Performance of a nation's capital market is not merely reflected by the performance of its secondary market and indices of stock exchanges, but also by the positioning of the market in the global financial circle in terms of reputation and presence of foreign companies. If we take the example of developed nations, all of them have a robust capital market with the presence of international companies and a high reputation. The major financial hubs over the past two decades have been cities from developed nations - New York, London and Tokyo - and in the recent past, Hong Kong and Shanghai are fast emerging as the next financial centers. To take the argument further, while the Indian economy has been growing at a rate higher than most of the other economies, India still has a long way to go before attaining the status of an attractive financial hub in the world. This poses one of the major hurdles for India to progress from a developing economy to a developed economy. China has developed its markets to make them more accessible to foreign capital. This is well illustrated by the fact that well known international companies like Glen core, Samsonite, Prada, to name a few, have approached the Hong Kong exchange for listing. As per current news reports, global conglomerates like Coca Cola, HSBC, Unilever and Standard Chartered are eyeing the Shanghai Stock Exchange. On the other hand, Indian exchanges are way behind to join this bandwagon. The question that begs asking is whether we would like these companies to come to India for listing? And if the answer is yes, are we providing a platform for international listings in India? The current legal framework in India with respect to listing of foreign companies in India is rather onerous and since the introduction of Indian Depositary Receipts ("IDRs") in 2000, there has been only one foreign company i.e. Standard Chartered Plc., which got listed in India. It was almost 11 years back that the concept of IDR was floated in India by way of insertion of Section 605A of the Companies Act, 1956. But even after several rounds of amendments to liberalize and lay down a detailed framework of rules to govern the issue of IDRs, Indian exchanges have not been able to attract foreign companies. There are onerous restrictions on foreign companies requiring them to have minimum pre-issue paid-up capital and free reserves of USD 50 million and a minimum average market capitalization (during the preceding 3 years) in its parent country of USD 100 million, for them to be eligible to list their IDRs in India. In addition, the regulations require such foreign companies to be listed in their home jurisdictions for a minimum period of three preceding years and a track record of profitability in at least 3 years out of the preceding 5 years. These restrictions would allow only large listed foreign companies to be able to list in India, for which India has not yet evolved into an attractive dual-listing venue. India should either relax these rather onerous restrictions for listing of IDRs or set-up an alternate exchange on lines of the Alternate Investment Market of the London Stock Exchange and the Growth Enterprise Market of the Hong Kong Stock Exchange, which allows for smaller foreign companies to get listed on their exchanges with no requirement of prior listing on home exchanges.

India should also provide a forum for listing of common shares of foreign companies in India. Currently, only common shares of Indian companies can be listed on Indian exchanges. In an increasingly globalized world where most multinational foreign companies have business presence in India, they should also have the opportunity to be listed on Indian exchanges and thereby assist in increasing India's competitiveness in the global securities market. There are two major schools of thought with respect to increasing the competitiveness of a securities market, the proponents of the 'issuer choice' approach and advocates of the existing legal regime where foreign issuers would be subject to the local laws. While the current Indian legal framework subject foreign issuers to local Indian laws, it is argued here that an issuer choice regime would be more beneficial to develop the struggling Indian capital Market.

Reforms in the Capital Markets

Some sweeping reforms led to spectacular growth in in the capital markets. There were increases in capital raised from the market, the number of stocks listed, the investor population, and most importantly technological sophistication leading to improved transparency and efficiency. Following are some of the important reforms that contributed to the capital market boom in India.

1. *Market Pricing of Issues*: The office of the Controller of Capital Issues (COCI) was abolished, which removed the administrative controls over the pricing of new equity issues. Pricing was left to the market. This facilitated better price discovery.

2. *Creation of the Regulatory Bodies*: The Securities and Exchange Board of India (SEBI) were empowered in 1992. It was created to protect the interests of investors and promote the development of the securities market. With the setting up of SEBI all market intermediaries are supposed to be registered with SEBI, which also sets down the guidelines for Disclosure and Investor Protection. This enabled transparency in the capital markets and built trust in the investors, playing a very important role in increasing the capital raised by companies from the markets. In addition, the establishment of the National Securities Clearing Corporation (NSCC) in 1996 removed the problem of counter-party risk as it guaranteed each trade.

3. *Open Electronic Limit Order Book Market*: A major reform was introduced in 1994 when National Stock Exchange (NSE) started Electronic Limit Order Book (ELOB) and screen based trading. It was followed by the Bombay Stock Exchange (BSE) in 1995. This enabled much higher liquidity and facilitated transparent screen-based trading, as the open outcry method earlier was dominated by the traders at BSE. This also paved way for nationwide connectivity. As the ELOB was based on a computer-based matching system, it integrated the nationwide markets, reducing the price variations between markets. Orders placed from any part of the country by a computer could be matched with any order from any part of the country, thus reducing arbitrage opportunities. It enabled the market to become more efficient and reduced transaction cost.

4. *Depository Services:* With lack of technology, share transfers till 1996 required physical movement of share certificates. To sell the stock the shareholders had to send certificates to the company through post offices. This resulted in a lot of back office work and increased transaction costs. Also to get the shares transferred it took up to 45 days, adversely affecting the stock liquidity. But with the passing of the Depository Act in 1996, depositories were allowed to dematerialize securities and convert physical securities into electronic form. The depositors were also supposed to electronically record who owned the stock. This directly reduced transaction and handling costs, while also reducing the possibility of forgery and counterfeiting. Liquidity improved and contributed to market efficiency. India currently has two depositories: National Securities Depository Limited (NSDL) and the Central Depository

Services Limited (CDSL).

5. *Derivatives Trading*: One of the most important reforms took place in June 2000 with the introduction of exchange-traded derivative instruments. Instruments such as futures and
Options enabled investors to better hedge their positions and provided them with better risk management.

6. *Capital from Abroad*: In 1994 Indian companies was given access to raise capital from abroad using Global Depository Receipts (GDRs) and American Depository Receipts (ADRs). Hence, the corporate capital formation was available from domestic savings as well as from foreign savings.

7. *Foreign Portfolio Investment:* Another landmark reform that took place in 1993 was the opening up of the Indian stock market for foreign portfolio investment and for the first time Foreign Institutional Investors (FIIs) were allowed to invest in the Indian stock market. This was a big boost to the secondary market. It also played a huge role in boosting India's foreign exchange reserves, especially at a time when the country's reserves were precarious after the 1991 crisis. In addition, the increase in capital flowing from outside reduced interest rates which had a positive impact on investment and growth.

8. *Corporate Debt*: Before 1991, the corporate debt market was extremely inactive due to control of interest rates and limited issuances. But in May 1992, the interest rate ceiling for corporate bonds was abolished. In addition, SEBI has approved trading of corporate bonds on NSE, BSE and Fixed Income Money Market and Derivatives Association (FIMMDA). Also Foreign Institutional Investors (FII) limit for investment in domestic corporate bonds have been increased to USD 40 billion. However, the corporate debt market is still rather underdeveloped and illiquid.

Conclusion

The empirical study and review carried out in this paper to prove India's capital market witnessed rapid growth since liberalization in 1991. It is evident that financial sector modernization preceded economic development of India and also that development of financial sector spurred economic growth in the country. Financial liberalization had a positive effect on the economy's saving, investment and efficiency, with a well-functioning stock market playing a major role. This led India to witness extraordinary growth for the next two decades. From 1990 to 2012 India's GDP grew at an average of 6.1 percent, second only to China. Moreover, new opportunities came up as the economy opened up. These were taken up by entrepreneurs, some of them becoming extremely successful. However, India still has to confront a lot of challenges to sustain rapid economic growth in the long run. This also means that more opportunities will be coming up for entrepreneurs. As the financial sector in India becomes more and more efficient the cost of capital will decrease. Also, as India constantly attracts more and more FDI, India's growth story is expected to continue in the years ahead.

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