COMMONWEALTH SECRETARIAT

SYMPOSIUM ON CAPITAL MARKET DEVELOPMENT AND PRIVATISATION

14-16 NOVEMBER, 1990, BOMBAY.

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Symposium on Capital Market Development and Privatisation, 14-16 November 1990

List of Participants

Country	Participants
Bangladesh	
	Mr Azad Rahul Amin Joint Secretary Finance Division Ministry of Finance
	Mr Imtiaz Hossain Vice Chairman Dhaka Stock Exchange
Barbados	
	Mr Ralph Carvallo Permanent Secretary Ministry of Finance & Economic Affairs
	Mr A Johnson Securities Exchange of Barbados
The Gambia	
	Mr A. M. Touray Chief Executive National Investment Board
India	
	Dr Kalyan Banerji Chairman and Managing Director Exim Bank of India
	Dr S Dave Unit Trust of India
	Mr K.Pandey Controller of Capital Issues Ministry of Finance

Mr M R Mayya
Executive Director
The Bombay Stock Exchange

Mr R.K. Pandey
Executive Director
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Mr R Viswanathan
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Mr Wain Iton
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Stock Exchange of Jamaica

Kenya

Mr I N Kariuki
Chairman
The Nairobi Stock Exchange

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Mdm Munirah Abdullah
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Ministry of Finance

Mrs Sharda Dindoyal
Chief Executive
Stock Exchange Commission

Nigeria

Mr H.I. Alile
Director-General
Nigeria Stock Exchange

Pakistan

Mr S A Khan
Member
Corporate Law Society

Mr J Siddiqui
President
Karachi Stock Exchange
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Sri Lanka

Mr D M G P De Silva
Deputy Executive Secretary
Public Investment
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Mr Hamid O'Brien
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Mr Ameer Edoo
Chairman
West Indies Stock
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Mrs Manett S. Mpofu
Registrar
Stock Exchange
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International Financial Institutions

World Bank

Mr. James Cowie

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Mr N Selby
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Mr P S Mistry
Senior Fellow for
International Finance
University of Oxford

Mr C S Adam
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Commonwealth Secretariat

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Miss G. Fernandes
Senior Secretary

SYMPOSIUM ON CAPITAL MARKET
DEVELOPMENT AND PRIVATISATION
14-16 NOVEMBER 1990, BOMBAY

OPENING ADDRESS

By

P.W. UNWIN
Deputy Director General
(Economic)
Commonwealth Secretary

OPENING ADDRESS

Opening Address by Mr P W Unwin, Deputy Secretary-General (Economic) at the Symposium on Capital Market Development and Privatisation, Bombay, 14-16 November 1990

Introduction

I am very grateful to Dr Banerji for his words of welcome. He is our host at this Symposium. He and his colleagues have done much to make it possible - providing ideas, contacts, encouragement and logistical support.

We are also grateful to Dr Malhotra, the distinguished Governor of the Reserve Bank of India, for agreeing to join me in opening this Symposium. All Central Bank Governors lead busy lives. I am therefore particularly pleased that we have been able to secure Dr Malhotra's participation this morning. I would like to think that his willingness to join us reflects the esteem which the Commonwealth enjoys here.

Commonwealth

Today marks the 101st anniversary of the birth of Pandit Jawaharlal Nehru. I do not need to tell our Indian friends about his achievement. But we in the wider Commonwealth also have reason to remember him with gratitude and admiration. It was his decision to keep India in the Commonwealth that made possible the association we see today: a world wide grouping of nations, governments and peoples. The Commonwealth has come a long way since he made his decision that India should remain in membership.

Pandit Nehru saw the Commonwealth as providing a bridge between states, a means of exercising influence in the world, and a way to bring "a touch of healing" to a troubled globe. He particularly valued the Commonwealth's flexibility. Two years before his death he said of the Commonwealth:

> "The real value is its extreme flexibility, which enables people from the four corners of the earth to gather together in a friendly way to discuss matters frankly and yet be able to come to some broad conclusions. I think this type of association.... is a very good type and far better than the associations which limit the way of each country, and that is why the Commonwealth has succeeded in spite of differing opinions. It is because of its flexibility that it carries on successfully. Rigid things tend to break up when there are vital differences...."

How right Pandit Nehru was. Over the years since his death the Commonwealth family has expanded from a membership of 5 to one of 50. It has survived many strains and crises, in part because of the flexibility to which he drew attention. As its numbers have grown, so have its concerns. But economic issues have continued to play a prominent role among them. In the early days the dollar gap, the safeguarding of dollar reserves and the defence of sterling were at the centre of the Commonwealth's preoccupations. Throughout, the Commonwealth has tried to bring clarity to international economic issues. But over the years, development has moved to centre stage. The Commonwealth has tried to build a consensus in support of development. It has encouraged bilateral development assistance within the Commonwealth. And it has steadily strengthened its programmes of multilateral assistance, most visibly through the Commonwealth Fund for Technical Co-operation.

There is one point about development assistance within the Commonwealth which it is particularly important to make to a meeting here in India. The days are long gone when development assistance flowed only from developed to developing countries. It now flows also from one developing member to another; and from India to smaller Commonwealth developing countries in particular. This is a very welcome phenomenon. It broadens the base from which assistance is given. It strengthens Commonwealth ties. And very often, the technical assistance which one developing country offers another is more appropriate to the recipient's needs than assistance from an industrial Commonwealth country.

<u>Change</u>

The '80s were a difficult decade for the developing countries. The external environment was unpropitious. There were domestic failures also. Many developing countries found it necessary to undertake painful adjustment programmes.

The challenges of the '90s are just as great. We are seeing fundamental political and economic changes which are reshaping the context of development: an end to East/West tension, increased competition for savings, rapid technological advance, regionalisation of trade, globalisation of production. We are all going to have to think hard and run hard if we are keep up with those changes.

But change brings opportunity as much as difficulty. One of the most noticeable changes is particularly relevant to our meeting today; and it is one that has much promise. I refer to the growing appreciation all over the world of the positive role of market forces and market mechanisms; of foreign investment; of institutions that promote private initiative; of human resource development; and of open, transparent and predictable economic systems.

But in an imperfect world, analysis is one thing, action another. If we more and more agree about our analysis of the economic situation, we still have difficulty in transforming that agreement into practice. Conditions vary. So do economic institutions. National capacities vary. And many developing countries inside as outside the Commonwealth face desperate shortages of economic and managerial skills. Their economic managers often have to live from hand to mouth, with little time to compare notes and draw on others' experience in formulating policy.

The Secretariat's Role

The Commonwealth Secretariat does what it can to repair this situation. In our theoretical work we are seeking to clarify the underlying issues. In meetings such as these, we try to help policy-markers exchange experiences. Commonwealth governments see the value in what we are doing. That is why we have had such support over the years for symposia we have organised on things like structural adjustment programmes, exchange rate management and trade policy.

In our work we have been paying particular attention to questions affecting the mobilisation of foreign and domestic resources for development. It is now increasingly accepted that foreign investment flows can make a significant contribution to growth, without adding, as loans do, to the debt burdens which handicap so many developing countries. Yet some potential recipients of foreign investment still have their misgivings; and, reflecting these misgivings, there are persistent difficulties with regulatory regimes that fail to reflect changed thinking. For its part, the international investor community has not in recent years shown itself to be very forthcoming. There is a climate of pessimism about investment, fuelled in particular by the debt crisis and now by fears of recession. In such circumstances, even specific good opportunities for profitable investment in the developing world can easily be overlooked. I hope that the Commonwealth Equity Fund, launched in September this year with a capital of over $56 million, will do something to improve the picture. In bringing equity capital to specific promising opportunities it can serve both investor and recipient. It can also demonstrate the case for a positive acceptance of foreign equity capital in the development process.

Equity Markets

We shall have to wait and see how well the Commonwealth Equity Fund performs. I am confident that over time it will bring benefit to investors and recipients alike. Meanwhile, there is more work to be done on the functioning of equity markets and on the role of privatisation - themes which will preoccupy this Symposium.

Equity markets function best as part of a well-functioning financial sector at large. We all know that savings and capital accumulation is one thing: the efficiency with which capital is put to work is another. We also know that high inflation and negative rates of interest handicap capital market development and hold back growth.

But equity markets are robust and flexible things. They can overcome many obstacles to the efficient mobilisation and allocation of resources. And they can exploit available opportunities very swiftly. In the past decade, I am told, the market capitalisation of companies listed on the Bombay Stock Exchange has increased about four-fold. During the same period market capitalisation in Malaysia has increased more than three-fold. And recognition of the value of stock markets is spreading to many other Commonwealth developing countries.

It will not all be plain sailing. The last year has reminded us very vividly that you can lose money as well as make it in every stock market in the world. And emerging stock markets face particular problems which do not characterise New York, Tokyo or London. Volume is usually limited, reducing market depth. Individual shareholdings are narrowly based. In many companies too small a share of the equity is available to outside investors. Accounting standards leave much to be desired. It is often difficult to estimate the underlying worth of securities. And there is the ubiquitous problem of insider trading - a problem which the markets of New York, Tokyo and London have had to recognise too. Clearly, all these issues pose challenges and you will want to exchange experiences on how to tackle them.

<u>Privatisation</u>

Many countries represented here are actively considering the pros and cons of privatisation. Motives vary. Privatisation can help cut the public sector deficit. More generally it can enhance economic efficiency. There is no inevitability about this. But privatisation, properly conducted, can assist in the achievement of many of the goals of economic adjustment. By subjecting an enterprise to market forces, it can push it towards productive and allocative efficiency, and efficient pricing. Privatisation can also help stimulate the development of emerging capital markets and, through them, a deeper domestic financial sector.

All the same there is no magic about privatisation. Experience to date suggest that the whole process requires very careful preparation and very sensitive execution. We have with us here the Queen Elizabeth House team who have been working on this subject with Secretariat support. Their work deserves very careful analysis.

India

Let me end where I began, by talking about the country in which we meet. India dwarfs other members of the Commonwealth: in size, in problems and promise, and in experience. I am told, for example, that the Bombay Stock Exchange was established as far back as 1875. I know that India is making strenuous efforts to adapt to changing circumstances. In Dr Malhotra's own words "serious efforts are underway to impart greater flexibility, dynamism and competitiveness to the financial sector through a process of liberalisation". And I note that the buoyancy of the Indian equity markets, in such contrast to those of the rest of the world, may reflect optimism and confidence about the Indian economy as a whole.

So India is a good place for us to be meeting. And Indian experience can help us in our work. I very much hope that all of you, drawn from such a wide range of Commonwealth countries, will benefit from the formal presentations in this Symposium and from informal discussion in the margins of this meeting, and outside.

bombay.sph

ADDRESS BY

SHRI R.N.MALHOTRA

GOVERNOR, RESERVE BANK OF INDIA

AT THE

SYMPOSIUM ON

CAPITAL MARKET DEVELOPMENT AND PRIVATISATION

HOSTED BY THE

EXIM BANK

IN ASSOCIATION WITH

UNIT TRUST OF INDIA

AT

BOMBAY

ON

WEDNESDAY, THE 14TH NOVEMBER 1990

I am indeed glad to participate in the Symposium on Stock Market Development and Privatisation organised by the Commonwealth Secretariat. This symposium provides a unique opportunity for an exchange of views and experiences on stock market development in developing countries in the Commonwealth. In the course of my talk this morning, I would be making some observations on issues which have arisen from our experience in India which may also be of relevance to other markets.

I. PRIVATISATION AND CAPITAL MARKET DEVELOPMENT

2. The past decade has seen major changes in economic systems the world over towards greater market-orientation. In many countries this impetus has been accompanied by privatisation, that is the transfer of assets and services from public to private ownership or control. Privatisation has been prompted by the objectives of improving economic performance and promoting a wider ownership of assets, while also reducing the public sector's borrowing requirements and the size of government. Notably, Eastern Europe and the Soviet Union are contemplating privatisation programmes which may be the most radical in scale and complexity. Plans for privatisation are being drawn up in Poland, Hungary, Czechoslovakia, Romania and the USSR. The difficulties are manifold for these economies as they do not have capital markets or banking and accounting systems which are attuned to

accommodate privatisation. Hungary has recently reopened its stock exchange through which it aims to sell some of its state-owned enterprises. Poland and the Sovic Union are also planning to set up stock exchanges in the near future. These developments would no doubt be watched with great interest by the international community.

3. Privatisation of state-owned enterprises can, given the right conditions, provide a measure of stimulus to stock markets. However, mostly capital markets have developed without such stimulus. Privatisation per se has not been undertaken in India where there is no large active privatisation programme. Nonetheless, policies increasingly stress greater market-orientation, relaxing industrial licensing requirements and permitting private sector participation in various production activities which were earlier exclusively or mainly reserved for the public sector. For instance, power generation, telecommunications and oil exploration have been opened up to the private sector albeit to a limited extent. Several joint ventures are also being promoted. These policies are intended to increase the sphere and scope of private sector activity without entailing a divestiture of state-owned assets. The Working Group on the Development of the Capital Market (Chairman Shri Abid Hussain) has recommended

that suitable public enterprises be permitted to sell up to 25 per cent of their equity to the public (including workers of the enterprises). But a concrete move in this direction has yet to materialise.

4. Privatisation has, therefore, not played a role in stimulating the Indian capital market; rather the catalyst, as in many other countries, has been the liberalisation of industrial, trade and financial sector policies.

II. MACROECONOMIC AND FINANCIAL SECTOR POLICIES : SETTING THE STAGE

5. The emphasis on market forces throughout the world has also led to sweeping financial liberalisation; in recent years deregulation and technological innovation have transformed the world's financial markets. From the "Big Bang" in the UK in 1986 to the more gradual approach followed by other countries, national stock exchanges have been doing away with restrictive practices and opening up to competition from banks and foreign firms. This has led to fierce competition globally among financial firms across a wide range of instruments. Technological advances, which have enabled the creation of several new products, have also accelerated the integration of capital markets.

6. Capital markets in developing countries also have been growing rapidly during the past decade. Data on 30 emerging markets compiled by the International Finance Corporation show that, as a group, they have grown faster than mature markets in terms of listed companies, market capitalisation and turnover. Undoubtedly, though, there is still a wide gap between the mature markets and those in developing countries where the financial infrastructures are not always well developed.

7. The experience of several developing countries, particularly those in the Southern Cone and Asia which have undertaken financial liberalisation, has shown that financial deregulation is more likely to succeed under certain conditions. Foremost among these is macroeconomic stability. In particular, inflation can seriously undermine financial reforms. The sequencing of reforms is also important. It has been suggested that liberalisation in the real sector should precede that in the financial sector so that resources are allocated to the most productive uses, and that liberalisation of the capital account of the balance of payments should follow that of the current account.

8. The pace of introducing reforms has also received attention. Experience shows that the sudden

and complete dismantling of controls may prove destabilising; an abrupt freeing of all interest rates in imperfectly functioning markets can result in high real rates of interest which exceed the marginal returns to capital. This can lead to insolvency of firms and financial distress, and exacerbate macroeconomic instability. It has also been argued that lifting interest rate ceilings in the absence of a well-functioning equity market may not result in an efficient allocation of capital. There is thus merit in a cautious and structured approach to liberalisation.

III. DEVELOPMENT OF THE INDIAN FINANCIAL SECTOR

9. First a little background for those unfamiliar with the Indian financial sector. For a low income country, India has a fairly high rate of saving of about 21 per cent of GDP. This is predominantly contributed by the household sector. Over the years, there has been an increasing financialisation of savings thanks to the expansion of the financial system. Although banks, with their vast network of branches throughout the country continue to dominate, the non-banking financial sector has also grown greatly. I might add that the Reserve Bank has, as is expected of a central bank in a developing country, played a leading role in developing the financial system. It has promoted term lending institutions,

investment institutions and, more recently, money market institutions. The pattern has been that the Reserve Bank has set up institutions and then after a period of time hived them off.

10. In order to create a more competitive environment in the financial sector, an element of deregulation has been injected in recent years. Reforms have focussed on introducing some flexibility in the administered interest rate structure, developing the money and capital markets and broadening the range of financial services.

11. Although debt instruments in the capital market continue to be regulated, the money market and about one-half of commercial bank lending has been freed from interest rate control. Deposit rates are still controlled, but banks have been permitted to issue a limited amount of certificates of deposit which are free from interest rate regulation. These changes should instil a greater degree of profitability-consciousness in financial institutions and help them to gradually adjust to a more competitive environment. Already, banks have begun to accord high priority to improved funds management.

12. Due to a process of gradual deregulation and development of the financial system, distinctions

between banks and non-bank financial intermediaries have become blurred. While financial institutions now have a strong profile at the short end of the financial market through their money market operations, banks and their subsidiaries have extended their operations to capital market related activities. At the same time, insurance companies have, through their subsidiaries, started activities like mutual funds and housing finance. While this should lead to healthy competition, it is necessary to ensure that all institutions operating in a segment of the financial market compete on equal terms. Also, while liberalisation no doubt imparts a greater competitive spirit, it also increases risks. Strong supervision and prudential regulation are therefore crucial for ensuring the health of the financial system.

13. Financial development in India has been facilitated by a relatively stable macroeconomic environment. Relatively moderate inflation and generally positive real rates of interest contributed to the process of financial deepening. In recent years, however, relatively large macroeconomic imbalances have surfaced, with growing fiscal and current account deficits. The persistent and widening fiscal imbalance has built up strong inflationary pressures which, unless contained, could constrain the

pace of further financial liberalisation. To that end, fiscal deficits as well as their monetisation need to be reduced. The government should raise its financing requirements from the open market thereby enabling the central bank to use open market operations for regulating monetary growth. Government borrowing from the banking system at below market rates through high liquidity reserve requirements, though less inflationary, reduces bank profitability and increases the spread between deposit and lending rates. Despite the substantial increase in the interest rates on government bonds in recent years and rising yields on 182-day treasury bills, these are nevertheless not attractive enough to potential investors outside the captive market. A prerequisite for the development of an active government bond market is therefore a move towards market-clearing interest rates on government securities. The development of a Government bond market would contribute to a balanced functioning of the stock market and also promote the secondary market for corporate bonds.

IV. DEVELOPMENT OF AN EMERGING STOCK MARKET: SOME ISSUES ARISING FROM THE INDIAN EXPERIENCE

14. The Indian capital market, which was dormant until the 1970s, has grown rapidly, particularly since the mid-eighties, spurred by a series of policy

initiatives by the Government to liberalise industry and trade, initiate tax reform and to widen and diversify the capital market. Market capitalisation has risen from an almost static five to six per cent of GDP until 1984 to an estimated 14.5 per cent of GDP by the end of March 1990. India now has as many as 19 stock exchanges, about 6,000 listed companies and around 12 million investors. The decade of the eighties with an average growth rate of 5.3 per cent and an inflation rate, as measured by the wholesale price index, of 7-8 per cent provided a highly supportive environment for these developments.

15. Since April 1988 there has been a steep appreciation in the stock market. In the two years between April 1988 and March 1990, share prices doubled and even in real terms registered a hefty 77 per cent increase (based on the RBI index of All-India Ordinary Share Prices). From the middle of this year share prices took an even sharper turn upward, escalating to an all-time high by the middle of October.

16. The appreciation in the stock market was accompanied by substantial increases in new capital issues during the 1988-89 and 1989-90. The quantum

jump in new issues over the past two years reflects the increasing private sector investment in large capital-intensive projects in industries such as fertilisers, textiles, petrochemical and steel.

17. The rapid growth of the capital market has increased the demand for various types of financial services such as issue management, corporate counselling, capital restructuring and loan syndications. Accordingly, financial institutions and banks have been permitted to establish subsidiaries to engage in merchant banking, mutual funds, equipment leasing, venture capital activity and the provision of miscellaneous financial services.

Market Efficiency

18. Impressive as this growth seems, the market has not attained sufficient depth. Both the primary and secondary markets are dominated by a few large companies. Less than 10 companies accounted for approximately one half of the amount of new capital issues in the last two years. Active trading in the secondary market is concentrated in relatively few issues. While the volume of turnover has been high, a considerable part of it is speculative trading. Reflecting this, in 1989, trading against actual deliveries of shares was equivalent to about 12 per

cent of market capitalisation while total value traded, including carry-forward transactions, was equivalent to 61 per cent of market capitalisation.

19. There remain the usual problems associated with a relatively thin market. Prices are unduly influenced by the actions of a small number of dominant participants. The unprecendented price increase witnessed between the middle of June and the middle of October 1990, when the Bombay Stock Exchange Sensitive Index of 30 scrips almost doubled and the market price-earnings ratio shot up from 16 to over 25, has raised concerns regarding market vluation. This rise was in stark contrast to the fall in stock market prices in many countries by 15 per cent to 40 per cent in anticipation of the effects of higher oil prices and interest rates, as a result of the Gulf crisis. While strong fundamentals and corporate performance underpinned the steady rise of the Indian market until earlier this year, the apparent dissociation from fundamentals in the recent period of stock market prices is a matter of some concern.

20. With limited floating stock, the increased demand for stocks from newly-created mutual funds has also exerted upward pressure on prices. Furthermore, even limited speculative trading in a thin market tends to exacerbate price volatility.

21. The allocative efficiency of the market depends crucially on whether stock prices correctly reflect the potential of companies. But there are several types of imperfections in a developing market such as poor information dissemination, inadequate disclosure requirements and accounting standards, as a result of which there is a strong possibility of price manipulation. Steps towards improving the efficiency and fairness of the market are therefore crucial and are being strengthened.

22. The priorities in this regard are to increase the number of participants and enhance the floating stock and market liquidity, while enforcing a strict code of conduct amongst the participants.

Role of Mutual Funds

23. An important aspect of market development is broadening the participation in the market. The Indian market is becoming increasingly institutionalised, as is the trend in many other markets. In the last three years, the number and importance of mutual funds have grown. Though the number of institutional investors is as yet not large, their investible resources are substantial. The resources mobilised by the mutual funds in 1989-90 were almost equal to the total deliveries on the

Bombay Stock Exchange. This explains the excessive influence on prices that the market operations of mutual funds inevitably exert.

24. In attempting to gain an edge over their competitors, mutual funds have been assuring a minimum return to investors, contrary to norms followed in well developed markets. This has weakened the risk-return link and also resulted in heavy investments in fixed income yielding instruments. Only about 20 per cent of investments of mutual funds were in equities in March 1990, with the rest being in fixed income instruments. Mutual funds have been obtaining large discounts in corporate bonds prices, as they are major buyers in a thinly traded market for debentures. There is, however, some evidence that competition could reduce such discounts. As it is difficult to forecast market conditions and interest rates over the next several years, mutual funds should eschew competitive promises of guaranteed returns to investors as these can lead to a distortion of investment and trading patterns.

25. The pattern of investment of mutual funds points to the need for still greater variety of financial instruments. To some extent though, mutual funds now have increased flexibility as they are also permitted to place their funds in the short-term money market.

26. To enable an evaluation of the operations of mutual funds and to provide fuller information to investors, mutual funds should adopt strict disclosure and accounting norms and transparency in their market operations.

The Regulatory Framework

27. The rapid growth in the Indian capital market in recent years has highlighted the need for a comprehensive regulatory code. Guidelines have been issued for fixing premia on new issues, and phasing in and monitoring the use of subscription funds. These should help in regulating the market. A systematic and comprehensive regulatory code prescribed for various market participants with adequate enforcement is a *sine qua non* for the sustained growth of the capital market. The Securities and Exchange Board of India (SEBI), which was set up in 1988, is working towards enforcing higher standards of information disclosure by companies, formulating measures for transparency in market operations and other means of investor protection.

Stock Market Reforms

28. The stock market needs to be strengthened to provide greater investor confidence and to improve market liquidity and competitiveness. At present

there are barriers to entry in our stock exchanges, which impede greater competition. Moreover, the cumbersome trading and settlement procedures will soon be inadequate to handle the increases in trading activity and expansion in volumes that are taking place. In this context it is essential to modernise the market.

29. To this end reforms are being examined in the following areas:

(i) The question of opening up membership of the stock exchanges to institutions and the corporate sector with adequate capital, so as to effectively serve the growing number of investors;

(ii) the feasibility of an electronic trading system, linking all the stock exchanges to improve the flow of information and increase the number of participants with access to the market;

(iii) the introduction of a system of market-makers in addition to the existing order-driven system;

(iv) a quicker settlement system; and

(v) the development of an over-the-counter market to help liquidity of scrips issued by the growing number of new and relatively smaller companies.

30. I am sure your deliberations in this Symposium will provide many constructive suggestions in dealing with these and other issues. Before concluding, I would like to thank the Commonwealth Secretariat for inviting me to address this distinguished gathering. I wish the Symposium all success.

BACKGROUND PAPERS

RESTRICTED

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SYMPOSIUM ON CAPITAL MARKET DEVELOPMENT AND PRIVATISATION
14-16 NOVEMBER, BOMBAY

Macro-Economic Policies and Financial Sector Development

A Paper by the Commonwealth Secretariat

Commonwealth Secretariat
Marlborough House
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that they would need to build up management capacities and institutions gradually. Historical experience, such as those of South Korea or Taiwan - which have been particularly successful in development in recent decades - has also thrown up policy lessons that are not always unambiguous. Moreover, the experience of countries in Latin America which have attempted financial sector reform shows that it is full of pitfalls. The purpose of this paper is to review some select issues in this context, to assist their consideration at the symposium. After making some throat clearing remarks regarding the role of price stability in fostering the role of financial intermediation (Section I), it concentrates on the following issues: the role of interest rate policy and credit controls (Section II); the roles of other macro-policies (Section III); and the importance of speed and sequence of policy reform (Section IV). Section V concludes the paper.

I. Price Stability

While few support rampant inflation, discussions on inflation nevertheless tends to be clouded by a certain amount of ambiguity on two accounts. One is the view, prevalent in development literature, that inflation is a means of 'forced saving', and that in developing countries it might be a legitimate instrument for increasing the saving rate. Second, too often discussions on inflation tend to be conducted in terms of a bargain between the control of inflation on the one hand and unemployment/income distribution, on the other. At one extreme, there is the view that inflation does not matter if employment could be preserved and vulnerable groups could be protected through indexation or other policies. To those who follow such a line of reasoning, while the possible costs of controlling inflation in terms of immediate unemployment or foregone output look tangible and measurable, the benefits of reduced inflation look less palpable. Such attitudes bias policy towards a degree of inflation tolerance (Leijonhufvud, A. 1977).

On the other hand, in recent years, there is also an increasing appreciation of the costs that inflation could impose on financial sector development, and growth in general. It is recognised that under conditions of inflation the normal basis for making price decisions and forming income expectations is eroded. Keynes, for example, long ago in (1919) noted:

"As inflation proceeds and the real value of the currency fluctuates wildly from month to month, all permanent relations between debtors and creditors, which form the ultimate foundation of capitalism, become so utterly disordered as to be almost meaningless; and the process of wealth-getting degenerates into a gamble and a lottery." (Keynes, 1972A).

Inflation has several consequences: (a) firstly, it tends to discourage savers from holding financial assets, whose real rate of return is uncertain; saving, instead, may be held in the form of physical assets such as land, gold or buildings; or be directed to self-financing of investment. (b) while borrowing costs may in general decline under conditions of inflation, shifting income in favour of borrowers, there will also be increased uncertainty regarding real costs, when inflation is fluctuating. Such uncertainty could deter investment. (c) The inflationary leads and lags will make it difficult to sort out real price signals from relative price changes. That makes it difficult for investors to choose projects efficiently; and, as Keynes observed, under such conditions a businessman 'begins to think more of the large gains of the moment than of the lesser, but permanent, profits of normal business' (Keynes, 1972B).

For all these reasons, inflation undermines the financial sector's ability to mobilise and allocate resources efficiently. Historical experience shows that under conditions of inflation, financial disintermediation occurs; the ratio of financial assets to GDP, which typically rises with development, tends to fall. (J.J. Polak, 1989).

All this, perhaps, is common ground, even though it is another matter whether governments do give sufficient weight or consideration to these issues in the formulation of policy. However, in the context of countries which are undergoing adjustment, some thorny issues do arise, given the general appreciation that inflation is harmful to financial sector development. Firstly, in instances adjustment seems to entail inflation, as policy reforms typically involve exchange rate devaluation, dismantling of price controls, removal of subsidies, etc. That poses difficulties in formulating financial sector policies: what should be the level of interest rate, for example? Will indexation be helpful? Secondly, similar problems also seem to arise as countries target for a reduction in the inflation rate. As a country aims to move from an annual rate of inflation of, say, 80 per cent to, say, 50 per cent, what type of strategy should it have in dealing with the financial sector? Should the interest and exchange rates be targeted or left to be determined by the market? Such issues have indeed posed difficult problems in countries undertaking financial sector reform (see section IV, below).

II. Interest Rates and Credit Direction Policies

A central issue in financial sector policy is the question of whether it is desirable to have a ceiling on interest rates or not, and whether governments should seek to direct credit to particular sectors or industries. Many developing countries have, in practice, adopted interest ceilings and sought to direct credit. Governments, by preempting credit for their own use at concessional rates through such instruments as reserve requirements or compulsory holding of bonds, have also created a significant gap between deposit rates and lending rates. Under conditions of inflation, which is not infrequent, these policies have also resulted in negative rates of interest to the saver. It has been argued that such policies are harmful to growth; and that growth and real rates of interest are positively related. While there is much literature on the subject, the following table, taken from J.J. Polak

(1989), illustrates the type of evidence that is advanced in this context:

Table 1: Real Interest Rates and GDP Growth Rates, 1965-84, per cent, 40 Developing Countries

Group	n	Real interest rate: Range of group[a]	Real interest rate: Median of group	Average annual GDP growth rate
I	10	Less than -5	-8.2	3.0
II	17	Between -5 and 0	-2.6	4.0
III	13	Greater than 0	2.1	6.1

a) Countries included in each group according to their median real interest rate over the period. Number of countries in each group: n.

Polak notes that the differences in average growth rates are statistically significant.[2] Based on further econometric analysis, he concluded that there might be a one for one rate of substitution between the interest rate and the investment ratio - that is, a reduction in interest rate by one per centage point below its equilibrium rate requires an increase in investment ratio by one percentage point in order to maintain a given rate of growth. Evidence in favour of a similar positive relationship is produced by M.J.Fry (1989), R.I.McKinnon (1989), among others.

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2. He finds that the difference between the first and the second group is siginificant at the 10 per cent level, and the difference between the second and the third group is significant at the 1 per cent level.

What explains the positive association between the real rate of interest and economic growth? Some have argued (e.g. M. J. Fry, 1989) that ceilings on interest rates distort the economy in three ways. First, low deposit rates discourage saving. Second, potential deposit holders may engage in relatively low-yielding direct investment, instead of lending their savings through a bank to investors with high yielding projects Third, they promote capital intensive projects by distorting the relative price of labour and capital. Hence, ceilings on interest rates reduce both the quantity and quality of investment.

Availability of credit at low or negative rates of interest might also result in situations in which credit, once tied up in unprofitable projects, continues to be directed to them, in order to avoid recognition of bad debts or because of political compulsions based on unwillingness to close up inefficient production units.

It has been also argued that the prevalence of positive real rates of interest might in general imply that economic conditions are inflation-free, and that the financial sector is not repressed - so that the positive association between interest rates and growth might be a reflection of the productive role of the financial sector.

Some have argued that the amount of financial dis-intermediation that occurs under conditions of low interest rates may be over estimated, as 'curb markets' play a larger role in intermediating finance in such situations. 'Curb markets', however, tend to be fragmented; and the degree of efficiency with which they allocate financial resources may be poor. Therefore, if the effect of a rise in interest rates is to divert transactions from the 'curb market' to banks, it may still result in a rise in overall productivity in the economy.

The policy conclusions are that economic growth can be increased by abolishing interest rate ceilings and credit-direction measures, and by raising the deposit rate through reducing the reserve requirements, which do not usually yield a competitive return.

The argument so far seems to support a freeing of interest rates, with the market allocating credit. Several concerns, however, are expressed in following such a policy. Firstly, it is argued that the market does not perform efficiently, where externalities are present. Infra-structural projects is one example. Another example is clusters of projects which when considered together may result in a different evaluation than when each one of the projects is considered in isolation. The market is also suspect in areas where the social rate of discount is significantly different from the private rate of discount. Secondly, it is argued that when high yield is associated with high risk, market allocation of credit may suffer from adverse selection under conditions of imperfect information (Stiglitz, J.E. and Weiss, A., 1981). Deposit insurance schemes aggravate such risk. Thirdly, it is argued that under conditions where the demand for consumption loans is high (e.g. out of poverty of some sections of population), market determined interest rates may reflect such pressure, pushing them above the rates that are considered beneficial for investment. Under such conditions, ceilings on interest rates and direction of credit for investment purposes might be necessary.

Governments in many countries are also concerned that the private sector may not perform the credit allocation function fairly, where linkages of ownership exist between finance institutions and others. There are also concerns that the small investor, or the agriculturist, may not receive adequate attention - as banks concentrate on big customers, out of institutional bias, conservatism or an unwillingness to incur higher transaction costs.

For all these reasons, many governments have tended to exercise control over interest rates and allocation of credit.

- Some Lessons of Historical Experience

Many have alluded to the historical experience of Korea,[3] Taiwan and Japan to argue that, even in successful economies, governments followed a policy of intervention. Reviewing the experience of Korea, Y.J. Cho, (1989), for example, says:

"Today, the conventional wisdom is that government intervention in the financial system limits rapid economic growth and development..... But the Korean government intervened heavily in the financial system to push its industrial development in the 1960s and 1970s." (p.88).

Korean experience shows that:

* Financial sector policies, including government ownership of banks, directed credit programmes, and interest rate controls were used as important instruments of industrial policy and export promotion.

* The role of the Government was central to identifying capable entrepreneurs and firms, arranging necessary finance for their investment, and sharing risks.

* The active role of the Government as an effective risk partner enabled Korean firms and entrepreneurs to take a longer-term view of their business and investment.

The Government of Korea pursued these policies in an environment in which, for long periods, it sought to keep interest rates positive, and also encouraged the inflow of foreign capital. The Government relied on banks as the main financial intermediaries, rather than equity markets, as the main source of finance in Korea's early stages of development.

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3. Unless otherwise specified, 'Korea' in this paper refers to South Korea.

Does the Korean experience represent a model for other countries to follow? There are several factors particular to Korea which seem to have made it a success; and, not all elements of its policy seem to have been beneficial to development. Among the special positive factors that underlie the Korean experience are the determination of the Government to proceed with industrial development; the good quality of its banking management, as well as public service; the close links between the Government and industry; and the special access to foreign savings and external markets due to geo-political factors. On the other hand, the policy of controlled interest rates seem to have limited the ability of the banking system to mobilise financial savings and caused a slow growth of the financial sector. The interventions in favour of heavy and chemical industries in the latter half of the 1970s also seems to have resulted in a misallocation of resources, involving large adjustment costs later.

Mr Cho concludes:

"Overall, the Korean experience suggests that, although financial allocation should ultimately be determined by markets, a balance between the roles of government and market in the early stage of economic development may have to be found depending on the initial status of financial market development and organisations." (p. 101).

Taiwan's experience is also instructive in this context. It has pursued a policy of positive - and comparatively high - real rates of interest against a background of remarkable price stability. Deposit rates typically averaged 10 per cent, and loan rates 2 to 3 per centage points above them. The Government had, at the same time, intervened to provide concessional credit to the export sector.

The experience of post-war Japan also points to a policy of controlled interest rates with the Government playing an active role in guiding credit to select industries and enterprises. It pursued these policies against a background of low inflation - enabling a significant amount of financial deepening. The Government loosened controls after substantial financial deepening had occurred.

In general, the historical experience seems to point to:

* the desirability of ensuring that real interest rates are positive;

* that macro-stability is critical in promoting financial deepening;

* that governments could play a positive role in steering credit towards priority sectors, but such a role could diminish with financial deepening; and

* that directed credit allocation policies succeed better when the priority sectors are few, so that expansionary pressures are not exerted on the money supply, and credit direction does not result in a great commercial cost to financial institutions.

It needs to be noted, however, that interventionist policies presume good managerial capacity on the part of the government and stability in policy objectives. Where such conditions are not satisfied, the balance of advantage may well lie in less governmental intervention, rather than more. The experience of the vast majority of developing countries seems to suggest that governments have, on the whole, been less successful than otherwise in intervening in credit markets. Recognition of market failure does not - and should not - automatically imply that governments can do the job better.

III. Other Macro-policies

The discussion so far has concentrated on inflation, interest rate and credit allocation issues. Financial sector development, however, also depends on getting other macro-policies right. We review below some select areas of policy.

(a) Fiscal Policy

An element of fiscal policy that has an immediate bearing on the development of the financial sector is the budget deficit, and the manner in which it is financed. A fiscal policy that is inflation-promoting is clearly not conducive for financial sector development. Control of budget deficits, therefore, would need to receive high priority.

It is recognised that government borrowing from the domestic banking system is less inflationary than borrowing from the central bank; but where such borrowing from the banking system is forced, it reduces bank profitability, distorts interest rates and crowds out private investors. It is desirable for governments to finance their deficits through the issuance of short-term government bills at market rates of interest. That builds up a base for open market operations and is usually a good step towards a building up of a market for corporate securities. A problem with the financing of the deficit at market rates of interest, however, is that it could push up the total budget deficit - which could be inflationary. It will be, therefore, necessary to supplement such a policy with fiscal tightening measures.

What of taxation policy? It has been argued that taxes are often not neutral between one financial instrument and another - e.g. double taxation of dividends - and, thus introduce distortions. Clearly, interference with the development of a range of instruments that best meet risk, yield and liquidity objectives of savers and investors, constrains the growth of the financial sector. It has also been argued that deposit insurance schemes, by shifting the risk from the private to public sectors, tend to result in financial institutions' supporting risky investments without adequate appraisal.

Some have argued that high rates of taxation fosters a 'black economy' and in so doing drives money away from organised financial markets. (Asian Development Bank, 1985). Under such circumstances, funds are not necessarily allocated on the basis of efficiency criteria, reducing overall productivity in the economy. Economic policies that foster black markets, therefore, impose additional costs on the economy via reduced roles for financial markets.

(b) Exchange Rate Policy

Exchange rates might be critical not only in the context of improving the competitiveness of an economy, but also in fostering the development of the financial sector. Overvalued exchange rates tend to create a premia on holding savings in foreign currency, and thus induce capital flight. It is possible that expectations of continuous devaluation could also promote capital flight, unless domestic interest rates, or returns on financial assets in general, are sufficiently high enough to compensate for such expectations. Under these circumstances countries that embark on adjustment policies, in which a key ingredient often is the adjustment of exchange rates, might find that adjustment, far from reducing capital flight, may accelerate it until the exchange rate is stabilised. The transitional costs under such a scenario are such that it might require large-scale balance of payments assistance to bring back stability.

A viable exchange rate is also critical in sustaining a reasonably free trade regime, which is in turn important in promoting private capital inflows. The belief that the current exchange rate is viable will also minimise adverse expectations regarding exchange risk, an important element in determining capital flows. Financial markets, which have a good degree of linkage with world capital markets, acquire an opportunity for sophistication in terms of competitiveness, availability of a range of instruments, and a discipline in management style (including exposure to good accounting standards). It is conceivable that such conditions act as good adjuncts in the development of financial markets, promoting domestic saving and investment.

(c) Foreign Investment and Capital Controls

An economy that is open to inflows of foreign private capital can be conducive for financial sector development. Inflows of capital can strengthen the merchant banking functions of the private sector, and can provide significant impetus for the growth of equity markets. Accounting and regulatory standards, in the process of being subjected to international scrutiny continuously, may undergo improvements in quality. By providing much needed finance, foreign capital also enables growth without risking high rates of inflation or unhealthy corporate indebtedness. Short-term, ratchet-like, upward pushes to prices can be avoided by maintaining an open regime that increases the chances of successfully financing short-term balance of payments deficits. The experience of Japan and Korea illustrates the positive role played by foreign capital in sustaining non-inflationary development.

There are, however, two types of problems which seem to argue for a degree of control on capital movements, while maintaining a regime open to foreign investment. Firstly, short-term capital movements attracted by differentials in interest rate (adjusted for expected movements in exchange rate) could be destabilising (as happened in the case of Latin America (see section IV below). Control over the monetary base could be seriously eroded, making it difficult to attain monetary targets. Secondly, while a repressive financial sector promotes capital flight, and macro-economic stability and freeing of the financial sector from repressive policies are important in preventing it, it might also be necessary to retain a degree of control on capital movements in the context of developing countries. Given the limited amount of financial resources, they may not be able to afford the uncertainty that arises from allowing complete freedom of movement of capital. A degree of industrial development and financial maturity might be needed before countries can abolish capital controls.

III. Speed and Sequence of Policy Reform

Financial sector reform has been pushed to the forefront of policy. At the same time, the experience of some Latin American countries has given rise to concerns that unless the sequence and speed of reform is phased properly, it could result in a worsening of the financial conditions particularly in contexts where there are acute macro-economic imbalances and a lack of strong regulatory institutions. Reviewing the Latin American experience, Diaz Alejandro (1985) wrote: "Good-bye financial repression, hello financial crash"! Argentina, Columbia, Brazil, Mexico and Uruguay have all instituted and then, abandoned quite radical liberalisation programmes. Chile had undergone an acute period of financial crisis before stability returned in the late 1980s.

Many of these countries, starting from condit of large budget deficits, high inflation and repre financial systems, had proceeded to remove control interest rates, abolished direct credit program privatised commercial banks and eased entry requirer into the financial sector. The ensuing developments not always been growth conducive. Maxwell J. (1989), commenting on the experience of Argentina, (and Uruguay wrote:

"Bank lending rates in real terms exceeded 2C cent, sometimes by large margins, in these countrie the second half of the 1970s and early 1980s. T high real interest rates, in conjunction with announced exchange rate devaluations, attracted l capital inflows. Monetisation of these for exchange inflows led to accelerating inflation eventually to large unplanned devaluations. T devaluations together with extraordinarily high interest rates, created financial distress in financial and non-financial sectors of these econon Non-performing assets rose rapidly and the mone authorities in all three countries stepped in to re insolvent banks and to impose controls again." (p 22

This does not imply, however, that all attempt financial sector reform resulted in failure. Exan of success, according to some observers, inc Indonesia, Greece, Portugal, Morocco and Tunisia M.J.Fry, 1989 and World Bank, 1989).

A central theme that emerges from a revie experience of countries that have undertaken finar reform is that the sequence of policies needs t right. Some lessons which the World Bank, for exan has drawn are

* Financial sector reforms carried out agains unstable macro-economic background can make instability worse. Real interest rates could sharply, and real exchange rates could appreci worsening the situation further.

* Where prices are distorted owing to protec or price controls, financial liberalisation may improve the situation - as resources will no allocated on the basis of price signals that themselves, distorted. In a generally disto

economy, reducing distortion in one sector does not necessarily improve welfare (Stiglitz, J.A. 1989). "Exchange rate realignments and reforms in trade and public enterprise policy should precede, or at least happen along with, financial liberalisation". (World Bank, 1989, P.127).

* All reforms have implications for the distribution of income; and where reforms may result in an accentuation of inequality or poverty, they could become unsustainable. It will be, therefore, necessary to anticipate these changes and take up reform in such a way that the adverse impact is minimised or other policies are put in place to mitigate them.

* It is desirable to liberalise trade transactions first, and capital movements later. Liberalisation of capital market prematurely can result in an inflow of capital which can lead to an appreciation of the exchange rate, which can in turn undermine trade liberalisation.

* If reforms are too quick, firms that entered into contracts on the basis of the old rules - and otherwise viable - may face losses and bankruptcy. Too slow a reform process could also involve losses. Reforms need to proceed at an appropriate speed.

While there may be agreement or disagreement on the particular points noted above, it is clear that an important aspect of macro-policy reform is the need to ensure that the speed and sequence of policy change is right.

V. Conclusion

It is clear that in various ways, getting the macro-policies right is critical to financial sector development. There is widespread evidence that policies that repress the development of the financial sector are costly in terms of growth. There had been, above all, insufficient appreciation of the importance of stable macro-economic conditions, including the need for stability of prices, in this context. In too many instances, insufficient attention is paid to the need to preserve positive returns to holders of financial assets, and to the need to let financial institutions carry on their functions in an atmosphere free of political intervention and ad-hoc decision making. Having said that, there is, perhaps, also a need to emphasise that a degree of development of market institutions and financial deepening, as well as strong regulatory frameworks may be needed before developing countries could begin to adopt a full blooded 'market' stance in policy. Yet, it will be wrong for the governments to assume that they can do well what the markets in their distorted conditions may fail to do; they would need to proceed cautiously, relying on the markets as much as they can, and nurturing their development through the establishment of stable macro-economic conditions, good accounting, regulatory and judicial systems, and through the provision of risk-sharing mechanisms that encourage private initiative.

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SYMPOSIUM ON CAPITAL MARKET
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Macroeconomic Policy & Capital Market Development

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MACROECONOMIC POLICY & CAPITAL MARKET DEVELOPMENT

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Introduction.

The main lesson learnt over the last forty-five years of development experience is that economic success depends on more than simply getting projects right or, more broadly, aiming at and achieving sector-specific targets. The developmental gains intended to accrue from a collection of good projects and sector development strategies, have all too often been vitiated where governance has been poor and macroeconomic policies unsound. The same holds true for capital market and financial sector development -- a priority which has assumed considerable prominence in the present era of debt and adjustment for the developing world. Nonetheless, until very recently, deficiencies in nascent developing country capital markets (i.e. in the diversity and depth of financial intermediaries, the number of security listings, the different types of securities and instruments, the regulation of capital market activity, and technological and trading capacity) were identified for correction without the accompanying realization that they were unlikely to be remedied in a weak, unstable macropolicy environment.

For that reason, capital markets have developed in a patchy way across the developing world. Observation and experience support the notion that a sound macropolicy environment is a *sine qua non* for sound long-term capital market development. People are simply unwilling to: save in financial form; to hold different types of financial claims on tangible and intangible assets or on future cash flows; and to make intelligent risk-reward trade-offs; when macroeconomic uncertainties persist. Capital markets therefore do not thrive where monetary conditions are unstable, fiscal and budgetary policies are inconsistent and whimsical, the discipline to control inflationary pressures (and consequently to maintain monetary values) is weak and where the political-bureaucratic ethos is such as to constrain the flexible use of macro-policy to cope with sudden shocks -- whether externally or internally derived. Evidence also suggests that incipient processes of capital market development can be quickly reversed when stable policy environments become turbulent and unpredictable. Conversely, changes in capital markets which occur as they develop have major implications for the management of macropolicy -- as most industrial country governments are discovering day by day.

A Digression.

The emergence of capital market development in Asia, Latin America and the Mediterranean basin can be traced back to the last century although these early days were heavily influenced by linkages with metropolitan centres of empire.[1] By contrast, emphasis on pursuing the right macroeconomic policies in sovereign developing countries is of more recent vintage, for two rather obvious reasons. First, with the exception of continental South America, most countries in the developing world were not sovereign until between 1945-60. Until 1945 at least, their economic policies were framed elsewhere, and administered by external agents whose objectives were not necessarily consistent with balanced, long-term development aimed at furthering the interests of indigenous populations. Second, discord in the global economic community since 1917, which intensified after 1945, led to considerable debate and confusion -

[1] With very few exceptions, in Africa the priority of developing capital markets and strenghtening the role of the financial sector has yet to assume significance. Given Africa's other chronic development problems this is no surprise.

- not least in the developing world -- as to what the "right" macroeconomic policies were or indeed even what the right model of development was.

Unfortunately, the domestic economic policy regime of all too many developing countries has, even after independence, been influenced by external pressures. A half-century of intense political competition between "command" and "market-based" models of development has not helped a clear consensus to emerge as yet on the right model or policy package for development under widely differing circumstances. The breakdown of economies in Eastern Europe and the USSR should have weakened considerably, if not destroyed completely, the attraction of alternatives to the market based model of development. Yet, for many developing country governments, the superiority of the market-model in addressing their own circumstances has not been conclusively established by these events. To them what may be clear is that at a certain level of development and technological sophistication -- and perhaps after a certain period of time during which the command system ossifies and warps the system of incentives under which individual economic agents function -- the internal dynamic of the command economy sows the seeds of its own eventual dissipation. But several LDC governments continue to behave as if they feel that they are a long way off from that level of development.

The logical corollary of that line of reasoning is that it may be possible under certain starting conditions -- given the handicaps of extremely unequal distribution of wealth, income and access to opportunity (which typically characterise underdeveloped environments) -- for countries to pursue command or quasi-command models at the early stages of development until they reach levels of distributional equality, output and consumption when movement to more market-flavoured alternatives occurs as a natural, if not inevitable, next stage of evolution.[2] The difficulty with this line of reasoning, however, is that we have yet to see the transition from collectivism to markets happen in an evolutionary fashion without accompanying dislocations large enough to threaten the social foundations and political structures of nation states. (That is a particularly clear danger in Africa where the drawing of national boundaries by ex-colonial powers has resulted in nations which are of fragile composition, economically, socially and politically).

This digression has been necessary to underline why, in discussing reciprocal linkages between macroeconomic policy and capital market development, a more widespread (if not yet universal) acceptance of the market-based model of development is taken as the principal point of departure. In theory, of course, it is paradoxical to talk about capital market development under non-market based models of development, reliant on varying dosages of command-style planning and public interventionism. Yet, in practice, this seems to be precisely what several developing countries are attempting to achieve.[3] In the long run, however, the inherent

[2] Indeed, between 1955-80, agencies like the World Bank appeared to operate as if the legitimacy of this viewpoint was implicitly accepted. Also, the growth and development experience of the east bloc economies (and of China in particular) between 1950-79 still holds attractions for some proponents who believe that the application of fully fledged market-based systems at too early a stage of development only entrenches extant inequalities and prevents seemingly market-based systems from functioning as market theory would intend. After all, in achieving sustained growth with equity, the performance of the command economies for nearly thirty years often equalled the best performance of developing countries which opted for the market model and surpassed the rest.

[3] India is a good case in point where a mixed economy -- with a major role played by public enterprises in the productive sector and with most financial institutions being publicly owned -- has managed to develop a capital market of considerable size and depth. But even India's experience begs the question as to whether its capital market can continue to diversify, grow and operate as a genuine "market", with prices emitting the right signals, without the Indian economy and financial sector becoming much more open and less dominated by the influence of the public sector and of public financial institutions in particular. In that sense the evolutionary pattern of the Japanese capital market may hold some interesting insights for the Indian, and possibly even the Malaysian, case.

contradictions in developing a capital market in a non-market or quasi-market economy must assert themselves through various stresses and strains which become increasingly difficult for governments to avoid or control. That conviction provides the basis for now exploring:
(1) the implications of macroeconomic policy for capital market development; and
(2) reciprocally, the implications of changes in capital markets for the management of policy.

The Implications of Macroeconomic Policy for Capital Market Development.

The main macroeconomic policies employed to govern indirectly the direction, rate and distributional aspects of growth and development in a market economy are: monetary policy, fiscal policy, exchange rate policy, internal and external debt management policy, regulatory policy and trade policy. In mixed economies which involve various doses of interventionism to restrict the degree of economic openness, governments also resort to more direct price controls, incomes (labour-market regulating) policies, industrial (and investment regulating) policies, and various forms of trade restrictions. This discussion is confined to the implications of indirect rather than direct policies in facilitating capital market development with the broad view being taken that, in general, all forms of direct policy intervention are, in the long-run at least, inimical to that process.[4] For obvious reasons, the comments made here are at a level of generality, and expressed in non-theoretical terms, rather than of a more technical nature aimed at impressing the academic community. For that reason, however, explanations of the interplay of macropolicies which result in (and at the same time are used to combat) phenomena such as inflation -- an extremely important variable influencing capital market development -- are offered in perhaps less depth than might be ideal.

Recent research supports theoretical (and the rather obvious, common-sense based) beliefs that the management of **MONETARY POLICY** has profound implications for the development of capital markets. The key control elements of monetary policy i.e. interest rates, targets for monetary aggregates, and credit policies, which together determine levels of liquidity in the economy, have the most direct impact on capital market behaviour in the short run and on its development in the long run. Perhaps no other single reason explains the inability of developing countries to foster the emergence of capital markets with a capacity to support their corresponding levels of development as their inability to exercise monetary restraint and to control inflation. To quote: .... **"A reasonable degree of price stability is possibly the most crucial pre-requisite for effective and efficient domestic resource mobilization and allocation through the financial sector"**. [5].... For that and other reasons monetary stabilization has assumed central importance in stabilization and structural adjustment paradigms. Though the pros and cons of stabilization and adjustment prescriptions are being heatedly argued, there is virtually no disagreement that more restrained monetary policies ought to be pursued in the developing world. The disagreement is usually more over HOW to exert effective restraint rather than over whether to exercise it at all.

Ineffective control over monetary aggregates, the presence of large and pervasive black markets in most developing countries which render the task of monetary control even more difficult, controlled interest rates at levels which are negative in real terms for prolonged periods of time, and loose credit policies aimed at specific target sectors, adversely affect capital market development in the following ways. First, these factors tend to create a bias against savings and deferred consumption in favour of immediate consumption. Second, to the extent that

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[4] Curiously though one has to accept that in certain circumstances direct policy interventions in the short-run can be extremely useful, if not indispensable, to stabilize capital markets under conditions of extreme uncertainty and to avoid the kinds of disruptions which, if left purely to market forces at those times, can severely disrupt (if not completely derail) the process of sound capital market development.

[5] Fry M.J. "Money, Interest, and Banking in Economic Development", Johns Hopkins UP, 1988 (pp 326). For a full discussion of the impact of inflation on financial sector development, see pp 327-335.

people must still save, they create a bias in favour of real forms of saving rather than financial savings. Third, they favour bank borrowings (especially if the banks are publicly owned and less particular about portfolio risks and profitability) by investors rather than debt or equity securities floated on capital markets in which participants (savers) are likely to demand rates of return which are better than those on bank savings deposits and, preferably, positive in real terms. Fourth, loose monetary policies induce behaviour on the part of financial intermediaries which is inimical to proper risk assessment and risk-taking, resulting in the systemic build-up of concentrated high-risk portfolios. Fifth, environments characterised by negative real rates of interest and directed credit often result in the wrong choices of investment and the resultant creation of assets which are a drag on the economy and on extant or incipient capital markets. Sixth, poor monetary policies create a climate in which term transformation becomes an excessively risky proposition; as a consequence, savers' preferences are for liquid instruments (i.e. highly tradeable and/or with very short maturities) which is detrimental to capital market intermediation and term-transformation. Seventh, loose monetary policy, which invariably feeds domestic inflation, deters foreign investors and particularly portfolio investors from entering developing capital markets because of currency risk or of sudden constraints being imposed on capital and dividend repatriation under controlled exchange rate regimes.

One could of course go on considerably further in this vein. But the purpose of making these points is not to enumerate a comprehensive and mutually exclusive list of reasons why poor monetary management can impede capital market development; it is, instead, to illustrate that relationship in sufficient detail for it to be conveyed with some force. For a more detailed foray into the importance of monetary policy (especially because it is a crucial determinant of inflation) on financial intermediation and capital market development members of the audience are invited to consider the writings of Goldsmith, McKinnon, Shaw, Friedman, Fry, Sprinkel and van Horne [6] among others -- with the important caveat that they do not accept as gospel everything that these worthies postulate simply because it happens to be in print!

The monetary system and the management of monetary policy are crucial to capital market development because they transmit, through various financial signals, the extent and significance of internal and external imbalances in the economy at any given time. The effectiveness and efficiency with which such transmission takes place depends upon of course on how "clean and transparent" the system and the policy are. It is, of course, in the nature of governments, especially harassed ones with limited capabilities, to dampen or obscure any signals or judgements which markets (or other agents) might emit about the bureaucracy's own failures, excesses and errors. This is particularly true of the way in which developing country governments (and all too many developed ones as well) manage their **FISCAL POLICIES**; usually without as much concern as they should have on its implications for the economy in general and on capital markets in particular. Rather than use capital markets constructively as a natural, private check-and-balance on the inherent public propensity to overspend, governments invariably bypass capital markets in raising domestic resources by pre-empting them instead. They do this by exerting public domain over financial institutions and requiring them to allocate a large share of their asset portfolios to compulsory purchases of government securities usually at below market rates of interest. In doing so governments retard capital market development and, at the same time, lose an invaluable device to facilitate more responsible self-governance.

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6 Goldsmith, R.W. "Financial Structure & Development", Yale UP, 1969
McKinnon, R.I. "Money & Capital in Economic Development", Brookings, 1973 (and other articles by McKinnon on the same subject -- see bibliography in Fry, op cit)
Shaw, E.S. "Financial Deepening in Economic Development", Oxford UP, 1973
Friedman, M. "Factors Affecting the Level of Interest Rates" in Savings & Residential Financing (1968 Conference Proceedings)
Fry, M.J. op cit.
Sprinkel B.W. "Money & Markets: A Monetarist View" R.D. Irwin, 1971
van Horne, J.C. "Function & Analysis of Capital Market Rates", Prentice-Hall, 1970.

By "fiscal policies" is meant the entire gamut of policies on: (a) the revenue side i.e. the structure of the taxation system and the balance between direct and indirect revenues; (b) the government's policy in handling the surpluses and deficits of public enterprises; (c) public investment, expenditure and price subsidization policies; and (d) budget deficit management policy. A large part of the reason for the high inflation which has been endemic in developing countries for the last fifteen years or so has had as much to do with an excessively (and unsustainably) expansive fiscal stance on the part of governments as with the consequent accommodation of such a stance by loose monetary policy. Since central banks are constitutionally subordinate to the Treasury in almost all developing countries, the monetary accommodation of unsustainable fiscal deficits is usually inevitable.

Developing country governments have a disconcerting tendency to persist in spending much more than they collect. In the 1980s, the gap between government revenue and expenditure has typically varied between 5% to over 25% of GDP in some egregious cases. Typically also, the countries in which such deficits are run are, with few exceptions (like India, China and most of East Asia), those in which the level of private domestic savings are insufficient to cover public funding requirements resulting from cumulative budgetary shortfalls. Public borrowings to cover deficit financing have a crowding out effect on private investment, which in the final analysis is the driving engine for capital markets. Nor is access to foreign borrowing to cover fiscal deficits as easy as it was in the 1970s. In the 1980s, containing the fiscal deficit has become much more difficult in the face of extremely large external debt service burdens which the public purse has to bear. Hence, deficits which cannot be covered by grants in aid, domestic borrowings, foreign borrowings, public enterprise profits or by public asset sales (i.e. privatization) are financed by printing money, thus adding to the inflationary spiral.

Apart from the interplay between fiscal and monetary policies (through the budget imbalance) which results in exacerbating inflation, the specific taxation and expenditure policies of governments can also have a profound influence on promoting or retarding capital market development. Where levels of income, corporate and capital gains taxation are so high as to encourage large-scale tax evasion and induce the growth of parallel markets, the formal capital market can hardly be expected to function properly. Moreover, when the differential between different forms of taxation are such as as to distort the preferences of taxpayers against one sort of income (say capital gains or dividend income or from bank deposits) in favour of another (earned income or tax-free government savings certificates), biases are introduced into capital market operations which are invariably inconducive to their healthy growth. The effects of taxes (and subsidies) on deposit rates and the effects of an implicit inflation tax (when interest rates are controlled and not adjusted to rates of inflation) are particularly pernicious (they have been studied in considerable depth by McKinnon, Shaw and Fry).

When misguided tax policies are further distorted by deductions and allowances to cater to special interests, capital market development can be impeded even more in focussing on designing instruments and activities which aim at accommodating fiscal distortions rather than encouraging the efficient mobilization and allocation of resources for productive purposes. The same holds true for public expenditure policies which attempt to influence the price of financial assets or claims through interest rate subsidies or directed credit programmes. When that happens a key price signal, the interest rate, is..." prevented from doing its job of reporting capital's marginal product in alternative uses and of equating demand for investment with the savings flow".[7] The main objection to such distortions is that they impoverish the economy and deepen the imperfection of the capital market which, as John Hicks claimed is .." the most fundamental of all kinds of market imperfection".[8] On the reverse side of the coin, tax policies which encourage saving

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[7] Shaw, E.S. op cit, pp 158-163. For a full discussion of fiscal policy's implications for financial deepening, refer to Chapter 6 (pp 149-181) in the Shaw book.

[8] Hicks, J. "Capital & Growth" p.203

and discourage excess consumption can be conducive to capital market development as long as such policies are not designed to support government pre-emption of private savings and they are not maintained after capital markets have reached a certain level of maturity.

Domestic monetary and fiscal policies obviously have the largest influence on capital market development (as indeed they do on overall economic prospects). But such development in many developing countries is also influenced, at times quite abruptly, by **EXCHANGE RATE POLICY**. When countries maintain artificially overvalued nominal and real exchange rates for prolonged periods of time, a parallel market in foreign exchange inevitably develops absorbing savings both for transactional purposes as well as to protect the real value of savings in financial form. Those savings are then no longer available to the domestic capital market. For the same reason, overvalued exchange rates constitute a major disincentive for foreign investors to participate in developing country capital markets because of heightened currency risk being added to commercial and political risk. Moreover, since misaligned exchange rates are simply unsustainable in the long run, the balance sheets of local financial intermediaries and corporate entities which are influenced by foreign borrowings or subject to exchange risk become extremely vulnerable, with consequent implications for the market value of their securities.

The destablizing effects on capital markets of large-scale devaluations across the developing world in the 1980s have been too numerious to require detailed elaboration. In country after country, financial institutions which had undertaken substantial foreign borrowings from official or private sources, and corporate entities which had assumed significant exchange risk obligations have gone bankrupt. Where these entities had been listed on domestic capital markets (e.g. across Latin America and in the Philippines) the implosive consequences have set capital market development in these countries back by at least a decade. By contrast, in countries which have pursued stable exchange rate policies (mainly in Asia) the opposite has been true; capital markets have blossomed when foreign and domestic investors have been assured that exchange rates will maintain or improve the relative competitiveness of these economies and which send the right price signals for tradeables throughout the economy.

For the same reasons the domestic and external **BORROWING POLICIES** of government have a significant impact on capital market development as does **TRADE POLICY**. Levels of borrowing (particularly foreign borrowing) which reflect political or bureaucratic unwillingness to make essential structural responses to changing internal and external conditions invariably result in destabilizing the economy and the capital market. The evidence supporting that assertion has been sufficiently overwhelming during the 1980s as to require little elaboration or debate. The practical mechanics of how excess foreign indebtedness feed into disrupting the normal savings-investment process through initial contraction, followed by a diversion of diminishing investment resources to the trade sector and the subsequent indefinite export of domestic savings by way of foreign debt service are much better understood now than they were earlier. The implications of domestic public indebtedness are less well understood and subject to greater controversy though, in practice, it is clear that such indebtedness does introduce major distortions in domestic interest rates, has severe crowding out effects and results in the accumulation of internal imbalance which most developing countries have not been able to deal with in a satisfactory manner without disruption.

Finally a word about **REGULATORY POLICY**. Experience from the industrial and developing world suggests that capital markets simply do not develop in a healthy manner without effective market regulation in terms of requirements for listing, disclosure and transparency, trading rules, liquidity and margin requirements, settlements, frequent auditing and accounting of brokerage operations and of listed entities. Effective regulation must encourage and support the market's own need for better information on macroeconomic conditions and signals as well as microeconomic signals on corporate health, performance and management through improved reasearch and reporting ability. It must allow for swift procedures in civil litigation concerning the settlement of disputes where financial transactions are concerned. Capital markets cannot develop sensibly when governments interpret regulation as requiring heavy-handed direct intervention either through the "market" operations of public financial institutions which influence price levels or through direct (and whimsical) interference by the authorities in trading operations or sudden changes in margin requirements and trading rules. Public intervention is no substitute for inadequate auditing, accounting and legal standards. Regulatory policy must therefore focus on invisible but effective maintenance of market discipline and depend on strenthening all the professional and financial support services which make markets work as they should.

Capital Market Development: Implications for the Management of Macroeconomic Policy.

As suggested earlier, the need for a sound macroeconomic policy environment is a necessary though not a sufficient condition for successful capital market development. That is not a one-way street. Capable, broad and deep capital markets can be indispensable (though again not sufficient) tools for government in the successful management of macroeconomic policy. This reverse aspect has unfortunately been given short shrift by most developing country governments (including the more sophisticated ones) as well as by agencies such as the World Bank and the International Finance Corporation. In their haste to develop the financial sector they have concentrated too much on what they should do for (and to) capital markets without asking in turn what capital markets can do for them, apart from increasing the level of aggregate savings and inducing more people to save in financial form.

In this context it should also be said that the term "capital market" in developing countries has become synonymous with "stock (equity) market". Rarely do developing country governments acknowledge the importance of the "bond (fixed income) market" segment which are essential complements in balanced capital markets. That is a serious omission which, hopefully, will be rectified in the 1990s.[9] Perhaps developing country governments feel threatened in competing for private savings in the marketplace having become used to pre-empting such savings, often at below market rates. Given the generally poor use that they have made of domestic resources, their reluctance to face the private individual or institutional saver with a choice in a competitive market may be perfectly understandable. But, if the market-based development is to become a more widespread, if capital markets are to develop properly, and if governments are to be subject to the same discipline of transparency and accountability in the use of resources as other economic agents, then that reluctance has to be overcome.

The experience of advanced capital markets in the industrial world suggests quite strongly that a bond market is a necessary complement to a stock market and that appropriate linkages between the two are essential for changes in key prices, i.e. interest rates and exchange rates, to emit the right kinds of signals about future behaviour throughout the capital market and the economy. No bond market anywhere in the world has developed succesfully without government securities across the maturity spectrum predominating in its trading. In the industrial world, government paper is generally regarded as the highest quality (lowest risk of capital loss on maturity) of tradeable security -- the bellweather issue -- against whose return investors assess the risk-reward quality of other securities, both fixed-income and equities. To maintain that quality, governments are required to pursue macroeconomic policies acceptable to the market.

With the progressive integration of money, capital and foreign exchange markets in the industrialized world, governments must satisfy participants on the wisdom of their policies not just in their own domestic capital markets but in world markets. That imposes a valuable discipline which even the most powerful or recalcitrant of governments cannot evade indefinitely. It is a market-imposed check-and-balance which establishes finite limits to

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9 The debt segment of the market is emerging in some of the more advanced developing capital markets (India and Malaysia for example) with private corporations regularly floating bonds, debentures and convertibles. But, one gets the impression that this fixed-income segment of the capital market is emerging in spite of, rather than because of, public efforts to aid its development.

government policy excess; even though it often appears that markets are far more elastic in their tolerance of unsound policies (witness the inability of the U.S. to deal with its twin deficit problems for the last seven years) than they should be. Nevertheless, "the global market" is able to send regular signals to governments about the wisdom of their policies by reflecting its views in the prices and yields of government's securities and in the value of its currency.

Though most developing countries are a long way from re-establishing the kind of confidence that is essential to tap global savings regularly and directly in world capital markets (though many were approaching that point before the debt crisis hit) they must realise that they are becoming increasingly dependent on such savings. No matter how well developing countries attempt to design exchange and capital controls the reality is that their parallel markets reflect, quite efficiently, price signals in global markets. Domestic savings often leak out in the form of capital flight and have to be recaptured from the "global market".

In general, the further a developing country is away from pursuing sound macroeconomic policies, the larger its parallel market is likely to be relative to the official economy. The parallel market thus operates as an informal money, capital and foreign exchange market (obviously with access limited to only a few operators) which transmits signals about government policy whether they like it or not. In the presence of exchange and capital controls it also determines the direction of capital flows from/to the domestic economy depending on the view taken by "the market" on government policy. If developing country governments are to regain effective control over their economies they will inevitably be faced with little choice but to accept the discipline of the global marketplace whether that discipline is exerted transparently through properly functioning formal capital markets or, more painfully, through informal parallel markets and/or official international financial institutions.

Faced with the reality of those choices the sensible response for developing country governments (especially those such as India) would be to concentrate more on developing their capital markets in ways which could reciprocally facilitate and reinforce the pursuit of sound macroeconomic management. The first step in that direction would be a gradual shift from resource pre-emption through the publicly owned banking system to raising an increasing proportion of public finances on capital markets through a bond market. The next step would be to increase the participation of private financial institutions in the non-banking, banking and contractual savings sub-sectors by permitting domestic and foreign investors to participate and through a programme of progressive privatization of public financial institutions.

Looking at the experience of developed economies suggests another aspect to the reciprocal impact of capital market development for macropolicy. The rapid development of industrial country capital markets in the 1970s and 1980s through institutional change, financial liberalization and innovation in instruments, and in particular the integration of these markets into a global market, has had major implications for the mix of fiscal and monetary policies in industrial countries. As one observer puts it ... " international financial integration increases the short-run scope for an independent fiscal stance, while it decreases the independence of monetary policy.... greater capital mobility makes it easier for countries, in the short-run, to finance fiscal and current account deficits.." [10] In other words, the availability of global finance permits countries to delay necessary adjustments to structural fiscal and external account imbalances, by permitting fiscal deficits to be financed more easily than if public borrowing were confined only to the domestic capital market. The crowding out effect which would occur if borrowing by private investors and government was confined to domestic markets is avoided by access to global finance. But if, as in the case of the US, the financing requirements are very large in absolute terms, tapping global savings can still result in a global crowding out effect. Foreign savers will finance a deficit country's fiscal imbalances only if interest rates or

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[10] Kincaid, G.R. "Policy Implications of Structural Changes in Financial Markets" in Finance & Development, March 1988. See also IMF, "International Capital Markets" January 1988.

exchange rates are attractive; thus reducing the independence of the country in its monetary policies. A perverse effect which can result is that if interest and exchange rates are too attractive, the resulting inflows of foreign capital put upward pressure on exchange rates at a time when for macroeconomic reasons it should be moving downwards. Striking the right balance act thus becomes a much more difficult act for governments to perform.

There are also important implications for monetary policy of changed global capital market conditions. Structural changes in world markets have profoundly influenced: the analysis of global market conditions; the meaning and relevance of traditionally targetted monetary aggregates; and the linkage of monetary policy and inflation to the real economy. To explain, the use of off-balance sheet risk-transfer instruments (such as interest and currency swaps as well as repos and asset swaps) and of new credit (home equity) and liquidity instruments (MMAs, CDs and commecial paper) has increased at a phenomenal rate in the 1980s. Resort to these instruments has made it increasingly difficult to assess liquidity conditions in global or domestic financial markets properly or even to decide which monetary control instruments to use at any particular time. The general impact has been to shift policy in industrial countries from credit rationing to price rationing through the interest rate. Also, financial innovation and institutional change has had an impact on altering the interest and income elasticity of the demand for money, contributing to larger prediction errors in estimating money demand and an underestimation of desirable real balance requirements.

These phenomena suggest that interactions between macroeconomic policy and capital market behavior at increasing levels of market development are reciprocal and increasingly complex to understand and manage. Developing countries can learn much from what has transpired elsewhere. They can avoid repeating mistakes and inducing imbalanced capital market development by evading, for as long as possible, the inevitability and the desirability of becoming subject to market discipline in mobilizing public finance even as they encourage capital market development to mobilize and allocate private finance.

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The Role of Securities Markets in Economic Develoment

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THE ROLE OF SECURITIES MARKETS IN ECONOMIC DEVELOPMENT

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INTRODUCTION

Mobilising capital for investment and ensuring that scarce capital is channelled into the most productive investments is crucial for economic develoment. Since domestic savings are usually inadequate to finance investment at satisfactory rates, foreign capital must be mobilised to supplement local capital. But the greater part of investment usually comes from domestic sources even for very poor countries. Every effort must therefore be made to increase domestic savings.

Increasing both foreign and domestic investment in developing countries and ensuring that such scarce capital are wisely invested depend on the proper functioning of the financial sector. But the part of the financial system which must grow and function effectively if such resources are to be tapped and channelled to the most productive investment is the securities market.

Securities markets are primarily the markets for longer-term instruments such as bonds and equities including new issues of these. In a wider definition they include also shorter-term money market instruments. Today especially in the industrial countries, there is much innovation and new instruments and the making of any sharp distinction between the securities market and the rest of the financial system is becoming artificial. Securities markets are important in linking institutions requiring funds such as governments and their agencies, financial institutions and companies with individual and institutional investors through the intermediation of brokers, dealers and underwriters. In this way supply and demand especially in terms of risks and maturities are matched. The primary role of securities markets is to provide risk capital through the issue of shares and long-term debt financing through the issue of long-term bonds.

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Much effort is currently being made by developing countries to improve their financial sector. Liberalisation of policies on foreign investment, privatisation and the contraction of the public sector, movement towards market-oriented interest rate policies and greater efforts to mobilise local savings are all giving a spurt to the development of the financial sector and these policies themselves require a facilitative financial system especially an improving securities market.

There are at least 35 "emerging" securities markets in the developing world. Although their importance has been growing, they are not yet in many cases playing a central role in financial systems. This is largely because of the undeveloped state of financial markets encouraged by development policies which emphasised government intervention in the allocation of financial resources. Investment allocation through financial markets was not until recently considered important in the third world; domestic savings mobilisation was not a top priority and the role that could be played by equity often overlooked. Some obstacles to the development of securities markets were:

(a) tax policies which are more favourable to interest earned on bank deposits than on yields and capital gains from stocks and bonds.

(b) high inflation which discouraged the use of long-term instruments.

(c) controls on interest rates at below-markets levels, thus reducing the cost of borrowing and encouraging bank financing rather than equity financing

(d) interventionist and discriminatory credit and investment policies.

(e) the domination of public enterprises and the consequent lack of demand for equity financing.

(f) the prevalence of private companies which tended to rely on bank financing rather than bond or equity financing.

These obstacles are being removed however as part of the overall shift in favour of private sector-led development and because of the increasing awareness that all means must be used to mobilise local and foreign capital for long-term investment.

THE NEED FOR SECURITIES MARKETS AND ITS FUNCTION IN ECONOMIC DEVELOPMENT

The economic contribution of securities markets must be seen in a wider context than the raising of funds for investment in long-term assets.

A well functioning securities market:

- provides additional channels for encouraging and mobilising domestic savings for productive investment and an alternative to bank deposits, real estate investment and the financing of consumption loans;

- fosters the growth of the domestic financial services sector and various forms of institutional savings such as life insurance and pensions;

- provides savers with better protection than most debt instruments against inflation and currency depreciation and thus alleviates two of the major reasons encouraging the flight of domestic capital abroad as well as providing attractive vehicles for repatriating flight capital;

- increases the overall efficiency of investment since the greater competition it encourages to raise investment capital in capital markets improves investment allocation and focuses the attention of management on the return on capital. It encourages higher standards of accounting, financial planning and public disclosure. It also facilitates the entry of domestic enterprises in international capital markets;

- encourages privatisation by increasing the marketability of new issues; this marketability also facilitates the dispersal of ownership from traditional industrial and financial interests;

- improves the 'gearing' of the domestic corporate sector by facilitating equity financing and this helps to reduce corporate dependence on borrowing: thus making the financial system more solvent;

- provides through equity financing a cushion for companies against the variability of cash flows and even possible losses; and it is permanent financing which does not demand regular fixed returns like debt financing;

- improves access to finance for new and emerging companies and encourages institutional development in facilitating the setting up of domestic and foreign mutual funds and venture capital funds.

- encourages public flotation of private companies thus increasing the supply of assets available for long-term investment.

PROBLEMS OF EMERGING SECURITIES MARKETS

Even when conditions are favourable for the creation of an organised securities market, certain obstacles are difficult to avoid at the early stages of development.

Market cycles are particularly pronounced during these stages, when the supply of stocks is limited, regulation inadequate and difficult to supervise and market operators unsophisticated. Emerging markets are known for greater volatility but they have also been providing higher returns on equity investment.

This volatility acts as a constraint. Instability in the secondary market undermines the confidence of investors and affects the ability of companies to raise new funds in the primary market. Crashes in the equity market or dramatic changes in interest rates and thus prices in the bond market may undermine public confidence in the country's financial sector as a whole, at least temporarily. Thus, securities markets cannot be counted on as a reliable source of new capital during these early stages. Inadequate marketability and liquidity are particular problems at these stages.

After periods of substantially negative real rates of interest, high positive real rates can be expected during the adjustment period following "liberalisation". Even if temporary, this problem may be quite severe on the profitability of existing businesses even though it could have a positive effect on savings and capital availability. High inflation and fluctuating interest rates have been particular constraints in the development of bond markets in developing countries.

Institutional improvement in securities markets would require a securities exchange, a securities commission or other regulatory agency, and intermediaries such as underwriters, dealers, brokers, investment managers and securities analysts. These services can be costly, especially in small markets. However in the long-run the benefits of these services tend to outweigh their costs.

Companies which go public not only pay the initial flotation and underwriting expenses but are also subject to the continuous costs of providing financial information, transferring shares, paying dividends and maintaining relations with shareholders. These costs and high taxes could deter public flotation which however requires encouragment since the predominance of private companies tends to constrain securities market development.

Inadequate regulation and supervision is a particular problem in emerging markets. Continuous attention would need to be given to improving securities markets. The improvement of regulation and administrative arrangements such as settlement procedures could be crucial to progress in the evolution of securities markets.

REQUIREMENTS FOR A SUCCESSFUL SECURITIES MARKET

There are several basic pre-requisites for the establishment and continued success of a securities market. Apart from requiring a reasonably stable political environment, launching a securities market is virtually impossible in a climate of high inflation, directed credit, unstable interest rates, unrealistic exchange rates and high budget deficits. Once progress has been made on the macro-economic front, the environment improves for viable development.

Adequate Demand and Supply

A viable equity market requires a sufficient demand for and supply of stocks and other market instruments. Supply and demand are however intrinsically linked. The number of investors is as important as adequate stock issues. Too few stocks may deter investors; at a later stage when trading is active, too many people may be chasing too few stocks. Thus, a balanced increase in both demand and supply of stocks is essential. However freer international securities trading is removing some of these domestic causes of volatility although it exposes the local market to international market movements. On the whole though the greater integration which has begun between emerging markets and international markets will produce increasing benefits to emerging markets. More capital could be tapped, local savers get higher competitive returns and investors are forced to become more efficient. Demand and supply of stocks depend on a number of factors.

In the case of individual demand,this is a function of the number of financially sophisticated individuals and income and savings levels; other investment alternatives; awareness of the stockmarket and of stocks and shares as investment media; as well as adequate disclosure of information on traded securities. In most emerging markets the individual retail market is small - less than 1% of the population (India - 2.5%) which compares with 10% in developed countries. Individuals who dominate stock holdings are family owners of companies rather than the household saver. Overseas remittances from migrant workers are an important source of demand for stocks both in the form of direct investment and through mutual funds.

Concerning institutional demand, the main demand is from insurance companies, pension or provident funds and mutual funds. However, although they are the main players in the stock market, stocks form a small part of these institutions' assets. Regulations governing obligatory reserve requirements have a major impact on their investment activities as well as legislation which constrain them to invest only in government securities. Thus there is not sufficient awareness of the important role these institutions could play both in mobilising long-term savings and in channelling them to equity and bond markets. Without their full participation there is a great risk of a market dominated by individual speculators.

In the case of foreign portfolio investment, this has become of major significance in several emerging markets mainly through the vehicle of offshore country funds (see below, Commonwealth Equity Fund). Some 50 developing country and multi-country funds have been launched over the past five years, raising over $5 bn for investment in emerging markets mainly in the successful economies of Asia and as well in the indebted countries of Latin America and Eastern Europe. A recent study of WIDER, an international economics research centre of the UN University, has estimated that by the year 2000, foreign portfolio investment in emerging markets could total $100 bn. If, however, developing countries take steps to reduce barriers for foreign portfolio investors (in terms of access, taxes on dividends and capital gains, repatriation of capital and income), to foster their equity markets and increase the supply of 'suitable' stock, the figure could become much higher.

The supply of stock would depend on the rate of economic progress, the buoyancy of the private sector and the incentives and environment to facilitate the movement from private ownership to public flotation.

The development of securities markets and the liquidity it encourages including the realistic values it gives to securities would itself increase supply by encouraging companies to go public or make bond placements. In many countries, under outdated company laws, the prices at which shares can be sold to the public are determined by government authorities on the basis of par or book value.

Corporate bond placements are rare in developing countries. Governments tend to dominate bond placement and the investors are usually insurance companies and pension and provident funds. Companies are crowded out but they too are not yet in a position to raise long-term loans. Medium-term loans tend to be provided by the banking sector.

Finally, where governments dominate the ownership of major enterprises they may be in a position to increase the supply of stocks available for trading, by divesting their interest in public sector corporations which are profitable and professionally managed.

Fiscal and Monetary Policies

When interest rate policies are generally held below inflation levels for sustained periods or loans with a large subsidy element are easily available, companies prefer borrowing rather than issuing shares. They also discourage savers from holding financial assets. Many countries, even some with strong equity markets, discriminate against equity by high rates of tax on dividends and capital gains. In contrast, interest on bank deposits and government bonds may have zero or low rates of tax. On the other side of the balance sheet, corporate tax regimes treat interest costs as a tax deductible expense but share dividends as non-deductible. Thus companies prefer to use debt rather than equity as debt is lower cost. However debt usually takes the form of bank loans rather than bond issues which provide marketable securities and widen the variety of securities available. It is still unfortunately a popular opinion that profits on stocks are the fruits of speculation and thus are deserving of a higher tax rate than earned income.

Fiscal policies can be used to provide incentives both to increase the demand for shares and for companies to go public and thus increase the supply of stock. Example of demand incentives are:

- tax concessions on dividends and capital gains of listed companies
- special tax credits for individuals and possibly companies investing in shares of publicly held companies
- freedom from tax on share transfers of listed companies

The most widely used supply incentive is lower corporate income tax for public companies than for privately held companies. An exemption from or reduction of tax paid on the profits of public flotations is also a strong incentive for privately held companies to go public.

In addition to the general policy environment, there are other legal and institutional factors which are critical to ensuring success of securities markets: (a) establishment and vigorous enforcement of rational legal and regulatory frameworks, so that abuses are prevented and investors are protected. This is extremely important in monitoring the integrity of the financial system and in sustaining investor confidence. (b) Reasonably well developed accounting, auditing and disclosure standards, so that financial information is available, transparent and accurate. (c) The existence of a sufficient member of market intermediaries, such as brokers, dealers and underwriters.

THE COMMONWEALTH EQUITY FUND

The development of securities markets are being greatly helped by the more liberal attitude which has developed to foreign investment whether direct or portfolio. In the case of direct investment, it is helpful if local participation is encouraged by the sale of shares in the local stock-market. While lending to developing countries through commercial banks and bond issues have declined in the 1980s, foreign investment is now showing some revival especially through debt-equity swaps. But as noted above it is in the area of portfolio investment especially through country and multi-country funds that there has been much activity.

A recent initiative by the Commonwealth to encourage portfolio investment in its member developing countries and at the same time facilitate securities market development is its efforts to get the Commonwealth Equity Fund (CEF) established. The CEF is intended to facilitate the flow of private institutional development into Commonwealth developing countries. It was launched in early September 1990 with $56.6 mn raised on the basis of a private placement with institutional investors in Canada, the United States and the UK. The Fund is "closed-end" and will operate on a purely commercial basis. Its aim is to seek long-term capital appreciation through investment in equities of enterprises already established in Commonwealth developing countries. Most of its investment will be in countries with established stock markets (of the 46 developing country members of the Commonwealth about 16 at present have or are shortly expected to have stock exchanges)* but up to 30% of its capital can also be invested in unquoted securities. The Fund will also give special attention to equities which become available through privatisation. Its planned niche is the smaller Commonwealth developing country markets which would find it difficult to attract foreign portfolio investment on the basis of individual country funds. By spreading investment risk among a variety of smaller markets the CEF would be playing an unique role in tapping investment possibilities which are arising in these markets.

The Commonwealth Secretariat has played a catalytic role in getting the CEF established. It had the blessings of Commonwealth Heads of Government and Finance Ministers. The justification for a multicountry equity fund for the developing Commonwealth was that it could be beneficial to both host countries and to investors and facilitated in its establishment by official intermediation by bringing together the promise of investment on the one hand and the promise of favourable access conditions on the other. There seemed little doubt that the array of emerging Commonwealth equity markets available to investors through a CEF would provide enough investment opportunities to sustain a successful Fund.

From the host country perspective, the Secretariat envisages that the CEF would satisfy significant development objectives. Among these are: a source of new money which is non-debt-creating; investment which can raise the standing of local companies and enable them in the future to directly access the international capital markets on attractive terms; improve the functioning of domestic capital markets by stimulating improved legal frameworks, accounting practices, information and disclosure systems and settlement

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* Apart from India and Malaysia, two highly liquid and capitalised of Commonwealth emerging markets, this total includes Pakistan, Bangladesh, Sri Lanka, Papua New Guinea, Mauritius, Kenya, Nigeria, Zimbabwe, Botswana, Ghana, Cyprus, Jamaica, Barbados and Trinidad and Tobago

procedures; provide a diversified vehicle for channelling overseas capital into smaller sized unlisted companies and into equities which become available through privatisation.

The CEF emerged from Commonwealth initiatives to encourage foreign investment. It points to practical ways in which official agencies can encourage practical development efforts. The Commonwealth Secretariat will continue to look for new initiatives of this kind to enhance the development prospects of its emerging member countries.

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SYMPOSIUM ON CAPITAL MARKET DEVELOPMENT AND PRIVATISATION

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Establishing a Stock Exchange in a Developing Country: Issues for consideration

Paper prepared by the Technical Assistance Group (TAG) of the Commonwealth Fund for Technical Cooperation (CFTC)

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INTRODUCTION

As the market regains the limelight in an increasing number of developing countries, the demand will increase in them for the various concomitant institutions of the market. In relation to capital markets, it is anticipated that developing countries which do not have stock exchanges will consider establishing such exchanges and some may decide to establish such exchanges. The Technical Assistance Group (TAG) of the Commonwealth Fund for Technical Co-operation has already received requests for assistance from some member governments of the Commonwealth in establishing stock exchanges or promoting the development of capital markets in those countries. Stock exchanges are now on the agenda of several countries where only a few years ago this would not have been expected. Will this movement last? Will it come to a dismal end with financial scandals or will it rather offer new and exciting opportunities for mobilising private capital, both domestic and foreign, for development projects and business enterprises?

The developmental impact of stock exchanges will be affected by the policy and legal framework into which they are introduced in any country as well as, of course, on the entrepreneurial resources available in the country. To assist in focusing discussion on the issues necessary for the formulation of an appropriate policy and legal framework for stock exchanges in developing countries, this paper draws attention to questions that will need to be addressed by those developing countries without stock exchanges which are seeking to establish one.

SECTION A: DESIGNING AN APPROPRIATE FRAMEWORK FOR STOCK EXCHANGES AND DEALING IN SECURITIES

(a) The Regulation of Stock Exchanges and Dealing in Securities

The foundation for securities trading is, before even any specific securities legislation, the companies legislation of the jurisdiction in question. The starting point for any assessment of the legal and policy framework for the trading of securities should therefore be the companies legislation of the jurisdiction in question. In most Commonwealth countries, this legislation will take the form of a Companies Act, usually influenced greatly by the companies legislation of England. Unless the Companies Act of the jurisdiction contains adequate provisions on public companies and the procedures by which they may solicit capital from the general investing public, then the initial task in that jurisdiction will have to be the reform of the companies legislation to ensure that it measures up to modern requirements. The purpose of specific securities legislation then becomes to give protection to investors over and above what is already available in the Companies Act. In other words, securities law is grafted on top of corporate law and both areas of law will require examination in any jurisdiction before it is decided to establish a stock exchange in it.

For the purposes of this paper it will be assumed that the country wishing to establish a stock exchange has an adequate companies legislation. Therefore our initial focus will be on "securities regulation", a branch of law whose evolution as a separate branch of law in the U.S., where it first gained prominence, owes much to the publication in 1951 by Professor Louis Loss of his seminal treatise on the subject, bearing the same title. The branch of law has evolved because experience in many jurisdictions has shown that when securities are traded either over-the-counter or on a stock exchange, there usually emerges a class of directors and managers of the companies whose securities are publicly traded. The business activities of these company officials cannot be adequately regulated by the shareholders acting in general meetings. Accordingly, institutional arrangements need to be made to provide for administrative regulation of companies with publicly-traded securities, to ensure that members of the general investing public who entrust their savings to quoted or other public companies are not subjected to fraud and dishonest practices. As Professor Louis Loss once remarked in a public lecture in Lagos*.

> "In the first place, securities are in a phrase used by a committee of the American Congress in 1933, 'intricate merchandise.' Though one cannot imagine a system of private capital without them, their very nature makes them a ready device for preying on the unsophisticated and the gullible. This creates the general problems of fraud, share-pushing (to use a British term), and market manipulation."

Accordingly, many governments have made it their business to establish a regulatory framework for securities where the establishment of a stock exchange is anticipated.

(i) Objectives of Regulation by Government

The securities industry is sustained by confidence; the confidence of investors that their capital when invested in securities will not be subjected to dishonest and unfair practices. An important objective of governmental regulation of the securities market is thus the protection of investors from fraud, dishonesty and unfair practices. A second objective of government regulation is to ensure that the market operations in securities measure up to the rules of the market place. This may be viewed as the economic dimension of the ethical objective earlier identified as the first aim of government regulation. Fraud and dishonesty can subvert the proper interplay of market forces. As William O. Douglas, then Chairman of the New York Stock Exchange observed in a press statement in 1937:

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* The J.I.C. Taylor Memorial Lecture of 1980, published by the University of Lagos Press (1981) as "Trends in Corporate Governance and Investor Protection" at p.33.

"I have always regarded the exchanges as the scales upon which that great national resource, invested capital, is weighed and evaluated. Scales of such importance must be tamper-proof, with no concealed springs - and there must be no laying on of hands."*

Protecting the integrity of the markets is a way of promoting another objective of government regulation, namely the development and growth of the securities market.

But it is not only fraud and dishonesty that can distort the proper functioning of the market. Differential access to information also can. Rules regulating the availability of, and access to, information relevant to the exercise of a sound commercial judgment on securities play an important role in the operation of orderly and efficient markets. Accordingly, government regulation has a role to play in ensuring that there is adequate and timely disclosure by companies of the information needed to sustain an orderly and efficient market in securities. Finally, Government may wish to regulate the securities markets in order to enforce particular public policy objectives that it may have.

(ii) Self-Regulation

Wherever securities markets operate, a certain degree of self- regulation has been allowed to the managers of the market. This is a pragmatic necessity since full government regulation of the markets would lead to excessive bureaucracy and would in any case be likely to be inefficient. Self-regulation gives a degree of autonomy to the stock exchange to formulate and apply rules on the conduct and ethics of its members and on trading practices and the range of securities that may be traded on its markets.

Such self-regulation is often effective since the governing body of a stock exchange is usually a repository of special expertise and likely to have greater insight into the day to day operations of the market than any governmental body.

But almost everywhere, untramelled self-regulation is not a practical proposition. A public body needs to exercise supervisory control over self-regulation for the following reasons, among others: first, conflicts may arise between the interests of members of the stock exchange and the public interest; secondly, experience has shown that sometimes stock exchanges are unwilling or unable to discipline their most powerful members. Other reasons are that a stock exchange may not be very firm in implementing its own rules, if there is no external supervision of its conduct. Moreover, where it is necessary for rules or standards formulated by a stock exchange to be applied by other professional bodies such as chartered accountants or valuers, the intervention of a government regulatory authority may facilitate the acceptance and application of such rules and standards. Finally, a self-regulatory stock exchange may not be a suitable vehicle for implementing overriding government policy in the securities area.

* Quoted in L. Loss, Fundamentals of Securities Regulation at p.616.

Given the need for both a degree of self-regulation and of regulation by the Government, the critical issue is how to structure a regime of co-regulation which is balanced and allows efficient market operations without undue government interference but at the same time enables Government intervention to protect the public interest.

(iii) <u>Scope and Content of Government Regulation</u>

A well-tried mode of regulating the securities industry is through the imposition of a regime of licensing. Under such a regime, no stock exchange may operate without a licence or authorisation from an agency of government. Similarly, no brokers, dealers, investment advisers or any other such intermediaries may engage in any aspect of the securities business without a licence from an agency of government. The power of the government agency to grant licences enables it to keep watch over standards of probity and professional conduct, and to ensure that only fit and proper persons obtain licences to deal with the public in relation to securities and that only well-regulated stock exchanges are authorised to do business.

Accordingly, an adequate regulatory framework for a particular developing country would need to formulate rules on the various licences and approvals considered appropriate in the circumstances of that country to ensure the proper regulation of the securities market and its intermediaries. Additionally, institutional and legal arrangements will need to be put in place to enable the government's regulating agency to oversee the activites of these market intermediaries and of the stock exchange. The issue as to whether the regulatory agency is to be a free-standing body or an arm of an existing Ministry or other existing Governmental Organ is one which is separately discussed later.

1. <u>The licensing of stock exchanges</u>

There will usually be need for framework legislation requiring government approval before a stock exchange may do business in the country concerned. The statutory basis for such requirement of government approval could be embodied in a comprehensive Securities Industries Act. The Commonwealth of Australia has such an Act and it is the inspiration for similarly entitled Acts in Singapore and Malaysia. Under the Australian Act, any body corporate proposing to establish, maintain or provide a stock market must apply for approval of the Ministerial Council established by agreement between the Australian States and the Federal Government, whilst in Singapore and Malaysia, it is the Minister's approval which has to be sought. Such approval should be conditioned on the Minister's satisfaction with the rules of the stock exchange relating, <u>inter alia</u>, to membership of the exchange, disciplinary control over its members, listing requirements etc.

After the initial approval by the Minister of the various rules of the Exchange, the issue posed is whether subsequent amendments would require his approval or whether approvals for such subsequent amendments should devolve on a subsidiary body. In Singapore, after the initial approval by the Minister, any subsequent amendments to the rules of the Exchange are to be approved by the Monetary Authority of Singapore (MAS). In the Australian Act, any subsequent amendment by an Exchange to its business or listing rules shall be notified in writing to the Commission. Upon receipt the Commission is obliged to send a copy to each member of the Ministerial Council. The Ministerial Council may, within 28 days after receipt by the Commission of the notice of amendment, disallow the amendment in whole or in part. Similarly, in Malaysia, written notice of any amendment to the rules of the Exchange must be given to the Minister who is given power to disallow such amendment in whole or in part within 21 days after receipt of the written notice from the Exchange.

After the initial approval by the Minister, it would seem preferable for approval of subsequent amendments to be dealt with at the technocratic level of the regulatory agency assuming that the regulatory agency is not an arm of the Ministry.

In both Singapore and Malaysia, the Government's power goes beyond the mere power to disapprove subsequent amendments. The Minister in Malaysia and MAS in Singapore (after consultation with the Securities Industry Council and the Exchange) are empowered to amend the rules of an approved stock exchange by written notice specifying the amendments and the dates on which such amendments are to take effect.

2. Licensing of Market Intermediaries

The scheme of investor protection through a licensing regime was first introduced in the common law world by the Prevention of Fraud (Investment) Act 1939 of the United Kingdom, later repealed and re-enacted by an Act of 1958. The essence of its legislative scheme was to prevent dealings in securities except by persons licensed to deal in them or expressly made exempt from the requirement of a licence. This same idea lies at the heart of the Securities Industry Acts of Australia, Malaysia and Singapore.

Under both legislative schemes, no person may carry on the business of dealing in securities unless he holds a dealer's licence or is an exempted dealer. Under the Singapore Act, only a body corporate may be a dealer, but in Australia and Malaysia natural persons may also be dealers. Also, under the licensing regime contained in the Prevention of Fraud (Investments) Act 1958 of the United Kingdom (P.F.I.A.) the principal's licence, which is roughly equivalent to the dealer's licence under the Australian based schemes, was not limited to corporate bodies. Thus an issue that a country establishing a new regulatory system will need to consider is whether there should be any limitation on the type of legal person who may be a dealer. So long as adequate rules are laid down regarding the solvency and proper conduct of the business of licensed dealers, whether they be incorporated or unincorporated, there would appear to be no overriding reason for imposing a Singapore type limitation on all countries.

Even if a person does not himself as a principal carry on the business of dealing in securities, under both the Australian-based schemes and the PFIA, if he acts in the capacity of a servant or an agent on behalf of a dealer in relation to the latter's business, he may only do so under the authority of a licence.

Under the PFIA, provision was made for two types of licences: the principal's licence and the representative's licence. Under the Australian Act provision is made for four types of licences:

(a) a dealer's licence;
(b) a dealer's representatives licence;
(c) an investment advisers licence; and
(d) an investment representatives licence.

The Australian regime is thus more comprehensive in its coverage. The PFIA in any event has been replaced in the UK by the more complicated provisions contained in the Financial Services Act 1986.

It will usually be necessary that provision be made for exempted dealers. The original Australian legislation and the legislation of Singapore and Malaysia make provision for this category of dealers, the rationale being that because their activities were already sufficiently regulated under other legislation, they could be permitted to carry on the business of dealing in securities without the requirement of a licence. Among those exempted are banks and approved financial institutions.

3. <u>The role of a regulatory agency</u>

In addition to licensing control, regulation by Government requires continuous oversight of the activities of stock exchanges, market intermediaries and investors and appropriate governmental intervention to protect the interest of investors and the integrity of the markets. This regulatory function may be discharged by either a free-standing regulatory agency or by some existing Ministry or organ of Government. The regulation of the over-the-counter market in securities will need to be exercised wholly by such a regulatory agency.

Regulation of a stock exchange and its activities has to be based on a thorough understanding of the securities market, and is best exercised in consultation with the different interests groups. An autonomous body, with specialist staff, could perhaps bring to bear greater expertise in enforcing the regulations, and could be more responsive to emerging needs than an arm of Government.

As against this it has to be noted that even where an autonomous body is set up to regulate the securities industry, there would be various matters of policy in respect of which consultations with, or approval of the Government would still be necessary. Besides, the establishment of an autonomous body would involve additional costs for staff and establishment. It is true that the regulatory agency would have a source of income in the form of fees, but this income, even in countries where the industry is established and there are a large number of licensees would not be adequate to meet in full the costs of the agency. The agency would need to be funded by Government. It would, therefore, be advisable to keep the costs low in the early stages and this could, perhaps, best be done by having the regulatory agency as an arm of a Ministry or of the Central Bank, with the minimum of staff allocated for the purpose.

As the stock market develops and the volume of business grows, at that stage, the question of making the regulatory agency an autonomous body could be considered. In Singapore, the regulatory functions are vested in the Monetary Authority of Singapore, and in Malaysia in the Ministry of Finance and the Registrar of Companies. In India, the regulatory functions are exercised by the Ministry of Finance and it is only now, with the growth in the number of stock exchanges and the volume of business, that a separate Securities Exchange Commission is being contemplated.

4. <u>Regulatory provisions to be embodied in the framework legislation</u>

The regulatory agency's task is facilitated by the imposition of obligations on stock exchanges and market intermediaries by the framework legislation. It can then monitor the observance by the stock exchange and by the intermediaries of the regulatory obligations laid on them by legislation. Not all such rules can be embodied in the principal legislation and, accordingly, the Minister or regulatory body will need to be given enabling powers to make regulations imposing more particular obligations.

Prominent among the obligations cast on market intermediaries by the framework securities legislation should be a duty sanctioned by the criminal law against the use of manipulative and deceptive devices in connection with the purchase or sale of securities. Specific conduct which should be prohibited include market-rigging, insider dealing and investment fraud. Where in spite of the criminal sanctions against dishonest behaviour, a market intermediary misappropriates clients' funds, his clients' interests will be protected to a degree if the framework securities legislation has required the establishment of a fidelity fund for the compensation of the victims of defalcations.

(5) <u>Fidelity Funds</u>

By way of illustration of the operation of fidelity funds, mention may be made of the securities legislation in Singapore, Malaysia and Australia which require the establishment of a fidelity or compensation fund by the Stock Exchange to compensate clients who suffer pecuniary loss on account of the default of a member of the Stock Exchange. In all these countries the Fund is administered by the governing body of the Stock Exchange. The monies required to be paid into the Fund and the minimum amount of the Fund is prescribed. The fund consists of:

(a) monies paid to the Stock Exchange by Members as required under the Act;

(b) interest and profits accruing from investment of the Fund;

(c) monies paid to the Fund by the stock exchange;

(d) monies recovered by or on behalf of the exchanges in the exercise of any right;

(e) monies paid by insurers pursuant to contracts of insurance or indemnity; and

(f) all other monies lawfully paid to the Fund.

Claims and costs which are allowed by the Exchange are settled by payments from the Fund. Such payments are also allowed for legal and other expenses incurred in investigating or defending claims, all premiums with respect to contracts of insurance and indemnity entered into by the Exchange, expenses incurred and involved in the administration of the Fund and other monies payable from the Fund in accordance with the Act. Provision is also made for the amount to be contributed by Members, and for the payment of a levy by Members where the Fund is insufficient to meet its liabilities.

With respect to claims, the governing body is given authority to settle claims, although generally claimants whose claims are disallowed will have the opportunity to institute proceedings against the Exchange usually after having exhausted rights of action and legal remedies against the Member in relation to whom or to which the claim arose.

Concluding Comment on the Regulatory Framework

It is hoped that the observations made in the paper so far have demonstrated the necessity, prior to the establishment of a stock exchange in a country where none existed before, for the enactment of legislation, distinct from the usual companies legislation, establishing a regulatory framework not only for stock exchanges but also for securities dealing in general and over market intermediaries.

A further issue that arises is what philosophy should be reflected in such a regulatory framework. In the U.S.A., prior to the enactment of the Securities Act of 1933 this issue was canvassed. On the one hand, there is the philosophy underpinning the prospectus provisions of the English Companies Acts dating back to 1844 which lay emphasis on the full disclosure of all information likely to influence the investor in making a decision whether to purchase a security or not. The Times of July 4, 1844 put this philosophy succinctly thus: "Publicity is all that is necessary. Show up the roguery and it is harmless." On the other hand, there is the paternalistic philosophy underlying most of the blue sky laws of the States in America. This latter approach entails the formulation by Government of substantive standards that must be met before securities may be offered for sale. Under this approach, any proposal to raise capital through the sale of securities is critically examined by Government officials to ensure that it complies with whatever substantive standards are prescribed in the State's laws.

In those States which apply the Uniform Securities Act, these standards, apart from precluding illegality or fraud, also regulate unreasonable distribution costs for the securities and promoters' profits. Some States even go further and provide for an administrative finding that the proposed plan of business for which capital is being raised is "fair, just and equitable". This phrase is undefined and it is left to the appropriate State official to give his own operational meaning to it. These blue-sky laws of the States in the U.S.A. are said to embody a "regulatory" philosophy, in contradistinction from the disclosure philosophy of the prospectus provisions of the English Companies

Acts. The latter philosophy was also that adopted by the U.S. Congress for the Federal securities regulation system.

In making a choice between the competing approaches, a Government may need to consider what weight to give to the following factors. The disclosure philosophy works best in an environment where there is a strong financial press and a competent independent accounting profession. The ordinary lay investor will usually be unable to digest the financial and other technical information which the disclosure doctrine may make available to him. In most financial centres of the world, competent financial journalists subject such information to critical analysis for the enlightenment of lay investors. Where such a strong financial press does not exist, another way through which ordinary investors may be given some guidance is through a cadre of investment advisers.

The regulatory approach seeks to protect the investing public by ensuring that public officials give the securities offering a measure of scrutiny before they can be put on the market. Accordingly, in an environment which lacks a strong financial press, or a cadre of financial advisers to the general public, such paternalism may play a useful role. The implication of the regulatory approach, however, is that a sizable bureaucracy may be needed to perform adequately the task of scrutinising securities offerings. Moreover, for this approach to work, there must be a sufficient pool of manpower available in the public sector to carry out what may in effect be business appraisal tasks.

A further consideration to be borne in mind is the extent to which an over-the-counter market in securities is to be permitted in the country in question. If all securities are to be marketed through the Stock Exchange as listed securities, much of the task of scrutinising securities could be delegated to the Council of the Stock Exchange, under the supervision of the regulator. If, however, securities may be marketed off the exchange, then powers of scrutiny may need to be vested directly in the regulator, if the regulatory philosophy is adopted.

The two approaches have been presented here rather simplistically as two stark choices. In reality, there can be half-way houses and the embodiment of elements from both approaches in a particular regulatory system.

SECTION B

THE MECHANICS OF ESTABLISHING A STOCK EXCHANGE

(a) Organisational Form of the Stock Exchange

The establishment of a stock exchange, as distinct from the regulatory system within which it is to operate, is best left to the initiative of private sector interests. However, Government may catalyse such initiative.

A Stock Exchange can be established by private individuals as a company under ordinary companies legislation of general application or created by legislation relating specifically to the Stock Exchange. The formalities attending formation would vary fundamentally depending on the modality adopted. It would appear, from the material available to TAG from a few Commonwealth countries, that establishment under companies legislation is a more common practice.

Stock Exchanges in Singapore, Malaysia, Hong Kong, India and Ghana, among others, have been established as companies registered under the Companies legislation in force in those countries. The constitution of the International Stock Exchange of the United Kingdom and the Republic of Ireland Ltd (the only stock exchange in the United Kingdom since 1986) is based on the Deed of Settlement (the then equivalent of the memorandum and articles of association of a company) which was drawn up when the Stock Exchange was founded in 1802.

The Rhodesian (now Zimbabwe) Stock Exchange was established by a Stock Exchange Act which provided for, among other things, its regulation. The New Zealand Stock Exchange (the successor of the Stock Exchange Association of New Zealand and the trading exchanges) was established as a corporate entity by the Sharebrokers Amendment Act 1981. The Australian Stock Exchange was incorporated by the Stock Exchange and National Guarantee Fund Act 1987 (which amended the Securities Industry Act) and is deemed to be incorporated under the Companies Act as a company limited by guarantee and to be registered under that Act. Both the Australian and New Zealand Acts were addressing special circumstances in those countries where several stock exchanges previously existed.

The incorporation of a stock exchange as a company under the Companies Act is considered to be a more simple and flexible approach than incorporation through legislation and provides scope for private sector initiative which is essential to the successful operation of an exchange. If established under the Companies Act, amendments to the constitution of the Exchange could be more conveniently undertaken in the light of experience or changing circumstances and administration will be facilitated.

A further issue to be determined by the promoters of a stock exchange is what type of company should be established. The choice, based on current practice, seems to be either a company limited by
shares (a share company) or a company limited by guarantee (a guarantee company). If a share company is to be established, the issue to be determined is whether it should be a private company or a public company (as in Singapore).

As regards a share company, a private company can be formed and operated with slightly less formality and expense than a public company and has many advantages over the latter which must comply with more stringent and complicated statutory requirements (for example with respect to raising and maintenance of capital). A private company's constitution prohibits offer of its shares to the public, restricts the right of its members to transfer its shares and, usually, limits its membership to fifty.

A fundamental distinction between a share company and a guarantee company is that a share company obtains its working funds by the issue of shares to its members (unless it obtains it as loan capital) whereas a "pure" guarantee company obtains its funds from other sources, for example, endowment, fees, charges, donations or subscriptions.

The guarantee company in its pure form is always a private company as it has no share capital. This type of company is unsuitable as a form of organisation for ordinary business purposes but has been used by professional, trade or research associations, for mutual insurance and for setting up stock exchanges.

A share is the personal property of a member which can be traded. Therefore, a member of a share company can sell and transfer his share (and his membership in the company) at a profit for his benefit, whereas, in a guarantee company, a person wishing to give up his membership merely withdraws from the company on giving notice leaving his membership to be offered by the company to interested persons; the withdrawing member gains no financial interest from the allocation of his membership.

Arguments against the establishment of a stock exchange as a share company are:

- that admission of new members is more difficult through the offer of new shares as any increase in the share capital has to be offered in the first place to existing shareholders who are generally averse to the issue of further shares - particularly to outsiders;

- that the right to sell shares (and seats) which are appreciating in market value encourages inactive members to retain their shares as an investment thus affecting activity in the market place and the interest of the Stock Exchange;

Following a comprehensive review of the rules and regulations of fourteen stock exchanges in India (six established as companies limited by shares, five as companies limited by guarantee and three as association of individuals) in 1985, a recommendation was made to require all stock exchanges in India to have a uniform organizational structure as companies limited by guarantee, and, since 1986, all new stock exchanges are required to be established under the Indian Companies Act as companies limited by guarantee.

A stock exchange, by itself, does not directly deal with the public or transact any business in its own name. It only provides facilities to its members to conduct securities transactions. Its objective, therefore, is not to earn profits on its own. Since stock exchanges are not profit making organisations there is no particular merit in having them established as companies limited by shares.

(b) Legal Instruments of the Stock Exchange

Apart from the regulatory framework external to the stock exchange which we have discussed in Section A above, each stock exchange needs to establish its own internal self-regulatory framework. The legal instruments for achieving this include the Memorandum and Articles of Association (or other constitutive documents), the listing rules and the rules (or bye-laws) of the exchange (including membership, trading and settlement) rules. A sampling of some of the issues that need to be addressed in these instruments of self-regulation by a stock exchange is presented in outline below.

(i) Membership Rules

There are several issues to be determined in the Membership Rules. The first issue to be considered is who are to be eligible as members of the stock exchange concerned - natural persons or corporate entities or both?

In Malaysia, for instance, only natural persons with certain minimum qualifications and experience who meet specified requirements are admitted as Members but they are not allowed to trade as dealers/brokers in their individual capacities. They can only do so through firms in which they are partners or private companies in which they are shareholder/directors and such firms or companies must be recognised by the Exchange as "Member firms" or "Member Companies". To be recognised as such the firm or company must meet the requirements for membership set out in the Rules of the Stock Exchange.

In Singapore, membership is given to limited or unlimited liability companies if requirements for membership specified in the Membership Rules of the stock exchange are met.

In most countries where individuals are admitted as members they are required to comply with stringent requirements and are not permitted to trade as individuals; they can trade only through firms or corporate bodies (which must meet specified requirements (as in Malaysia, Australia, U.K. and U.S.A.).

(ii) The Governing Body of the Stock Exchange

The Memorandum and Articles of Association (or other constitutive instruments) of the Stock Exchange determine the type of persons who manage the affairs of the Exchange.

The management of the business of the Stock Exchange is usually entrusted to a governing body whose members stand in the position of directors. In various stock exchanges, this body has been called by different names such as Committee, Management Committee, Council, Council of Management, Governing Board or Board of Directors. In this paper this body will hereafter be referred to as "the Committee"

A Committee on Stock Exchange Reforms in India considered (inter alia) the management of various Indian stock exchanges (14) and succinctly stated the desirable characteristics in a governing body. The Report of the Committee states:

"…. the affairs, of the Stock Exchanges have to be conducted with the highest standards of professional conduct and business ethics and morality to inspire and sustain the confidence of the investing public and the Government. The Governing Body of any Stock Exchange should, therefore, be composed of persons possessing professional competence, wide experience, business acumen, honesty, integrity and proven probity. To be effective and successful the Governing Body must have specific objectives, clear cut perspectives, fair and non-partisan approach to problems, an awareness of the role it is expected to play and the responsibility it has to shoulder in the national economy. The Governing Body must possess necessary vision and foresight to prevent malfunctioning of Stock Exchanges and to avoid crises in the working of the Stock Exchanges by taking timely and effective action and a strong will and determination to stamp out malpractices and unethical behaviour in the conduct of the affairs of the Stock Exchanges so as to ensure fair and equitable trade practices. It must also display firmness and courage in taking strong disciplinary actions against erring members in order to ensure smooth and efficient functioning of the Exchanges. Only such a Governing Body can command respect of the investing public and enhance the image and credibility of the Stock Exchanges in the eyes of the public."

The securities industry is highly specialised and sensitive with its own peculiar intricacies and problems. The composition of the Committee is therefore an important issue to be determined. The question to be addressed is whether members of the Committee should be directors of member companies of the Exchange only, or a mix of such members and suitably qualified and experienced independent persons (i.e. not connected with the Exchange) and Government representatives.

There is an argument against leaving the management of the Stock Exchange solely (or even mainly) in the hands of directors of member companies of the Exchange who are dealers/brokers as large sums belonging to investing members of the public are belonging to investing members of the public are involved. Experience has shown that in some countries such bodies have sometimes tended to act in favour of the interests of the members of the Exchange, rather than that of the investors at large; thus the confidence of investors has been undermined and there has been a general feeling that their interests are inadequately protected by such governing bodies. Moreover, in addition to expertise in the trading of securities, management of the securities business requires wide general knowledge and a good understanding of subjects such as corporate finance, accountancy, law, economics, taxation, investment and financial analysis etc. Accordingly, there is a case for appointing as members of the Committee eminent persons who are not members of the Exchange but who are professionals with wide knowledge and experience in corporate matters.

The securities legislation in some countries (for example in Singapore, Malaysia, India) empowers the Minister to appoint to the Committee, from time to time, one or more persons knowledgeable about the securities industry and not associated with a trading member or his representative, to represent the public interest. Such a person has the same rights, powers, obligations etc., as any other Committee member. The appointment is for a period specified by the Minister and may be revoked at any time.

Government representation on the Committee of a Stock Exchange could assist in building public confidence in the Exchange and in facilitating the system of co-regulation which is desirable. It seems reasonable that if a Committee is to be representative of various interests and is to be seen as performing its functions impartially, then it should be comprised of members of the Exchange, independent members and representatives of the Government.

(iii) Listing Rules

A company wishing to list on a stock exchange must comply with the relevant listing rules determined by the stock exchange concerned.

In addition to any information which may be required under the Companies Act, listing rules usually require companies to provide detailed information about their affairs so that the stock exchange can satisfy itself that the company is suitable for listing. Listing particulars must contain all such information on the issuer and its securities as investors and their professional advisers will reasonably require for the purpose of making an informed assessment of, among other things, the prospects of the issuer and the merits of a particular investment. Information required on the issuer include details of assets and liabilities, financial position, profits and losses and future prospects. As regards securities, the rights attaching to them must be stated. The precise information required varies according to the nature and circumstances of different cases.

In order to accommodate companies of varying sizes and characteristics different tiers (or boards) for listing have been established in various stock exchanges with different listing criteria whereby the requirements for listing of smaller and less mature companies on the second tier market are less onerous than for the first tier market. In time, companies on the second tier may graduate to meet the listing requirements of the first tier. The disclosure requirements in respect of each tier may be the same or may vary from tier to tier as determined by the Stock Exchange. Within the same tier there may be different requirements for different categories of companies, for example, for companies in the field of mining or property development and for different securities.

(iv) Trading and Settlement Rules

(a) Trading Procedures

In general, there are two types of trading which are practised:

1. Call-over system or conventional auction system; and
2. Two-way auction system.

In the call-over system, quoted securities are called over in alphabetical order by an official of the Exchange. The sellers make their offers and when a buyer and seller agree on a price, a bargain is complete. This system is suitable when the number of listed securities and the number of transactions are small. With an increase in the number of listed securities, the number of brokers and the number of transactions on stock exchanges, this system has usually been replaced by the two-way auction system in many countries.

In the two-way auction system, buyers compete with each other to purchase at the lowest possible price the securities which they wish to buy. Simultaneously, sellers compete with each other to get the highest price. When the buyer bidding the highest price and the seller offering the lowest price agree on a figure which is acceptable to each, a transaction is made. Under this system completion of transactions in a large number of listed securities can be quickly achieved.

In a number of developed or newly industrialised countries a system of computerised transactions has been introduced and it is no longer necessary to go to the trading floor to complete a transaction. The buy and sell orders are recorded in the computer and when buy and sell orders match, a transaction is concluded.

In the computerised trading system the mechanics of two-way auction system are followed.

A limitation of the call-over system is that different securities cannot be traded at the same time and the system can therefore be time consuming. There is no such limitation on the two-way auction system which can more expeditiously cope with a greater volume of work.

Given the likely volume of business in new exchanges in developing countries in the initial years, it is likely that the call over system will be more suitable in the first instance. A shift to the two-way auction system or the computerised trading system may be considered later when the volume of business warrants the change.

(b) Settlement Procedures

Detailed rules relating to settlement procedures governing all aspects of settlement of deals between members and members and members and their clients will need to be established for any new stock exchange. A decision will also need to be taken on whether dealings between Members of the stock exchange will be settled either:

(i) directly between the members, or

(ii) through a clearing house.

In the first case, the selling member will deliver shares to the buying member who will make the payment to the selling member. This system is more common where the number of brokers and the volume of business are small.

Alternatively, a designated bank could be appointed in the first instance as a clearing house to deal with delivery and payment on behalf of members.

SECTION C

FINANCIAL POLICY CONSIDERATIONS

With countries moving rather rapidly from command economies to market-oriented economies, there is increasingly a tendency to turn to market forces to lead and sustain economic development. Also, with concessionary foreign aid dwindling and commercial bank lending drying up, developing countries are recognising the need for attracting both domestic and foreign capital through direct and portfolio investment. Given these trends, there is growing anxiety on the part of developing countries to establish or strengthen domestic capital markets and, as already noted, in that process to establish Stock Exchanges. Many of them seem to see a Stock Exchange as a panacea; sceptics in those very countries see them as unnecessary 'super structures', which could lead investors astray.

A stock market clearly has certain advantages. It provides an effective mechanism for funding large-scale capital assets; where there is a credit squeeze it provides an alternative method of financing enterprise. It helps to promote and mobilise savings and the equitable distribution of wealth in the society. It increases the solvency and efficiency of local firms and encourages the development of accounting and information systems. It could in turn lead to the creation of Venture Capital Funds to finance new and growing businesses.

There are also disadvantages. There are the setting up and operating costs; there are also the costs of financial intermediation. In addition, there is the cost of regulation. Perhaps, the most serious disadvantage is that the securities traded on stock markets fluctuate in value and such fluctuations can be to the disadvantage of both the investors and the financial system as a whole as the October 1987 crash has illustrated. Fluctuations could undermine general economic confidence and thereby strike at the very objectives which led to the establishment of a Stock Exchange.

A Stock Exchange is not a stand alone institution. It cannot be expected to succeed and thrive irrespective of the state of the economy. There are therefore certain pre-conditions for the successful establishment of a Stock Exchange and any developing country attempting to do so would need to look at these pre-conditions. In other words, the first step in the establishment of a Stock Exchange would be to carry out a detailed feasibility study.

A Stock Exchange is basically a market place for the sale and purchase of stocks and securities and obviously there cannot be a sale or a purchase if there are no instruments to buy and sell.

In carrying out a feasibility study, therefore, one would have to look at the supply and demand sides rather carefully. On the supply side as a rule of thumb one would expect the existence of at least twenty strong well-established companies whose securities would be available for trading. Some countries have started with fewer. However, to ensure the long-term viability of the market, market depth is important. Also there should be at least 25% of the shares of each listed company for purchase by completely new investors. This "flow" of shares is important to ensure liquidity.

A Stock Exchange would usually draw its listings from four principal sources: existing public companies, private companies wanting to go public, parastatals being fully or partially privatised, and foreign companies willing to divest a proportion of their shares in the local market. Obviously, there have to be either compulsions or incentives to make these companies list. Public companies must find accessing funds through a Stock Exchange more attractive as compared to alternative methods of corporate financing, even after providing for tax deduction at source, the cost of issuance and continuous financial reporting. Equally, private companies need to be provided with incentives to go public and widen the base of the ownership of their enterprises. Enlightened policy decisions need to be taken to bring governments' holdings in parastatals partially or fully into the market. Companies would also need to be satisfied that the structure and management of the Stock Exchange, the provisions for listings, the provision relating to the disclosure of information, trading and settlement procedures and, above all, the regulatory framework would ensure fair play and give each one of them an equal opportunity to tap the capital market for additional resources.

On the demand side, there have to be measures to increase domestic savings. These have to be supplemented by education to divert those savings into the market. In other words, confidence has to be created in the investing public to place their savings in stocks and securities. The market has to have both the necessary depth and liquidity to meet the requirements of the investor. The investor has to be assured that the entire regulatory framework and legislation will operate in a manner that would ensure total fair play in the market and that his interests would be fully protected. There are also the institutional investors like insurance funds, pension funds, etc in whose case enabling legislation may be necessary to permit investments through the Stock Exchange. Basically, stocks and shares should provide the investor with returns which are at least comparable with, if not better than, the returns he could obtain from alternative sources. To achieve this, it would also be necessary to provide certain tax reliefs such as relief in respect of Capital Gains Tax, Dividend Tax, etc.

Even if the supply and demand sides were strong, there is the need for a strong and healthy intermediation between the two; i.e. there have to be well-trained and responsible financial intermediaries who, without any conflict of interest, would be available to act on behalf of the seller and the buyer. Measures have to be taken to create such financial intermediaries and ensure that they adhere to a set of severe guidelines and code of conduct.

Policy and action is therefore necessary in different areas of the economy before a Stock Exchange can be effectively established. While the creation of a Stock Exchange itself can be an initiative in the private sector, clearly the enabling legislation and the regulatory framework should be in the area of public policy and such policy has to be developmental in its approach and has to create the necessary atmosphere that would attract both the companies to list and the public to invest. Governments in developing countries have, therefore, an important role to play in the establishment of a Stock Exchange. Government policy on privatisation and divestment of shares in relation to the corporate sector has to be geared to the promotion of an increased flotation of public companies and to the strengthening of the supply side. And, lastly, there is the major area of tax reform without which operations on the stock market could become totally unviable.

While this paper considers at length the various issues that need to be considered before legislation can be drawn up to provide for the successful establishment and operation of the Stock Exchange, issues that would impact on the supply and demand sides need equal attention. In fact, unless measures to strengthen the supply and demand sides are taken imaginatively, legislation alone will not help. A good architect can produce an attractive and well-designed swimming pool, but there needs to be water to swim in, water of sufficient depth and breadth to attract both learners and divers.

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Problems of Emerging Markets: A Review of Issues

A Paper by the Commonwealth Secretariat

Commonwealth Secretariat
Marlborough House
Pall Mall
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PROBLEMS OF EMERGING MARKETS
A REVIEW OF ISSUES

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PROBLEMS OF EMERGING MARKETS
A REVIEW OF ISSUES

There is now greater appreciation within developing countries of the importance of equity markets. The emerging equity markets in developing countries, 30 of which had a capitalisation of $620 bn in 1989, have quintupled in size over the last five years in $ terms and are providing an important mechanism for mobilising domestic savings and for attracting foreign capital in non-debt creating forms. While there are certainly many problems, it is important to emphasise the opportunities that successfully dealing with them can provide. This paper makes some comments on the benefits of having a strong equity market, lists the main problems and suggests some possible solutions.

I. Introduction

Most developing countries have some form of an equity market although many of these markets are, as yet, embryonic or dormant. Some have a considerable history with, for example, the informal trading of shares in Bombay dating back to the 1830s. The International Finance Corporation (IFC) monitors some 19 emerging markets on a weekly basis and keeps less detailed track of a further 11. Together the market capitalisation of the 30 markets totals about $620 bn with over 7,000 companies listed (with Bombay alone accounting for over 2,000). Market characteristics vary widely. At one end of the spectrum, Taiwan's market is speculative and dominated by the individual retail investor while in contrast other markets may be dominated by passive holders of stock, frequently family owners, banks and institutional, including government, holders.

In the developing Commonwealth there are several markets that are long established and regarded as being among the leading emerging markets (Singapore, India, Malaysia, Pakistan, Zimbabwe, Kenya and Nigeria - only the last being a post-independence, government-sponsored, creation). Singapore, like Hong Kong, is now far larger than most European markets and is no longer seen as 'emerging'. A few others operate on a smaller scale (Sri Lanka -where a securities exchange was established in 1889; Mauritius, which has had informal share trading since the early 19th century; Bangladesh, Jamaica, Barbados, Trinidad and Tobago and Botswana) while others are being planned (Cyprus, Malta and Ghana). Among the many small states that do not have an organised market, a few public companies may be listed on regional markets (e.g. Papua New Guinea enterprises in Sydney or Singapore) and other shares of public companies tend to be traded informally.

II. Features of Emerging Markets

There are several distinctive features of emerging markets:

* Most are small, though Brazil, India, Malaysia, Korea, Taiwan, Thailand, compare with medium-sized developed country markets like Milan or Amsterdam. (The six countries accounted for 85 per cent of the total emerging market capitalisation in 1989). In many instances the smallness relates

usually to market values than to numbers of listed companies. India, for example, has almost as many listed companies as New York, Tokyo and London combined.

* Trading volume is limited because of the closed character of most companies. Thus turnover is usually low (less than 20 per cent as compared to 60 per cent in the United States), though some very active markets (e.g. the six noted above) compare well with major markets.

* Individual shareholding is much more narrowly based than in mature markets.

* Equity comprises a small proportion of financial assets but some developing countries have a significant equity contribution (Malaysia).

III. The Importance of Securities Markets

Many developing countries had an ambivalent attitude towards their equity markets. Neglect was due in part to a bias against the private sector, and financial sector distortions in favour of borrowers (partly reflecting a desire to finance the public sector cheaply) and the greater use of loan funds to finance industry. There was not much interest in encouraging foreign investment, especially foreign portfolio investment. Attitudes are, however, changing as part of an overall shift in favour of private sector-led development as well as by the need to attract foreign capital in non-debt creating forms.

A well functioning equity market:

- provides an additional channel for encouraging and mobilising domestic savings;

- fosters the growth of the domestic financial services sector;

- provides savers with greater opportunities to protect themselves against inflation;

- increases the overall efficiency of investment;

- facilitates privatisation;

- helps dispersal of ownership from traditional industrial and financial interests;

- improves the 'gearing' of the domestic corporate sector and helps reduce corporate dependence on borrowing; and

- provides through equity-related financing a cushion for companies against the variability of cash flow and even possible losses.

It is worth stressing, however, that the equity market in no way detracts from the importance of long-term debt financing which relates to supply and demand needs. The crucial point is that it is important to ensure that government policies improve the status of equity markets to allow them to fulfil their key role of providing equity finance, and to complement the banking system's more conventional short-term working capital financing. At the same time, it is important that commercial bank financing should neither enjoy undue encouragement nor face barriers.

IV. Some Constraints in Emerging Markets

There are obvious problems in emerging (as well as in some mature) markets: potentially high levels of instability caused by market over-reaction and confidence factors; high costs, especially where intermediation (underwriting, dealing, broking) is underdeveloped; and the manipulation of markets by shareholders (individual or institutional) where supervision and regulation are inadequate.

In addition to economic and political fundamentals, tradeability (liquidity) is one of the key qualities sought after by investors. There is usually a shortage of stocks in emerging markets that meet this criterion. This partly reflects the under developed nature of equity markets in general. It also reflects the fact that, among the stocks listed in the markets, many are usually not traded due to lack of depth in the market. Another potential problem frequently encountered in developing stock markets is the lack of float, that is, the percentage of a company's capital available for stockmarket trading to outside investors rather than being held by the major existing owners.

There are other risks confronting investors.

* Accounting standards are often poor and the quality and timeliness of company and market information inadequate.

* The underlying worth of securities is difficult to estimate, not only because of unreliable company information, but also because of distortions in some markets due to flotation pricing policies (India), much speculative activities (Taiwan), and lack of sufficient trading (for example where family or government holdings predominate); and because of lack of full transparency in inter-company ownership e.g. in the case of quoted affiliates of holding companies that are controlled by family interests.

* Insider trading is often uncontrolled and political interference can also add to risks in the market.

* Transactional efficiency in stock markets is widely regarded as improving but supervisory standards are uneven. Lack of price transparency (i.e. immediate publication of the true price at which deals are struck) is another risk factor.

V. Factors Influencing Demand for and Supply of Stocks

A viable equity market requires a sufficient demand for and supply of stocks. Supply and demand are however intrinsically linked. The number of investors is as important as adequate stock issues. Too few stocks may deter investors from entering the market; later, when trading is active, too many investors may be chasing too few stocks, adding to price volatility. Thus, a balanced increase in both demand and supply of stocks is essential. However, freer international trading in securities is helping to offset some of this volatility, although it exposes the local market to international market movements. On the whole, the greater integration that has begun between the emerging markets and the international markets should be beneficial to the emerging markets: more capital could be tapped, local savers get higher competitive returns and investors are forced to become more efficient.

While demand and supply depend on a number of factors, the following are of interest:

* In most emerging markets the individual retail market is small - less than 1 per cent of the population (India: 2.5%), compared with about 10 per cent in developed countries. Individuals who dominate stock holdings are family owners of companies rather than the household saver. Overseas remittances from migrants are an important source of demand for stocks both in the form of direct investment and through mutual funds in select countries. Individual demand, in general, is a function of the number of financially sophisticated individuals in a country; other investment alternatives; awareness of the stockmarket and of shares as an investment medium as well as adequate disclosure of information on traded stock.

* In most emerging markets the main demand is from institutions such as insurance companies, pension, provident or mutual funds. However, although they are the main players in the stock market, stocks form a small part of their assets. Regulations governing obligatory reserve requirements have a major impact on their investment activities as well as legislation which restrict them to investing mainly in government securities. In many cases, there is not sufficient awareness of the important role these institutions could play both in mobilising long-term savings and in channelling them to equity markets. Their full participation in the stock market could be a significant source of stability.

* Foreign portfolio investment has acquired great significance in several emerging markets, mainly through the vehicle of offshore country and multi-country funds. Some 50 country and multi-country funds have been launched to invest in emerging markets over the past five years, raising about $4 bn for investment mainly in the successful economies of Asia, as well as in the indebted countries of Latin America and Eastern Europe. A recent study by WIDER has estimated that by the year 2000, foreign portfolio investment in emerging markets could total $100 bn.[1] If developing countries take steps to reduce barriers to foreign portfolio investors in terms of access, taxes on dividends and capital gains and repatriation of capital and income and to increase the supply of 'suitable' stock, the figure could be much larger.

* In many emerging markets, the supply of stock could depend significantly on the attitude of existing owners to allowing others into the company and opening up their books. This may depend upon

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1 World Institute for Development Economics Research (WIDER) of the United Nations University, Foreign Portfolio Investment in Emerging Equity Markets, Helsinki, March 1990.

whether the companies are still managed by the original owners or whether professional managers have been brought in; and the need for a sizeable amount of additional capital that could not be met by internally generated cash flows or by commercial bank financing. However, no incentives can overcome the obstacle of unrealistically low or artificially influenced prices. In many countries, for example, the prices at which shares can be sold to the public are determined by government authorities on the basis of par or book value.

* Finally, where governments dominate the ownership of major enterprises they may be in a position to increase the supply of stocks available for trading by <u>privatisation</u>.

VI. Policy Issues Related To The Development of Equity Markets

There are several basic pre-requisites for the establishment and continued success of an equity market. Apart from requiring a reasonably stable political environment, launching an equity market is virtually impossible in a climate of high inflation, directed credit, unstable interest rates, unrealistic exchange rates and high budget deficits.[2] Once progress has been made on the macro-economic front, conditions improve for a viable equity market to develop.

(i) Fiscal and Monetary Policies

In a number of countries, tax and monetary policies taken together tend to favour debt rather than equity financing. When interest rate policies are generally held below inflation levels for sustained period or loans with a large subsidy element are easily available, companies prefer borrowing rather than issuing shares. They also discourage savers from holding equities. Many countries, even some with strong equity markets, discriminate against equity by high rates of tax on dividends and capital gains. In contrast, interest on bank deposits and government bonds may have zero or low rates of tax. Corporate tax regimes also tend to treat interest costs as a tax deductible expense. This introduces a bias in favour of debt rather than equity, as debt is lower cost financing. It is still the popular opinion that profits on stocks are the fruits of speculation and thus are deserving of a higher tax rate than income which is regarded as genuinely earned. The case must increasingly be made that profits earned from taking entrepreneurial risks should receive better tax treatment, as they are a fair compensation for the high risks involved in financing business expansion.

Fiscal policies can be used to provide incentives to both increase the demand for shares and for companies to go public and thus increase the supply of stock. Examples of <u>demand</u> incentives are:

- tax exemption or reduction for capital gains on shares of listed companies;

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[2] see also Macro-Economic Policies and Financial Development, a paper by the Commonwealth Secretariat, ... which deals with this theme more extensively.

- total or partial exemption of tax up to a certain amount for dividends;
- special tax credits or deductions for individuals and possibly companies investing in shares of publicly held companies;
- tax-deferred retirement plans to stimulate long-term investments in shares and bonds; and
- freedom from tax on share transfers of listed companies.

These incentives should, of course, be adopted keeping in mind equity considerations and other fiscal objectives such as the need to preserve a neutral tax regime.

The most widely used supply incentive is a lower corporate income tax for public companies than for privately held companies. An exemption from or reduction of tax paid on the profits arising from flotation is also a strong incentive for privately held companies to go public.

(ii) Investor Protection and Regulatory Systems

An adequate legal framework to protect investors, especially minority shareholders, is essential to build confidence. Protection typically includes deterrence of insider trading, requirements relating to disclosure and financial reporting, accounting and audit standards, listing, margin loans, trading floor procedures and professional standards. Changes in company laws are required to allow securities underwriting and trading. Items which need to be covered include the easy transfer of shares; ownership registration in the name of intermediaries such as brokers, and regulations on take-overs. However, it is politically impossible, and in practice often not feasible, to introduce too many rules at the same time. "Overkill" can easily strangle a stock market during its early growth; it is desirable to introduce legislation in distinct stages. On the other hand, too gradual an approach could lead to uncertainty and confusion.

Three models for market regulation can be found in emerging markets. In securities markets based on the United States model (such as in Pakistan, Nigeria, Korea and most of Latin America), the securities commission plays the major role through extensive securities legislation. The law is comprehensive covering the regulation of both primary and secondary markets and the monitoring of stock exchange(s), underwriters, dealers, brokers and investment managers. Such laws provide standards for disclosure, accounting and auditing and penalties against price manipulation and insider trading.

In securities markets, based on the British model (used with modification in Malaysia, Zimbabwe, Kenya, Singapore), self-regulation is the dominant factor. It relies not on comprehensive securities legislation and a securities commission, but on listing requirements, codes of behaviour, and self-regulation by members of stock-exchanges. There is no specialised, separate and comprehensive body of securities legislation; regulatory provisions are incorporated in more general legislation such as company laws, mergers and acquisition codes etc. An advantage of this system appears to be greater informality and flexibility. Disadvantages may be the lack of regulatory rigour to discipline those who abuse the system, a bias favouring brokers rather than investors and the potential exploitation of loopholes between various laws.

Several recently reorganised markets have chosen a new approach by combining the functions of the securities commission and stock exchange. This approach is similar to the United States model, since a comprehensive capital market law forms the basis of the regulatory framework. What is perhaps different in this approach is that the developmental role - as opposed to the "protective" role - is explicity recognised. This type of model appears to function well during the early stages of development of a securities market when it is likely to be more cost effective than a separate securities commission and securities exchange.

(iii) Institutional Development and Stock Exchanges

(a) Financial intermediaries

An equity market cannot function without brokers, dealers and underwriters for issuing new securities and trading in existing ones. Brokers handle the mechanics of completing trades, the transfer of shares and the payments involved. Dealers make a continuous market in shares, step in when price gaps develop and smooth out price fluctuations. Underwriters assist companies in going public and raise capital by taking the risk of buying whatever portion of an issue is not sold to final investors. They also help to structure the deal, write the prospectus, find investors and handle the mechanics of the distribution process.

A well organised securities industry typically includes a number of brokerage houses. Some of them may provide the full range of investment banking services from trading in shares, bonds and money market instruments to underwriting, investment management and financial advisory services.

There is some evidence that, especially in emerging markets, specialisation within the financial system, whereby merchant banks and brokerage firms participate only in capital market activities and commercial banks only in banking, results in a faster development of the equity market than otherwise.

In addition to the financial institutional structure, there are various technical issues which are of minor importance compared to the broader issues discussed above, but collectively can inhibit professional investors and detract from the efficiency of the equity market. These include:

* Clearing and settlement: these cover one of the most complex areas in the handling of financial market transactions. Settlement periods can vary between immediate delivery of cash in exchange for a bearer share certificate to settlement in a two-month period. The longer the gap between an execution and its settlement and then the clearing and ultimate transfer of the shares into the name of the new owner, the greater the risk of things going wrong. Not only can honest errors occur and pieces of paper become lost, but also participants in transactions can fail to settle, either deliberately if they are speculators and the market has gone against them, or for reasons beyond the control of even the most responsible investor.

* Transfer of Title: In one sense this is part of the clearing and settlement issue. However, it is of ongoing importance in that, ultimately, a purchaser of securities needs to know that title has been transferred to his name both so that dividends, rights to new share issues etc. will be credited

automatically as well as for selling his shares when he wants to. There are complete breakdowns in some stock markets when volume increases rapidly. Outdated company laws may stipulate complex transfer procedures and company registers are often maintained manually. In instances, it may take from two weeks to several months before transfer of title actually takes place.

In a number of markets (Brazil, Korea, Mexico, Chile and Thailand) automated clearing and depository facilities have been established which eliminate the need for the actual transfer of share certificates by holding them centrally in the name of the brokerage house or investors. Malaysia is planning such a system from next January and India already has a Stock Holding Corporation for institutional investors and is planning to allow individuals also to use its services.

* Availability of Information: This includes appropriate, timely and accurate information from companies to investors; as well as on the prices and volumes of transactions and to have this information disseminated promptly to all investors at the same time. Abuses occur in those markets where the stock exchanges are not required to post trades as they occur and to report them daily in the press, and where companies are not required through similar regulation to make appropriate information available simultaneously to stock exchanges and the press. The essence of insider trading lies in some actors taking advantage of new information before the investing public at large has acquired it.

* High Transfer and Stamp Taxes: Many countries have such taxes, ranging up to 1 and 2 per cent of the face value of securities transactions. They are intended to be revenue producing but the effect is usually the opposite as they impede trading.

* Automation: Trading by computer has not yet been introduced in any of the emerging markets, although many have installed computer systems to record trading transactions upon execution between the brokers. Such computerisation facilitates the maintenance of daily records and subsequent settlement between the brokers. It also allows some control over price collusion, and makes possible the immediate display of price movements to the general public.

VII Conclusion

The action governments need to take to strengthen their domestic markets will obviously depend on the stage they have reached and progress made on the macro-economic front and in encouraging the establishment of stock exchanges. Several governments are actively seeking to create or improve markets. In some cases this is linked to opening their markets to foreign investors. A checklist on reform and improvements include the following:

(a) Are the roles of the various government agencies clear? Which agency (e.g. Ministry of Finance, Central Bank) will supervise equity markets? Will an independent securities commission be appointed and, if so, by whom?

(b) Is there an anti-equity bias in the tax system (e.g. double taxation of dividends or interest rate subsidies or both)

(c) Is tax reform planned? Are there plans to ensure that contractual savings institutions such as pension funds and insurance companies participate more effectively in the equity market?

(d) Has action been taken to creating specialised equity-financing institutions (e.g. Unit trusts and mutual funds) to act as a conduit for investors' savings, assist in spreading risks, and aid fledgling capital markets?

(e) Are attempts made to enforce strict accounting and auditing standards?

(f) Are company laws and procedures to facilitate primary issues, investment in and trading of securities, kept under review and reform as needed?

(g) Are the institutions needed to provide support for primary and secondary markets established? For example,

- stock exchange and over-the counter markets;
- securities brokers and dealers;
- underwriters and market makers;
- securities custodians;
- depository and clearing institutions;
- fund Managers;
- securities analysts and financial information companies;
- credit rating agency;
- venture capital firms?

(h) Are the telephone and communication services adequate?

(i) Is there a regulatory environment to ensure the disclosure of corporate and market trading information to facilitate registration and regulation of securities markets and measures to provide adequate investor protection?

Despite the adoption of policy reform, realism requires the recognition that equity markets would be slow to develop because of the small size of many economies and because of the existence of deep-rooted barriers such as resistance to dilution of family control of companies; fears of government interference and tax authorities following public disclosures; as well as traditional ties to investing in gold, real estate and bank deposits. Success breeds success and these barriers can only be gradually overcome as equity markets improve and seen to be so both by companies and for investors.

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9 Toward more liberal and open financial systems

A number of countries, both developed and developing, have taken steps to liberalize their financial systems during the past decade. Interest rates have been liberalized in Argentina, Australia, Chile, France, Ghana, Indonesia, Japan, the Republic of Korea, Malaysia, New Zealand, Nigeria, the Philippines, Sri Lanka, Turkey, the United States, and Uruguay. In other countries, such as Thailand and Yugoslavia, interest ceilings have been managed more flexibly than before. Several countries, such as Chile and Korea, privatized their commercial banks. Argentina, Chile, Pakistan, and Turkey reduced their directed credit programs, and interest rate subsidies were reduced or abolished in Korea and the Philippines.

Several factors prompted these shifts in policy. During the past decade many developing countries began to place greater emphasis on the private sector and on market-determined pricing. In higher-income countries, the inflationary shocks of the 1970s and early 1980s underscored the limitations of regulations on interest rates and credit. Rapid advances in telecommunications and information processing have spurred the development of new financial instruments and have promoted greater financial integration both domestically and internationally. This has made it harder for governments to control financial markets.

The lessons of reform are obscured by difficulties in interpretation. The starting point and the pace and breadth of financial reform varied among countries, and it is difficult to disentangle the effects of financial reform from those of other reforms that were taking place at the same time. Overall, though, it seems clear that financial liberalization has helped to mobilize resources through the formal financial system and to improve the efficiency with which they are used.

The task of reform is not straightforward. This chapter discusses the pitfalls to be avoided in the transition from a regulated financial sector to one that is more market-oriented. It also discusses the issues raised by the integration of a country's financial system with international financial markets.

Recent experiences with financial reform

The pace and scope of reform have differed substantially from country to country. Financial sectors in most of the high-income countries were already mature and market-based, and reform focused on eliminating controls and thereby promoting competition. In some developing countries, however, financial systems were heavily repressed before reform. Three countries in Latin America—Argentina, Chile, and Uruguay—shifted within a few years from highly controlled to largely uncontrolled finance. The Philippines and Turkey also eliminated most of their interest rate controls within a very short period, but they did not undertake major financial reforms in other areas. Elsewhere, reforms were even more limited and were introduced more gradually. Some developing countries—Malaysia, for instance—already had market-oriented systems, but in others, such as China, the overall economy remained controlled. The process of reform was frequently interrupted when political resistance or deteriorating economic conditions forced governments to slow or even to reverse liberalization.

With few exceptions developing countries introduced financial reforms in periods of economic stress as part of stabilization and structural adjustment programs. But the degree of stress also varied among countries. For example, Argentina, Chile, Turkey, and Uruguay had large fiscal deficits and suffered from inflation of between 50 and 200 percent in the five years before financial reform. In contrast, Indonesia, Korea, Malaysia, and New Zealand had relatively low levels of inflation both before and after financial reform. Although these countries were also attempting to stabilize their economies and restructure their trade and industrial sectors, their reforms were quite different because they were conducted against a more stable background.

Southern Cone countries

Three of the most dramatic and far-reaching programs of financial reform were carried out by Argentina, Chile, and Uruguay in the mid-1970s. The measures included the lifting of controls on interest rates and capital movements (local banks were allowed to offer dollar-denominated loans and deposits), the elimination of directed credit programs, the privatization of nationalized banks, and the lowering of barriers to entry for both domestic and foreign banks. These reforms were implemented relatively quickly, during periods of high and volatile inflation, and as part of broader programs of stabilization and liberalization. Each program encountered serious difficulties, partly because of the way in which financial deregulation was handled and partly because of problems in the real sector.

Following the reforms in Chile, inflation declined from 600 percent in 1974 to 20 percent in 1981. In the face of decelerating inflation, the real interest rate rose to extremely high levels: lending rates were more than 30 percent in real terms in the years between 1975 and 1982. In Argentina and Uruguay, in contrast, inflation remained high and volatile. As it surged from time to time, real interest rates fell, but even so they were often very high in both countries.

All three governments tried to change deep-seated inflationary expectations by publishing a schedule of preannounced changes in the exchange rate. These schedules (*tablita*) allowed for a slowing rate of devaluation and were intended to convince the public that the domestic rate of inflation would gradually converge with the international rate. Similarly, the countries liberalized their capital accounts to bring domestic and foreign interest rates into line. It was hoped that these measures would hasten the return to low inflation and at the same time bring down the countries' high domestic interest rates. Inflation, however, stayed higher than the rate implied by the tablita, and as a result the real exchange rate appreciated considerably and exports and output suffered. The wide differentials between high domestic and lower foreign interest rates, together with preannounced changes in exchange rates, promised very high returns and attracted large inflows of capital. These in turn caused rapid monetary expansion and made it difficult to control domestic demand. The lack of effective regulation and supervision allowed speculation and reckless lending to go unchecked.

To restore external balance in the early 1980s, all three countries had to devalue their currencies substantially. These and other measures were necessary, but, together with persistently high interest rates, they added to the financial distress of the corporate sector, and many financial institutions failed. By one estimate, the nonperforming assets of Chile's banks amounted to 79 percent of capital and reserves in 1982 and to more than 150 percent in 1983. The monetary authorities in all three countries were forced to rescue failing banks. Monetary expansion, partly caused by these efforts to assist the banks, undermined the governments' broader adjustment programs and jeopardized financial liberalization. Argentina and Chile were both forced to reintroduce direct controls on their financial sectors. But after nationalizing its failed banks, Chile resumed its liberal policies. It began a long-term program to rehabilitate and reprivatize the banks and to put in place a sound system of prudential regulation and supervision. Argentina, too, has been gradually liberalizing since it reimposed direct controls.

The financial crises in the Southern Cone countries were caused by macro- and microeconomic problems at home and shocks from abroad. Within a brief period firms faced rapid changes in relative prices, a fall in domestic sales, sharp increases in interest rates, a major devaluation of the currency, and a sudden termination of external credit. The biggest problems began in the real sectors of the economy, but efforts to liberalize the financial sector undoubtedly contributed to the resulting instability.

The Philippines and Turkey

The Philippines and Turkey have also reformed their financial systems, which were once heavily repressed. Their reforms, however, centered on freeing interest rates. In the early 1980s the Philippines liberalized interest rates and allowed commercial banks to provide a much broader range of financial services. In the first years after the reforms, interest rates rose to about 10 percent in real terms, and the financial sector grew rapidly. But when the country suffered serious macroeconomic instability during 1983–85, a widespread financial crisis developed.

Beginning in the late 1970s the Philippines pursued expansionary policies to sustain high economic growth despite a world recession. The fiscal deficit increased from 0.2 percent of GNP in 1978 to 4 percent in 1982, and the current account deficit rose from 5 percent of GNP to 8 percent over the same period. Political uncertainty reinforced a gradual loss of confidence in the domestic economy; capital began to flow abroad just as the supply of foreign finance began to dry up. A smaller external deficit in later years was made possible only by sharp cuts in imports and domestic absorption. The peso devaluation of 1983–84 and the large fiscal deficit caused inflation to rise to 50 percent in 1984. In that year the government implemented a stringent stabilization program that included the sale of new high-yield instruments by the central bank, with the aim of slowing monetary growth. To keep their deposit base in the face of this new competition, banks and financial companies also increased their interest rates, which at times rose to more than 20 percent in real terms. The highly leveraged corporate sector thus faced mounting financial strain.

Financial distress in the corporate sector, bad management in the banks, political corruption, and inadequate regulation and supervision all led to a rapid deterioration in the balance sheets of financial institutions. Eventually the crisis forced the government to intervene. A number of smaller banks were taken into the public sector, and the two largest banks, both government-owned, were radically reorganized. Between 1980 and 1986 the banking system's assets shrank 44 percent in real terms.

Until 1980 the Turkish government maintained strict control of nominal interest rates. Inflation was high, and real interest rates were negative. In 1980 the government removed the controls and allowed banks to issue negotiable certificates of deposit (CDs). At the same time it embarked upon a stabilization and structural adjustment program. The financial reforms were short-lived, however. Two years later, after financial difficulties, the central bank reimposed ceilings on deposit interest rates.

Turkey's liberalization program differs from the others in several respects. The government's budget deficit declined between 1980 and 1982, which took some pressure off the financial markets. The government did not liberalize capital flows between 1980 and 1982 and thus avoided some of the complications that plagued the Southern Cone countries. The annual inflation rate, as measured by changes in the wholesale price index, declined from more than 100 percent in 1980 to 25 percent in 1982. Real interest rates increased sharply during the stabilization period. The domestic currency depreciated in real terms, GNP growth became positive after two years of contraction, and the composition of demand shifted from domestic absorption toward exports. Turkey appeared to be on the right path.

These macroeconomic changes, however, hit corporate profits and left businesses struggling to adjust. Financial problems in the corporate sector then caused distress in the banking system. Nonperforming loans, especially among smaller banks, prompted intense competition for financial resources. Banks that needed liquidity increased their deposit rates. Bigger banks tried to limit this competition with a gentlemen's agreement on interest rates, but they failed and the competition continued. Banks also issued large volumes of CDs through brokerage houses (which offered higher interest rates), even though this practice was prohibited after 1981. Additional financial resources were used to meet immediate obligations and to refinance nonperforming loans: in other words, many insolvent borrowers continued to borrow. Indicators of financial depth improved during this period, but a large part of the additional intermediation went to finance interest payments on nonperforming loans.

The government finally intervened in mid-1982. It found that some banks had failed to meet their reserve requirements because of liquidity prob-

Box 9.1 Financial liberalization in New Zealand

New Zealand is an example of a developed country that has made the transition from a heavily regulated financial system to one more reliant on market forces. By 1984 government intervention in finance had become widespread. Most intermediaries were subject to interest rate controls, credit was directed toward preferred sectors such as housing and farming, and intermediaries were obliged to buy government securities at below-market interest rates. Although these policies stimulated investment in housing and agriculture and provided the government with a cheap source of deficit financing, they contributed to slow growth by reducing the credit available for other, potentially more profitable activities. They also undermined financial stability and the effectiveness of monetary policy as financial intermediation shifted to firms less amenable to regulation and to institutions less constrained by prudential standards.

Following the 1984 election the government introduced a new market-oriented strategy. The comprehensive package of structural reforms sought to spur growth and to redress external imbalance by increasing the role of market forces in the economy. Included were trade liberalization, labor market reforms, measures to restore fiscal discipline, and reform of state-owned enterprises (including privatization). In the financial sector the government abolished all interest rate controls and credit directives, floated the exchange rate, introduced market-based tenders for sales of government securities, and established a new system of monetary control. To promote competition among financial institutions, the government encouraged the entry of new banks irrespective of domicile and extended the right to deal in foreign exchange to institutions outside the banking sector. External capital controls were removed to deepen the foreign exchange market. Liberalization was accompanied by strengthened supervisory capabilities. Prudential regulation emphasized the prevention of system-wide failure rather than failures of individual institutions, and the government chose not to introduce a deposit insurance scheme.

It is too early to make definitive judgments on the success of the financial reforms, but the evidence thus far is reassuring. The removal of capital controls did not lead to capital flight—an outcome attributed to the credibility and the comprehensive nature of New Zealand's program of reform. The number of banks operating in New Zealand has risen from four to fifteen. Financial activity appears to have gravitated back toward the banking sector, and the narrowing of some banking margins, especially on foreign exchange transactions and consumer loans, indicates that competition has increased. New Zealand's apparent success suggests the importance of incorporating financial reforms into a broader program of structural reform.

lems. The government merged five insolvent banks with bigger ones, imposed ceilings on deposit interest rates, and increased its monitoring. In the meantime several brokerage houses, including some of the largest, went bankrupt.

While Turkey reregulated interest rates, the Philippines—after substantially restructuring its financial intermediaries—continued its liberal policy. The financial problems of both countries reflected past economic policies and bad bank management. External shocks, structural adjustment, and abnormally high interest rates turned these problems into a financial crisis. The liberalization of interest rates left the corporate sector vulnerable to macroeconomic shocks. In both countries weak prudential regulation and supervision allowed the capitalization of interest and a rapid deterioration of bank portfolios.

Reforms in other countries

Australia, Japan, Malaysia, New Zealand (see Box 9.1), and the United States have all liberalized their interest rates during the past decade. Restrictions on the services that could be offered by different institutions were also reduced or eliminated. Financial systems in these countries were already market-oriented, and the reforms were designed to stimulate further competition and efficiency. With modestly rising inflation in the 1970s and early 1980s, interest rate controls on deposits prevented institutions from competing effectively with unregulated suppliers in the securities markets and Euromarkets. Although the reforms generally improved the efficiency of financial systems, they caused stress for certain institutions such as the savings and loan system in the United States and finance companies in Malaysia. Interest rates in general were affected more by macroeconomic developments than by the financial reforms. Bank deposit and loan rates rose modestly in real terms. Financial depth increased substantially. Interest rate spreads and the dispersion of rates in different market segments narrowed—all signs of greater competition and efficiency.

Other countries that had more repressed systems have also undertaken financial reforms. The scope and pace of reforms, however, have been

Box 9.2 Financial reform in Korea

Korea's heavily regulated financial system was a key instrument in the government's industrial policy of the 1960s and 1970s. Interest rates were controlled and were kept low during most of this period. A substantial proportion of bank credit—well above one-third—was directed by the government to designated sectors. By the late 1970s, however, a growing consensus had emerged that this approach was retarding the growth of the financial sector and preventing the efficient allocation of resources. Confronted with a significant macroeconomic imbalance and slower economic growth, the government changed directions.

Stabilization, structural adjustment, and financial reform programs were all introduced in the early 1980s. The government adopted several measures to encourage competition in the financial market. Nonbank institutions, which were relatively new and lightly regulated, were further deregulated, and barriers to entry were greatly relaxed. Additional foreign financial institutions, including banks and life insurance companies, were allowed to open branches. Commercial banks, most of which had been owned by the government, were privatized. The government eliminated its preferential lending rates and did not introduce any new directed credit programs. At the same time, the authorities fostered greater competition among different sorts of financial institutions by allowing them to offer a wider range of services.

The loans of commercial banks, even after privatization, continued to be closely monitored and supervised. The authorities continued to regulate the interest rates of banks and nonbank institutions, but they partially deregulated interest rates in the money and securities markets. Controls on capital flows were maintained. When inflation started to decline, real interest rates rose, and growing numbers of highly indebted firms found it difficult to service their debts. The government swiftly reduced nominal interest rates, but because inflation declined, real lending rates stayed between 5 and 10 percent throughout the 1980s. By the mid-1980s Korea had established macroeconomic stability: the annual inflation rate fell to 2-3 percent, and the fiscal and current account deficits were eliminated. Industry undertook a major restructuring. The financial sector has grown rapidly in the 1980s, largely owing to the explosive expansion of nonbank institutions and securities markets and, to a lesser extent, to growth in the banking sector. The ratio of M3 to GNP almost doubled between 1980 and 1987 (see Box table 9.2). Building on this progress, the government began the full liberalization of bank interest rates in late 1988. Most lending rates were freed at that time, although deposit rates are still controlled. The government also announced plans to open Korea's financial markets to further foreign participation.

Box table 9.2 Korea's financial sector, 1980, 1984, and 1987

(percentage of GNP)

Indicator	*1980*	*1984*	*1987*
M2	34.2	37.2	41.3
M3	48.6	68.1	94.4
Corporate bonds	4.5	8.0	10.2
Stock market capitalization	6.9	7.8	26.8

Note: M2 is currency in circulation plus demand, time, and savings deposits and residents' foreign currency deposits at the central bank and deposit money banks. M3 is the sum of M2, deposits at nonbank financial institutions, debentures, commercial bills, and certificates of deposit.

Source: Bank of Korea and Ministry of Finance, Republic of Korea.

limited and gradual. In Indonesia the major banks are still publicly owned, but the government has liberalized the credit ceilings and interest rates of public banks and shifted control to the banks' managements. Certain categories of deposit and loan rates, however, remain controlled. Korea also changed its financial policy in the 1980s, moving away from heavy regulation to a more market-oriented approach. These reforms have led to rapid growth in the financial sector (see Box 9.2). Financial reforms in Greece, Morocco, Portugal, and Tunisia have included a substantial reduction in directed credit programs, an extensive—although far from complete—liberalization of interest rates, and efforts to develop money and capital markets.

Latin American countries, other than those of the Southern Cone, have proceeded much more cautiously. Several countries, particularly Brazil and Mexico, were more successful in building balanced and diversified institutional structures. But financial reform there and elsewhere in Latin America was hindered by the failure to reduce inflation.

In Sub-Saharan Africa financial reforms are in place or under way in several countries, including Côte d'Ivoire, Ghana, Guinea, Madagascar, Mozambique, Nigeria, and Tanzania. The objectives are to restructure institutions, improve regulatory procedures, and prepare the way for a greater reliance on markets. The centrally planned economies have also undertaken some financial reforms that involve higher interest rates and somewhat greater competition in the provision of services.

Lessons of reform

These attempts at financial sector reform point to certain pitfalls, although the longer-term benefits are considerable. The clearest lesson is that reforms carried out against an unstable macroeconomic background can make that instability worse. Complete liberalization of interest rates in countries with high and unstable rates of inflation can lead to high real interest rates and wide spreads between lending and deposit rates. Furthermore, it did not prove possible in unstable economies to prevent the real exchange rate from appreciating or to keep interest rates in line with the productivity of the real sector. As a result, the removal of capital controls allowed volatile capital flows and undermined monetary control.

In contrast, countries with reasonable macroeconomic stability were able to avoid the pitfalls of high real interest rates, fluctuations in the real exchange rate, and insolvency among firms and banks. Some countries with considerable macroeconomic instability chose to liberalize gradually; they retained certain controls on interest rates and capital flows while encouraging greater competition and adjusting interest rates to reflect market conditions. These countries also avoided serious disruption and achieved rapid growth in their financial sectors.

A second lesson is that where prices are distorted owing to protection or price controls, financial liberalization may not improve the allocation of resources, which is one of its key objectives. In fact, deregulation may make matters worse by causing the financial system to respond more flexibly to bad signals. For example, Chile's overvalued exchange rate in the early 1980s greatly favored the nontradables sector, which led to excessive investment in real estate. Financial reform allowed more resources to flow to that sector. In the subsequent crisis, real estate was one of the sectors that were hardest hit. Exchange rate realignments and reforms in trade and public enterprise policy should precede, or at least happen along with, financial liberalization.

A third lesson is that direct intervention in finance must be replaced by an adequate, if less invasive, system of laws and regulations. Failure to provide adequate prudential regulation and banking supervision contributed to financial insolvency in the Southern Cone, the Philippines, and Turkey. In freeing the financial system from heavy economic regulation, these countries failed to establish an adequate system of prudential regulation. In Chile, for example, privatizing banks without an adequate framework of prudential regulation allowed them to be acquired by industrial groups, which used them to make excessive loans to group firms. Effective regulation and supervision by bank management, by market forces, and by public authorities are all necessary to reduce recklessness and fraud.

Financial liberalization, like other reforms, involves transfers of wealth and income. Creditors gain from higher interest rates, and debtors lose. Financial institutions with long-term loans and short-term deposits can be adversely affected by interest rate deregulation that results in higher rates. Firms with foreign exchange debt can suffer huge losses when the currency is devalued. In the long run the change in relative prices is necessary to bring about economic adjustment; in the short run the losses can be a political and economic obstacle to needed reforms. So a fourth lesson is that the authorities must anticipate how reforms will change relative prices and how these changes will affect different groups. Considerations of equity and political feasibility alike may make it necessary to provide transitional compensation to those most adversely affected.

All this suggests that in the initial stages of reform many developing countries will be unable to liberalize as extensively as some of the high-income countries. Although generalization is hazardous, experience to date suggests the following steps in moving from a regulated to a more liberal financial system. Reform should start by getting the fiscal deficit under control and establishing macroeconomic stability. The government should then scale down its directed credit programs and adjust the level and pattern of interest rates to bring them into line with inflation and other market forces. In the initial stage of reform the government should also try to improve the foundations of finance—that is, the accounting and legal systems, procedures for the enforcement of contracts, disclosure requirements, and the structure of prudential regulation and supervision. It should encourage managerial autonomy in financial institutions. If institutional insolvency is widespread, the government may need to restructure some financial institutions in the early stages of reform. Measures to improve efficiency in the real sector—that is, more liberal policies toward trade and industry—also ought to be taken at an early stage.

In the next stage, financial reform should seek to promote the development of a greater variety of markets and institutions and to foster competition. Broader ranges for deposit and lending rates should be introduced. On the external side, foreign entry into domestic financial markets should be encouraged to increase competition and efficiency—but perhaps with restrictions, until domestic institutions are able to compete fully. Until such reforms are well under way, it will probably be necessary to maintain controls on the movement of capital. If, however, a country already has an open capital account, the government should give priority to maintaining macroeconomic stability to avoid destabilizing capital flows. After substantial progress has been made toward reform, the government can move to the final stage: full liberalization of interest rates, the elimination of the remaining directed credit programs, the relaxation of capital controls, and the removal of restrictions on foreign institutions.

In sequencing the removal of exchange controls, trade transactions should be liberalized first and capital movements later. Latin America's experience suggests that liberalizing them simultaneously is undesirable. The speed of adjustment in the capital market is faster than in the goods market. An inflow of capital can lead to an appreciation of the exchange rate, which undermines trade liberalization. In the end, internal and external liberalization will be complementary, but external reform should wait until internal reform and the recovery of domestic markets are under way. When macroeconomic stability has been established and the domestic financial system has been liberalized and deepened, it will be safe to allow greater freedom for foreign institutions and capital flows, to link the domestic and international financial markets.

If the reform process as a whole is too quick, firms that entered into contracts and arrangements under the old rules and that would otherwise be viable may face heavy losses. A gradual liberalization will also impose losses, but it will allow firms time to adjust and financial institutions time to develop the new skills they will need. Undue delay, however, carries the cost of perpetuating the inefficiencies of financial repression. The appropriate balance must be judged in each case. Here, at any rate, generalization is not helpful.

Components of financial reform

Many countries have taken the first steps toward reforming their financial systems. The elements necessary to take the process further will vary, depending both on economic circumstances and on political possibilities. This section reviews the main components of a broadly conceived program of financial reform.

Financing fiscal deficits

Macroeconomic stability depends on reducing public deficits to a level that can be financed by means other than inflation or other taxes on the financial sector. Central government deficits have in recent years been equivalent to about one-fifth of total government spending for a large sample of developing countries. About half of this total was financed by borrowing from central banks. The resulting monetary expansion caused high inflation in many countries. Government borrowing from the domestic banking system through high reserve and liquidity requirements is less inflationary than borrowing from the central bank, but it reduces bank profitability, distorts interest rates, and crowds out private sector borrowers. To the extent that a government finances its deficit domestically, borrowing from a securities market is therefore preferable to forced borrowing from financial institutions, which in turn is preferable to borrowing from the central bank.

In most countries it is possible to start a market for government bills, provided the government is willing to pay the market interest rate. Indeed, several developing countries, including Indonesia, the Philippines, and Sri Lanka, have established short-term government securities markets. This is desirable not only because borrowing from such a market is less inflationary than borrowing from banks but also because a bills market makes it possible for the government to engage in open market operations. These can be used to manage the monetary and credit aggregates without the distortions entailed by direct controls. A government bills market is also a first step toward building a broader market for corporate securities. Once market participants have become familiar with owning and trading government instruments and the infrastructure of brokers and traders is in place, it is relatively easy for the private sector to issue its own securities. And by borrowing from a bills market instead of from the insurance and pension systems, governments free long-term funds for investment in private sector assets.

Interest rate policy

Studies suggest that rigid ceilings on interest rates have hindered the growth of financial savings and reduced the efficiency of investment. High and volatile inflation worsens their impact. In most countries this overall rigidity has been compounded by a pattern of interest rates that failed to discriminate between borrowers on the basis of loan maturity, risk, or administrative cost. Governments have often told banks to charge lower interest rates on loans to small borrowers and on loans of longer maturity. Growing recognition of the harm that administered interest rates can cause has recently led many governments to give market forces a bigger say. Governments in developing and developed countries alike have deregulated interest rates during the past decade.

If the initial conditions are wrong, however, liberalization may fail to bring about the correct pattern of interest rates. In countries that have not yet been restored to macroeconomic stability, governments may need to continue managing interest rates. In such cases the aim should be to adjust interest rates to reflect changes in inflation and exchange rates. Countries with open economies need to pay close attention to the differentials between domestic and international rates. Beyond that, governments should phase out preferential interest rates. When good progress has been made toward establishing macroeconomic stability, liberalizing industry, and restructuring the financial system, the government might then move toward a more thoroughgoing liberalization of interest rates. Some countries began by setting ranges and allowing banks to fix their rates within them. As liberalization moved to later stages, the ranges were widened and then removed.

Directed credit

In most developing countries government intervention in the allocation of credit has been extensive. Although a degree of intervention may have been useful during the early stages of development, many countries have come to recognize that this policy has had an adverse effect on industrial and financial development. The evidence suggests that directed credit programs have been an inefficient way of redistributing income and of dealing with imperfections in the goods market. Some programs that were well designed and narrowly focused, however, have been reasonably successful in dealing with specific imperfections in the financial markets, such as a lack of risk capital. In the future, governments should attack the conditions that made directed credit appear desirable—imperfections in markets or extreme inequalities in income—instead of using directed credit programs and interest rate subsidies.

Many governments are unwilling to eliminate directed credits entirely but are nonetheless increasing the flow of credit to the private sector and reducing their own role in credit allocation. Two principles should guide the design of any remaining programs. First, there can be only a limited number of priority sectors: a wide variety of directed credit programs means that nothing is being given priority. Second, governments should be conscious of how little information they have in relation to the information they would need to price credit for different sectors appropriately.

With regard to interest rates, the aim should be to eliminate the difference between the subsidized rate and the market rate. The lowest interest rate should not be less than the rate charged by the commercial banks to prime borrowers. Increasing the availability of credit to priority sectors should be the main focus of the remaining directed credit programs, since experience has shown that generous subsidies badly distort the allocation of resources.

Charging nonprime borrowers the prime rate implies a subsidy to the extent of the added risk and administrative costs. Instead of forcing the banks to cover these costs by charging other borrowers more or paying depositors less, the authorities would be better advised to bear the costs themselves. Directed credit administered through central bank rediscounts rather than through quantitative allocations forced on the banks promotes voluntary lending. Governments should not, however, let central bank rediscounts become a significant source of monetary expansion. Sectors that require large subsidies should be dealt with in the budget, not through credit allocation.

Finally, it seems more defensible to provide directed credits for certain activities (for example, exports or research and development) or for specific sorts of financing such as long-term loans than to target specific subsectors such as textiles or wheat. Targeting specific sectors is too risky in a world of shifting comparative advantage.

Institutional restructuring and development

Many financial institutions today are insolvent, and successful financial reform requires that they be restructured. Insolvent institutions allocate new resources inefficiently because their aim is to avoid immediate bankruptcy rather than to seek out customers with the best investment opportunities. Because financial institutions often become insolvent as a result of ill-advised policies toward trade and industry, policy reforms and the restructuring of industrial companies may also be necessary. Governments should not simply recapitalize the insolvent financial institutions but should seize the opportunity to restructure the financial system in line with the country's future needs.

Liberalization should not be limited to the reform of the banking system but should seek to develop a more broadly based financial system that will include money and capital markets and nonbank intermediaries. A balanced and competitive system of finance contributes to macroeconomic stability by making the system more robust in the face of external and internal shocks. Active securities markets increase the supply of equity capital and long-term credit, which are vital to industrial investment. Experience in countries such as Malaysia and the Philippines suggests that the liberalization of commercial banking will not add much by itself to the availability of long-term credit and equity capital. In Korea, by contrast, the rapid growth of the securities market and the development of new nonbank institutions substantially improved the supply of long-term credit even though only limited liberalization of the banking system took place.

In many developing countries today the financial institutions in the most distress are part of the public sector. Privatization of government banks is one way of improving their efficiency. But this course should be followed only after the quality of bank portfolios and the regulatory framework have improved. In some countries thin capital markets mean that selling bank shares to a large number of individuals is hardly feasible. Hence privatization of public banks may simply shift the ownership of the bank from the government to large industrial groups. That would increase economic concentration and undermine sound banking—as Chile discovered in the late 1970s. In small countries with few banks and weak regulation and supervision, greater foreign participation in bank ownership and management (as in Guinea of late) is well worth considering.

Where public institutions are not privatized, other steps should be taken to improve efficiency. It is important that managers of public banks be professionals with autonomy and accountability; clear procedures will be needed that keep government interference in individual loan decisions, asset management, and personnel policy to a minimum. It is equally important that public banks not be shielded from prudential regulation.

External financial policy

Financial reforms have been undertaken in international as well as domestic markets. Many high-income countries have eased their capital controls and cut restrictions on the entry of foreign intermediaries. The result has been an increase in cross-border financial flows and in foreign participation in domestic markets. Conversely, the development of offshore markets has reinforced the trend toward deregulation in domestic markets. Offshore financial markets have grown much more quickly than domestic markets in recent years—a sign of the pace at which finance is becoming an integrated global industry. International bank lending and net issues of international bonds grew two and a half times faster than GNP in the high-income countries during 1976–86.

The growing importance of international finance is also reflected in the rise in the share of foreign loans, or of purchases of foreign securities, in banks' transactions. For example, the ratio of external assets to total assets for banks in the high-income countries rose from 14 percent at the end of 1975 to 19 percent at the end of 1985. External finance went mainly to firms in high-income countries, but some of the growth represents commercial bank lending to the now overly indebted developing countries. Similarly, the greater participation of foreign financial institutions has been evident in most major markets. The number of foreign banking firms in the high-income countries has increased sharply. The ratio of the assets of foreign banks to the assets of all banks increased in Belgium from 8 percent at the end of 1960 to 51 percent at the end of June 1985, in France from 7 to 18 percent, in the United Kingdom from 7 to 63 percent, and in Luxembourg from 8 to 85 percent. In the United States the ratio increased from 6 percent at the end of 1976 to 12 percent in mid-1985.

Advances in telecommunications and data processing have driven these changes, which are likely to prove irreversible. The greater international mobility of capital, the globalization of financial markets, and the development of new financial instruments have rendered a closed financial policy costly and largely ineffective. To varying degrees, developing countries have participated in the trend toward more open and integrated financial markets, partly in response to the growing economic integration brought about by trade, tourism, and migrant labor. Some countries have adopted foreign currency deposit schemes to induce a greater flow of remittances from migrant workers. To encourage remittances and to discourage and, if possible, reverse capital flight, countries will need to make domestic financial assets competitive in yield with foreign assets. Achieving macroeconomic stability with positive real rates of interest and a realistic exchange rate will also encourage foreign investors to increase direct and portfolio investments.

The merging of domestic and international finance has certain advantages for any country. Foreign competition forces domestic institutions to be more efficient and to broaden the range of services they offer. It can also accelerate the transfer of financial technology, which is especially important for developing countries. The countries that succeed in integrating their markets with the rest of the world will gain greater access to capital and to financial services such as swaps, which will permit them to diversify their risks. But opening financial markets also poses problems. If it is done prematurely, it can lead to volatile financial flows that can magnify domestic instability. Free entry of foreign institutions can lead to the disintermediation of high-cost domestic banks. Furthermore, internationalization means giving up a large degree of autonomy in domestic monetary and financial policy. Domestic deposit and lending rates can be kept in line with world rates only if reserve requirements and banks' costs of intermediation are in line with those in other countries.

Entry of foreign financial institutions. Attitudes toward licensing foreign banks and other financial institutions vary widely among developing countries. A few exclude foreign financial institutions; others permit representative offices but not branches. At the other extreme, the Bahamas, Bahrain, Hong Kong, Panama, and Singapore view exports of financial services as a source of employment and foreign exchange. They either allow foreign institutions to operate under the same rules as domestic banks or provide liberal rules for offshore financial institutions.

Maximizing the benefits of foreign entry requires the deregulation of domestic financial institutions and the establishment of a competitive environment. Artificially low interest rates, directed credit, barriers to entry, and other impediments to competition make it likely that foreign intermediaries will simply capture monopoly rents rather than promote competition and efficiency. Where markets are not fully liberalized and domestic banks have not been restructured, foreign participation may be beneficial, but some restrictions will remain necessary to prevent excessive disintermediation by local banks.

Capital flows. The integration of domestic and world financial markets requires freer trade not only in financial services but also in financial assets. Restrictions on capital flows have been relaxed in many developing countries, generally as part of broader programs of reform. Capital flows are already quite free in Argentina, Chile, Malaysia, Mexico, the Philippines, Thailand, Uruguay, and Francophone Africa. A growing number of developing countries are encouraging foreign participation in their domestic securities markets. Since 1980 more than thirty closed-end funds have been established as a means for foreigners to invest in developing country equities.

Capital movements to and from the developing countries are already substantial. In 1982, for example, more than a quarter of cross-border bank lending went to developing countries. (In more recent years the flows have, of course, been much smaller.) The developing countries' stock of outstanding foreign debt is very large—$1,176 billion at the end of 1988, of which more than half was lent by commercial sources. In 1987 the recorded amount of foreign bank deposits held by residents of developing countries was $290 billion; this is undoubtedly an understatement of capital held abroad. Economic agents in many developing countries have been borrowing and depositing more abroad than in their own banks. This partly reflects the natural international diversification of portfolios, but to a greater extent it reflects efforts to avoid the repressed yields of domestic financial systems.

The scale of capital flows to and from developing countries does not mean that their financial markets have been substantially open. On the contrary, many developing countries continue to restrict outward capital flows in an attempt to direct more domestic funds to domestic investment. Furthermore, fears that foreigners would gain control of domestic corporations have led to restrictions on inward portfolio investment in new ventures.

Although the capital market should not be opened prematurely, freer capital movements will promote better alignment of domestic interest rates with international rates, increase the availability of funds from abroad, and provide more opportunities for risk diversification.

Conclusions of the Report

This Report has tried to capture the essentials of the complex field of finance. In at least two respects it fails to do justice to the subject. First, too often the developing countries have been discussed as though they were all alike, when in fact policies and experience vary widely among countries. Second, the Report has treated in a perfunctory way the human and political dimensions of the subject, both in discussing the origins of the financial problem and in offering prescriptions for change.

Unlike the problems of industry, those of finance are not frozen in bricks and mortar, plant and machinery. Financial claims, together with the all-important "rules of the game," could be rewritten overnight by government decree. But this is not to imply that reforming a country's financial system can be accomplished quickly or easily. Time is needed for people to acquire the necessary skills in accounting, management, and bank supervision. Training staff, building new institutions, and—perhaps hardest of all—getting people to revise their expectations have proved among the greatest challenges to development. Moreover, change is certain to encounter political opposition: people benefiting from the present arrangements will resist reform. Others—although they stand to benefit in the long run—will be hurt in the short run and may not choose to make the sacrifices demanded today for uncertain gains in the future. Change may be most resisted in the very countries where it is most necessary.

Once reform is under way, the response will not be immediate; indeed, it may be painfully slow. After prolonged periods of inflation and many failed attempts to control it, the public will expect inflation to continue and will behave accordingly. Entrepreneurs unpersuaded of the permanence of new policy will be slow to change their ways.

This Report has tried to specify the prerequisites for building an efficient financial system capable of mobilizing and allocating resources on a voluntary basis. Such a system would continue to make mistakes and waste resources. But it would probably make fewer mistakes and waste fewer resources than the interventionist approach followed in many developing countries today.

KEYNOTES & OTHER PAPERS

STOCK MARKET DEVELOPMENT

IN INDIA

Study prepared by:
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The analysis, comments incorporated in this study are entirely attributable to the consultants in their personal capacity.

17 September 1990

STOCK MARKET DEVELOPMENT IN INDIA

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Introduction

In a developing economy, what tends to limit the speed of capital accumulation is the low capacity to save. This, in turn, restrains adoption of productive technologies, given an acute deficiency of material capital. Low income, low savings, low investment as a related causal chain has been variously described. It is a vicious circle. It is also a debilitating iron triangle that holds back the growth process in a developing economy.

India appears to have broken through the 'vicious circle' in the 1960's when the gross domestic savings rate pushed forward to an annual rate of 13 per cent in 1967-68. This rate stood at 20 per cent in 1985-86 and touched 21 per cent in 1988-89 (Source: Chart I in Appendix I to this study). Over 80 per cent of gross domestic investment has been financed form domestically created savings.

The Household Sector is the principal source of national savings (Chart I in Appendix I). Over 80 per cent of Household Sector Savings is in the form of income yielding financial assets, covering equities, debentures, life insurance policies and bank deposits. This is a supply factor. On the demand side, the private corporate sector and the public sector have been increasingly bidding for national savings. A partial explanation might be the increasing scale of production, with economic growth. Large-scale production makes it necessary to gain access to large amounts of financial capital. No individual or small groups of individuals can provide the amounts of capital required by the growing number of manufacturing establishments in the corporate sector. The corporate form of organisation is appropriate for the task of raising industrial capital from a large number of persons. This task calls for intermediation. The stock market provides a marketplace for a continual process of intermediation which acquires importance when savers that wish to invest need to be brought together with borrowers that require industrial capital. For such investment, the stock market also provides a liquidity mechanism.

The stock market in India is developing at a rapid pace. Evidence for this is provided in this study which deals with non-government owned public limited companies. This study is presented in three parts. Part I establishes the magnitude of growth in stock market development. It examines the growth of institutional developments in the context of growth and outlines the regulatory framework within which such growth is occurring. Part II deals with the Primary and Secondary market and identifies some gaps in the stock market. Part III deals with some of the gaps like supply of equities, supply of venture capital and the current state of responses to such problems.

Stock market development in India is a visible phenomenon of the nineteen eighties. The take-off of the Indian stock market can be attributed to the nineteen eighties. The nineteen sixties and nineteen seventies were clear phases when preconditions of 'take-off' were introduced and established. Hence, this study focuses on the decade of the eighties whilst discussing issues and problems relating to stock market development in India. These are problems emanating from growth and are not uncommon to emerging stock markets, around the world.

Part I

Stock Market Development

Three Phases

The decade of the 1980's has been a clear watershed in the history of the stock market in India. In 1950 when India became a republic and adopted development planning, modern history of the Indian stock market commenced. Three clear phases of development are discernible. 1956-1973 marks one period of development; 1974-1979 marks the second period of development. It is between 1980-1989 that the Indian stock market came into its own.

In the first phase of development, between 1956-1973, the basic legislative and institutional framework for stock market operations came to be established. The four basic pieces of legislation are: the Companies Act 1956, the Securities Contracts (Regulation) Act 1956, the Monopolies and Restrictive Trade Practices Act 1969 and the Foreign Exchange Regulation Act 1973. During this period, the stock market was not an important tool in mobilizing and investing national savings. Commercial banks and contractual savings institutions like life insurance and pension funds were keys players in the supply of industrial capital. Equity was attractive to neither savers nor borrowers. Equity earned less than government securities, for an investor. Demand for equity was poor. On the supply side, few companies sought industrial capital in the stock markets as borrowing from development finance institutions worked out cheaper. Some evidence of the scant demand and supply in the stock market is available in the total number of equity issues between 1955-63. Over this period, an amount of Rs1.45 billion was raised through 255 equity issues. During this first phase, major term lending institutions, which in due course became major institutional players in the stock market, got into place. The following Table will demonstrate that beginning in 1955 and by 1973, a strong underwriting organisation had grown in the country through the establishment of development finance institutions.

Table I: Development Finance Institutions

Year of Establishment	Institution	Acronym
1948	Industrial Finance Corporation of India	IFCI
1955	Industrial Credit and Investment Corporation of India	ICICI
1956	Life Insurance Corporation of India	LIC
1964	Industrial Development Bank of India	IDBI
1964	Unit Trust of India	UTI
1973	General Insurance Corporation of India	GIC

In the second phase, 1974-1979, a basis for momentum in stock market growth emerged. One apparent factor was the increase in supply of equities from well managed companies. In 1973, certain sections of the Foreign Exchange Regulation Act 1947 were amended. As a consequence of the 1973 amendments, many Indian companies, where non-resident shareholding was preponderant, found it advantageous to convert their status to that of a domestic Indian Company . Through issue of equity in the stock market, in many such companies non-resident shareholding was reduced to 40 per cent of issued capital. For the initial shareholders in such companies, there was capital appreciation. During this period, the general level of awareness about equity investments improved. Between 1974-79, Rs5.5 billion was raised through equity issues.

The decade of 1980s saw the emergence of the stock market as a mobilizer of savings and increasing investor preference for stock market instruments. Upwards of Rs.76 billion was raised through equity issued in the stock market, between April 1980 - March 1990. What we see is a clear rise and growth of the equity culture over the five year periods viz. 1974-79, 1980-85, 1985-89. Resources raised by non-government public limited companies through equities during 1974-79 were Rs.4 billion which rose by over six times to Rs.25 billion, during 1980-85, and the latter figure doubled to Rs.51 billion during the remaining period of the decade.

Magnitudes of Stock Market Growth: 1980-89

Eleven measures are available to reflect the growth of the Indian stock market. These are as follows: i) increase in approvals for new issues; ii) rise in actual resources raised from the stock market; iii) the growing number of issues in the stock market; iv) increasing number of listed companies in the stock market; v) expansion in the number of listed stocks; vi) proliferation of market centres including stock exchanges; vii) rising turnover on the Stock Exchanges (S.E); viii) expanding market capitalisation; ix) increasing percentage of Household Savings invested in the stock market; x) growth in the number and diversity of investor population; and xi) expansion of the number and type of stock market intermediaries.

Chart III in Appendix I presents graphically the above magnitudes. Tables II and III in brief reflect the growth in the eleven measures referred to in the preceding paragraph. The data covers equity, preference and debentures including rights, raised by the private sector.

Table II:
(In Rs billion)

Sr. No.	Measure	1980	1989
i	Approvals for new issues	5.1	82
ii	Resources raised	1.6	31
iii	Daily turnover on S.E.	0.2	1.3
iv	Market capitalisation	0.7	600
v	Household savings invested in stock market (%)	3.6%	7.5%

Table III
(In numbers)

Sr. No	Measure	1980	1989
i	New issues	95	382
ii	Listed companies	2,000	6,000
iii	Listed stocks	4,000	8,000
iv	Stock exchanges	8	19
v	Investor population	2(mn)	12(mn)
vi	Stock market intermediaries (Brokers)	300	1,500

The Basic Framework: A Question of Ground Rule;

The stock market operates within a system of laws and regulations, designed to provide investor safety through clearly articulated ground rules. Rapid growth in the stock market has led to expanding ground rules in the light of experience. This is necessary to increase investor confidence. Four basic pieces of legislation constitute the basic framework within which the stock market operates . The four pieces of legislation are: the Companies Act 1956, the Securities Contracts (Regulation) Act 1956, the Foreign Exchange Regulation Act 1973, and the Monopolies and Restrictive Trade Practices Act, 1969.

The Companies Act establishes the detailed structure and legal functioning of a limited liability company, from its entry to exit. It lays down the role and duties of management and administration; the constitution of a Board of Directors; the role and power of advisory committees; the conduct of annual meetings; the appointment and duties of auditors, general accounting practices. The structure of a corporation is fixed and is in line with that used in western economies. Shareholders' rights are stoutly protected. The Companies Act represents a comprehensive set of rules addressing every aspect of an Indian company's existence.

The Securities Contracts (Regulation) Act regulates stock exchanges, trading practices, the buy and sell contracts traded on an exchange, and the listing of securities. This piece of legislation seeks to prevent undesirable transactions in securities by regulating trading and by stipulating the precise terms for transfer and settlement.

The Foreign Exchange Regulation Act (FERA) 1947 is a detailed piece of legislation, enumerating methods of controls on imports and exports. the Act went through several amendments in 1973. For example, no FERA company can, since 1973, invest in securities or portfolio schemes above the threshold of 1% of any issue of securities or 5% of the equity capital . A FERA company is one where majority shareholding is by non-residents. As a consequence of the 1973 amendments many FERA companies found it advantageous to alter their status to that of a domestic Indian company This provided the first major stimulus to the supply of equity in the stock market.

The Monopolies and Restrictive Trade Practices Act (MRTP) 1969 aims to regulate mergers and acquisitions of companies with a view to avoid situations of corporate monopoly and restraints of trade. In a manner of speaking, the MRTP Act is to Indian companies what FERA is to non-resident companies. MRTP has used a licensing system (quotas on capacity, production) to control the growth and expansion of companies. In recent years, with increased freedom to produce, many rigours of the MRTP have abated. Since 1985, asset limit of companies that come within the purview of the MRTP has been raised. Hence, many well managed companies have been able to expand and raise new issues in the stock market.

Besides the four pieces of legislation outlined in the preceding paragraphs, there are two other areas that merit mention. One is the fiscal environment, since tax laws carry á direct bearing on investment decisions. The other is the control of capital issues. All companies and individuals are assessed for a fiscal year, beginning 1 April which has now become the standard accounting period in India. Direct taxes have been reduced. This seeks to stimulate consumer demand and encourage investments. The corporate tax rate has been reduced from 55% to 50% for widely held companies; from 65% to 55% in case of non-trading, non-investment closely held companies, and from 65% to 60% in case of closely held trading and investment companies. In case of foreign companies, the tax rate was reduced from 70% to 65%. The corporate tax rate has been further reduced to 40%.

The rates of personal income-tax have now been rationalised and the maximum marginal rate has been brought down from 61.9% to 50%. The tax exemption limit has been raised from Rs.18,000 to Rs.22,000. A number of fiscal incentives have been introduced, over a period, to encourage stock market investments. One illustration is the inclusion of a separate limit for income-tax exemption for dividend income upto Rs.3,000; bank interest and other specified income upto Rs.7,000; and income for instruments of Unit Trust of India upto Rs.3,000.

The Controller of Capital Issues (CCI), in the Ministry of Finance, Government of India, New Delhi, approves applications from companies wishing to make new issues in the stock market. Capital issues controls apply to capital publicly raised in excess of a specified minimum. From 1945-1959, a firm required prior permission of the Controller if it raised capital in any one year in excess of Rs.500,000. In 1985, this limit was raised to Rs10 million. The CCI has many other functions. It decides on pricing issues, licenses establishment of mutual funds, venture capital units and issues prudential guidelines affecting the conduct of players in the stock market. From a review of paragraphs 12-19; it will be apparent that the framework within which the Indian stock market operates is structured and illuminated with an increasing repertoire of ground rules. This is relevant both for investor confidence as well as for orderly growth of a stock market. Wild-cat issues have therefore been kept in check.

Institutional Developments: A Question of Expertise

The rapid pace of stock market development in the eighties has been accompanied by comparable growth in the institutional infrastructure. Institutional developments can be viewed at two levels i.e. institutions that help to broadbase the stock market and institutions that help protect investors.

Intermediaries

Mutual funds, merchant banks, development finance institutions, commercial banks, Insurance Corporations together are important players in the stock market. Their impact on the primary as well as secondary markets is considerable. Besides, they act to impact the demand for and supply of stock market instruments.

The ongoing endeavour is to broaden and deepen the stock market. One dimension of this task is to increase the number of the shareholding population and expand the investible funds in the stock market. Currently, the shareholding population is rather small at 12 million. Moreover, they are concentrated in four metropolitan centres. Financial asset preferences of the dispersed savers in the Household Sector have to be addressed. It can be safely stated that the small savers in the Household Sector are, generally, risk averse. Hence, to draw such savers into the stock market, a 'risk pooling' mechanism is relevant. Mutual funds respond to this need. A mutual fund consists of equal units/shares/certificates and encourage savers to invest in them. The fund uses such investible resources in equities, debentures. The resulting earnings are distributed amongst the investors in a mutual fund, after deducting expenses, service charges and appropriation for reserves. Mutual funds are institutional investors. They have the capability to process more extensive information and utilise stock market operations to earn such returns that would be beyond the scope of individual, especially small, savers.

In 1964, the first mutual fund was set up in India. This is the Unit Trust of India. Commercial banks in India, have in recent times set up mutual funds as subsidiaries. They are well placed to reach dispersed savers in the Household Sector, through their 60,000 strong branch network in the country. Commercial banks through their branches and subsidiaries can now offer a range of financial instruments to savers who, in the normal course, might want to avoid direct investments in the stock market. In addition to the commercial banks, the Life Insurance Corporation of India and the General Insurance Corporation of India have set up mutual funds. Amongst mutual funds, the Unit Trust of India is the largest with investible funds of about Rs120 billion. The mutual funds are major players in the primary and secondary markets. Registration with the Securities and Exchange Board of India and approval of the Controller of Capital Issues is mandatory for mutual funds. Ground rules exist for the conduct of mutual funds including how much can be invested in shares of companies and in the shares of a single company.

Merchant banks in Europe undertake a range of business unlike the investment banks in North America. European merchant banking includes underwriting of securities and provision of advice on corporate finance and portfolio-management services. They also act as commercial bankers, taking wholesale deposits and making loans. Some European merchant banks have expanded into leasing, insurance and venture capital. Merchant banks in India are more like the investment banks of North America as commercial banking is segregated from merchant banking activities.

In an institutional sense, merchant banking in India was initiated by the State Bank of India, and the Grindlays Bank. In the past decade, erstwhile stockbroking and brokerage houses have converted themselves into merchant banks. The process has been strengthened by the recent facility permitting financial institutions companies to gain membership of stock exchanges. Their range of activities cover the following: underwriting, active dealing in the secondary market, money market activities, corporate advisory activities and portfolio management. The process of underwriting, involving origination, evaluation, syndication, regulation, pricing, distribution and settlement, is indeed well set in the Indian stock market. Given the vigour in the corporate sector and the stock market, merchant banking institutions have learnt to compete and complement a variety of financial intermediaries in the stock market. The new issue market is some evidence for this statement.

Investor Protection

A set of institutions has arisen in the nineteen eighties, in the face of growth problems in the stock market. These relate to investor guidance and protection. The major initiatives are discussed here.

In April 1988, the Securities Exchange Board (SEBI) was established to oversee and regulate the stock market. It is similar to the Securities and Exchange Commission of the U.S.A. and the Securities Industries Board of the U.K. In August 1988, The Credit Rating Information services of India (CRISIL) was established. This agency rates companies as well as securities participating in the stock market. It provides individual as well as corporate investors a tool in making investment decisions.

An electronic link-up between five major stock exchanges (PTI Stock Scan Service) is in operation. Price information and stock market data are disseminated. Such dissemination of information reduces arbitrage. The Stock Holding Corporation of India was formed by the development finance institutions to provide clearing house facilities to promote speed in transfer of stock market securities. This corporation is acting as a central clearing agency for registering transfers of securities and is helping to reduce time lags in effecting transfers in the stock market.

Three features will be apparent from discussion in Part I of this paper. The past decade has been a decade of growth in the Indian stock market. This growth has occurred within a responsive regulatory framework. The growth in the stock market has led to further issuance of new ground rules and emergence of a strong institutional infrastructure. This infrastructure covers issuers in the stockmarket, intermediaries, the stock exchanges, as well as savers who are investors. The general aim has been to increase the capability of the stock market to attract increased volumes of investible funds, new debt instruments and increase new issues - all in an ambience of increasing investor confidence. The growth of primary and secondary markets is a measure of stock market development in India. This is discussed in the succeeding part of this study.

Part II

Primary and Secondary Markets

A primary market creates long-term instruments through which corporate entities borrow from the stock market. A secondary market provides liquidity and marketability to the debt instruments. These markets interact. The debt of a secondary market depends upon the activities of the primary market as that is the source of supply. The Indian primary market witnessed vigorous levels of new issues in the 1980s.

The Primary Market

The following discussion on the primary market in India occurs at two levels. At the first level, two measures of growth are analysed. These are, the volume of new issues between 1980-1989; and the volume of capital raised in the primary market, over the past decade. At the second level, certain characteristics and practices relating to the primary market are discussed. Discussion at the two specified levels provides data to show that the primary market has reached a level of strength which can only be a stepping stone to further growth.

Measures of Growth

Where capital is raised in excess of Rs10 million, consent from the Controller of Capital Issues (CCI), of the Government of India, is necessary. There has been an impressive increase in approval of new issues and in the quantum of capital raised. This is shown in the following two tables: Table IV and Table V. The data covers equity, preference as well as debentures.

Table IV

Approval of New Issues
(Fiscal years)

Year	No. of Consents	Amount (Rs billion)
1980-81	1,465	5.11
1981-82	511	7.78
1982-83	472	8.93
1983-84	459	10.23
1984-85	712	20.03
1985-86	1,128	36.95
1986-87	963	58.43
1987-88	647	51.66
1988-89	1,639	82.20

Source: RBI Report on Currency and Finance (various issues).

Table V

Capital Raised
(Fiscal years)

Year	Amount (Rs billion)
1980*	1.6
1981-82	6
1982-83	7
1983-84	8
1984-85	11
1985-86	17
1986-87	26
1987-88	18
1988-89	31

Source: SEBI.
*Calendar Year.

Approvals for new issues increased sixteenfold. Capital raised increased almost thirty times. The decade of the 1980s was a period of vigorous growth in the primary market. In 1989, there were 382 issues on the Bombay Stock Exchange (BSE) by non-government public limited companies. The BSE is by far the largest stock exchange in the country. For the year 1989, three features are discernible in the primary market. First 54% of the capital raised in 1989 related to large public/rights issues of Rs.1 billion and above. This is in the context of new issues by non-government public limited companies. Second, in 1989 only four equity issues were undersubscribed. Third, after the 1986-87 relative quietness in the primary market, a return of investor confidence is observed in 1989. Growth magnitudes are further evidenced in Chart III, in Appendix I.

The FERA Act 1973, in effect, required foreign multinationals to reduce their shareholdings in Indian subsidiaries to 40%. About 90 companies came to offer stock to the public. These issues were oversubscribed. These developments resulted in the stock market boom of 1980-81. An awareness of equities also began to spread amongst small investors. Stock market developments were sustained by growing industrialisation in the 1970s and 1980s. Government fiscal and monetary policies as well as new initiatives in institutional infrastructure nurtured the rise and growth of the equity market. Changes in industrial policy, M.R.T.P. and FERA contributed to the strengthening of stock market performance.

Apart from equity and debentures, new instruments to mobilise savings of investors have been introduced. Equity linked saving scheme, a combination of equity, convertible debentures and non-convertible debentures with an option to choose any of the three options or a combination of them, convertible zero interest bonds, attachable warrants have been some recent introductions in the stock market. There is increasing innovation to address asset preferences of savers and investors. Nonetheless, scope for wildcat issues is limited as the supervision of Government is continuous.

Characteristics of Primary Markets

Three characteristics of the primary market are discussed here, to illuminate some aspects of the market. First, more than existing companies, new companies have been raising capital in the primary market. This is evidenced in Chart V, in Appendix I. This was a marked feature in the years 1983-87, over which period about 1771 new companies entered the primary market and raised close to Rs.20 billion. With some restraint in subsequent years and new guidelines on the basis of experience, investors are returning to take interest in issues of new entrants in the primary market.

A second characteristic of the primary market is the way issues are priced. The CCI determines the pricing of all public issues. Three principal methods are employed. All issues of new companies are priced at par. Shares of widely held, listed, companies are priced by a method which considers par value, net asset value and market value. The following method is employed where companies are closely held and wish to go public, for the first time. They are valued by considering the book value net of revaluation of assets and after capitalising the last three years' after-tax profit. An effective tax rate of 50%, irrespective of the actual rate paid, is assumed. In each case, historical data alone is taken into account.

A third characteristic that merits highlighting is the repertoire of ground rules that exist in the area of listing, issue by prospectus vs private placements and the increasing level of disclosures that are being enforced. These developments are in a constant state of flux as the primary market has developed considerable momentum. This has thrown up new experiences and new problems which are attracting answers in the shape of increasing ground rules that carry the interests of the investor as well as that of the borrower, in the overall interests of greater financial broadening and deepening.

The Secondary Market

The secondary market is a source of liquidity for investors in the stock market. The discussion is presented in two parts. First, the organisation and structure of the stock exchange is presented. This is the institutional set up of the secondary market. Second, the coverage of the secondary market is reflected through three measures viz. the daily turnover level, the market capitalisation and the liquidity of equity shares.

The Set Up

There are, at present, 19 stock exchanges. They are regulated under the Securities Contracts (Regulation) Act, 1956. Each stock exchange works within its rules, by-laws and regulations which are subject to Government approval. A governing body comprising elected members manages each stock exchange. The president of a stock exchange is a member elected by the governing body. The Executive Director, appointed by the governing body, is subject to approval by the Ministry of Finance, Government of India. Chart V in Appendix I lists the major stock exchanges in the country and the number of stocks listed in the major stock exchanges. The Bombay Stock Exchange (BSE) is the largest. It accounts for over 60% of the market value of listed stocks and of secondary market dealings. Market capitalisation of BSE exceeded Rs.400 billion out of a total market capitalisation of Rs.600 billion, comprising of all stock exchanges in 1989.

Market Coverage

The market capitalisation was Rs600 billion in 1989, with BSE accounting for over 60% of the total. This is arrived at by taking the market value of all listed companies at the close of 1989. The market value of a company is the share price multiplied by the number of shares outstanding. There has been a sixfold increase in market capitalisation in 1989 over the year 1980. This is graphically presented in Figure 4, Chart III in Appendix I.

There are about 6000 stocks listed in the stock exchanges, a figure only next to U.S.A.

There has also been appreciable increase in the daily turnover in the stock exchanges. The BSE represents the major share. The average daily turnover has increased sixfold between 1980-1989, to Rs1.2 billion in the year 1989. The turnover of a scrip is a function of the paid-up share capital of a company and its floating stock, its price and the velocity of transactions in the scrip. The turnover at a stock exchange is the sum of turnover of all scrips traded on a stock exchange. The annual and average daily turnover are significant measures of expansion of the secondary market. It is estimated that about 50,000 deals are struck on an average, in a two-hour trading session on the BSE.

Figure 6 in Chart III, in Appendix I, reflects a study on liquidity of equities. It shows that only 6-8% of all listed equities are traded on a daily basis.30% of all listed shares are traded on a monthly basis and yet another 30% of all listed shares are traded only once a year. This is a problem area. It is best described as one of lack of liquidity for a large number of scrips. This is an appropriate stage to make a transition into the problems and gaps that constitute the substance of current endeavours in the Indian stock market.

The current problems and gaps have been well identified in a report (1989) of the "Working Group on the development of the capital market", headed by Mr. Abid Hussain, then a member of the Planning Commission of India. An outline of problems and gaps in the market now follows.

Gaps in the Market

In January 1989, the Working Group on the development of the capital market submitted its report (WG report). It has identified the following problems and made recommendations:

i) Liquidity of scrips of companies with varying size and track record needs to be enhanced; hence a multi-tier system replacing the current system of listing shares of the stock exchange has been recommended. An over-the-counter (OTC) market is being established. Small companies with a paid-up capital of Rs.10 million and above may be eligible for listing, provided certain criteria, like 10% of shares of a company being in the hands of the public are met. Dealers in the OTC can be market makers, quoting a two-way price for scrips. Additionally, to increase the liquidity of corporate scrips, appointment of market makers with access to credit has been recommended.

ii) Broadbasing the investor base is sought to be achieved through greater integration of stock exchanges in the country and simplification of transfer procedures, allowing banks and financial institutions to gain membership of stock exchanges; the WG report accepts the relevance of private sector mutual funds after working out a comprehensive regulatory framework governing the mutual funds; in the interregnum joint sector mutual funds, in addition to the present 'public sector' mutual funds have been recommended. New instruments like non-voting shares and 3-5 years (medium-term) corporate debentures have been recommended.

iii) Increase the supply of scrips, a variety of fiscal concessions to investors in and managements of companies with moderate equity has been recommended.

The WG report has recommended a variety of measures to contain trading malpractices and improve the efficiency of trading. Whilst all these are necessary conditions, they do not constitute a sufficient condition of efficient functioning of the stock market. Several recommendations like introduction of the OTC, commercial banks and financial institutions gaining membership of the stock exchanges, have been acted upon. The WG report, therefore, serves as an useful stock-taking exercise and as a blueprint for immediate action. Progress made in three significant areas where gaps exist in the stock market are reviewed in the succeeding part of this paper.

Part III

Supply of Equities

A measure of the shortage in supply of tradeable scrips in the stock market is the market concentration technique. This provides as a percentage, the share of value traded held by the ten most active stocks. This measure demonstrates that in 1989 the ten most active stocks accounted for 47.3% of share value traded in the Indian stock market.

Factors that inhibit the supply of stocks merit enumeration. In the context of identified factors, various measures introduced in the stock market can be appreciated. Five factors can be identified. First, amongst private sector companies, resistance to dilution of ownership and control inhibits entry into the stock market. However, as scales of production increase, it is no longer possible to limit sourcing of financing to own, informal and bank sources. This inhibition can either be strengthened or weakened by the direction in which other factors operate.

Development finance institutions have been a principal, concessionary, source of term finance. Therefore, availability of debt finance and permissibility of such debt as interest allowable in tax has kept companies away from the stock market. However, this trend is altering as Development Finance institutions have raised their price for loans. They are also increasingly prioritising those sectors of industry that are not able to go to the stock market. This gains additional significance as development finance institutions have now to raise resources in the face of competition from many new public sector agencies like housing.

Companies have been discouraged from going to the stock market because of burdensome listing requirements and high costs of new issues. Steps have been initiated in streamlining listing requirements. Simultaneously, the concept of over the counter trading for companies with a moderate equity base is being implemented. With a multi-tier stock market in the offing, a major barrier to increasing supply of stocks might diminish.

From a company's point of view, the cost of raising funds from the stock market is seen to be higher than bank debt. Dividends are paid by a company out of its after tax income, whereas interest payments on bank debt are paid out of gross earnings before taxes. Further, equity holders seek to expect higher returns as a hedge against inflation, and the higher risks than in respect of government related debt instruments. This picture is likely to alter, if the recommendations in the WG report on the development of the capital market are acted upon. The WG report has recommended that in respect of new companies entering the stock market, upto a maximum of ten percent of (dividend paid) may be deducted from taxable profits (in the year in which it is actually paid), for a period of 7 years from the year of commencement of commercial production. This can encourage new companies to enter the stock market. New companies coming to the stock market is a potent source for supply of stocks.

Yet another source of increasing supply of stocks is the WG report recommendation for public sector companies. Public sector enterprises account for a large proportion of industrial capital and production. The WG report recommends that a number of public enterprises might be led to operate under conditions of competition by selling a proportion of their equity to the general public (including their workers). It is recommended that this proportion be limited at present to 25 percent. Several recommendations of the WG report on the development of the capital market are under implementation. It is likely that even in the short-term, the supply of seasoned stocks will increase.

Supply of venture capital

Availability of finance for companies in the areas of new technology, and in untried areas of production, has been difficult. Such enterprises are generally referred to as venture companies. These are companies venturing into activities involving uproven technology, and modification/adaptation of a proven technology. Frequently, the cases involve commercialisation of technologies, which have been tried successfully elsewhere but may or may not succeed in India. The problem has been to create professionally managed institutional sources of equity finance for venture capital companies. In this context, venture capital has been appropriately described as the business of making businesses.

Endeavours have been made, in recent times, to foster the development of venture capital industries. The venture capital industry in India is of recent origin and rather thin. The Controller of Capital Issues (CCI) issued guidelines on venture capital on November 18, 1988. The recognition for venture capital needs, therefore, exists. Creditcapital Venture Funds was the first private sector venture capital company to go public. The House of Mafatlal is planning to establish a venture capital company. Public sector financial institutions have set up the Technology Development and Investment Corporation of India, Risk Capital and the Technology Finance Corporation, as venture capital financing vehicles. The momentum, however, has not gathered. This is notwithstanding the facility under the venture capital guidelines in pricing of shares when a venture capital company goes public. Disinvestment by a public issue of offer for sale by a venture capital at a price based on "objective criteria like book value, profit earning capacity" are allowed. The guide lines also permit the capital gains of the company to be taxed at a rate applicable to individuals, which is lower than in the case of corporate entities.

The WG report on development of the capital market has recommended that a venture company should be allowed to raise capital through issue of non-voting shares upto 50% of its equity capital, with an option to convert them into voting shares. These investments should be free of the ceiling applicable to inter-corporate investments, according to the WG report. With a view to successful equity issues for venture capital companies, the WG report has made a number of recommendations. The environment is, therefore, improving for venture capital companies wishing to go public.

Globalisation of Indian Stock Market

Direct foreign investment in the Indian secondary market is not permissible, in current times, except for Non-Resident Indians (NRIs) and foreign companies in which NRI shareholdings is not less than 60 percent (NRIs). NRI is allowed to acquire a maximum of one percent of the paid-up value of the outstanding stock in a company, after obtaining approval of the Reserve Bank of India. The sum total of all secondary market purchases of a stock by NRIs cannot exceed five percent of a company's paid-up value. Moreover, transfer of securities between NRIs or other non-residents also require prior sanction of the Reserve Bank of India. NRIs had an outstanding investment of Rs.630 million as of end June 1987 through transactions in the secondary market. Country funds are the only vehicle through which foreign investment in the Indian stock market is permissible.

Four country funds to the amount of US$500 million (approx.) have been initiated. The India Fund and the India Growth Fund have been initiated by the Unit Trust of India which is the premier mutual fund in India. The India Fund is quoted on the London Stock Exchange. The India Growth Fund is quoted on the New York Stock Exchange. The India Magnum Fund is registered in the Netherlands Antilles, sponsored by the State Bank of India. A fourth Fund, the Himalayan Fund has been sponsored by the Indo-Suez Bank.

Country funds have channelised about US$500 million equivalent into the Indian stock market. The four funds have received good response in overseas markets. The policy is directed towards encouraging foreign investment through country funds. A start has been made through these four country funds.

With the decreasing barriers between major money and stock markets in the developed world, there has been a trend in a clutch of developing countries to access savers/investors in the developed world. Nineteen developing countries appear in the International Finance Corporation 'Emerging Markets' database. India is one such country. Whilst the pace at which the nineteen developing countries have been accessing the international stock markets is uneven, there appears to be a common direction. This direction appears to be a movement, albeit steady for some economies, to achieve increasing global integration.

IN BRIEF

The period 1950-89 for India has been significant for many reasons. During this period, planned economic growth on the basis of a 'mixed economy', with public and private sectors participating, has established an incomparable country case-study in economic growth in the context of large countries with a large population. Several decades of economic growth have been compressed in four decades. Real GNP grew by 5.3% p.a. during 1980-89 compared to 3.2% p.a.

during the 1970s. Prof. W.W. Rostow* has stated that India, along with some other developing economies, "took-off" in terms of economic growth many years ago. In the sequence of economic development, Prof. Rostow* identifies three periods: "a long period (upto a century or, conceivably, more) when the preconditions for take-off are established; the take-off itself, defined within two or three decades; and a long period when growth becomes normal and relatively automatic. (India has entered the "early phase of modern growth)." The cycle of growth is being compressed in many developing countries.

Industrialisation is a sign of modern growth. The rise of and growth in stock markets in India is evidence of industrial capital growth. It is also evidence of "financialisation" of the Indian economy. The ratio of assets of financial institutions to GDP has increased from 38% in 1950 to 103% by 1980. Behind this extensive financial deepening, the stock market has and is playing an increasing role. The stock market, after all, is a component of the financial system in a country. The economic environment within which an entrepreneur can generate profits and accumulate wealth has improved in India. A growing stock market, as a part of the market arrangements, contributes to improved intermediation between savers and borrowers. It represents the power of the many in providing investible funds.

The growth of the stock market in India has been rapid in the past decade. It has grown on a structured basis, keeping the interests of borrowers, investors and intermediaries in view. The structured growth continues.

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* Prof. W.W. Rostow: Reflections on the Drive to Technological Maturity (Banca Nazionale del Lavoro Quarterly Review: June 1987).

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APPENDIX I

CHART I

Gross Domestic Savings and Capital Formation

(as % of GDP at current prices)

Year	Houshold Sector	Private Corporate	Public Sector	Total Savings	Private Corporate	Public Sector	Total Capital Formation
1950-51	7.7	1.0	1.8	10.4	6.9	2.4	9.3
1967-68	9.9	1.2	1.9	13.0	8.9	5.8	14.7
1970-71	11.3	1.5	2.9	15.7	9.1	5.5	14.6
1978-79	17.0	1.5	4.6	23.2	10.1	8.0	18.1
1985-86	15.2	2.1	3.2	20.4	9.9	10.5	20.4
1988-89	17.5	1.8	1.6	21.0	10.3	10.2	20.5

Source: Economic Survey: 1989-90, Government of India.

CHART II

Houshold Savings in the Stock Market

(% of total household savings)

1980-81	1983-84	1984-85	1985-86	1986-87	1987-88	1988-89
3.6	4.2	5.6	7.0	7.0	6.9	7.5

Source: RBI Report on Currency and Finance (various issues).

APPENDIX I

CHART III

FIG. 1

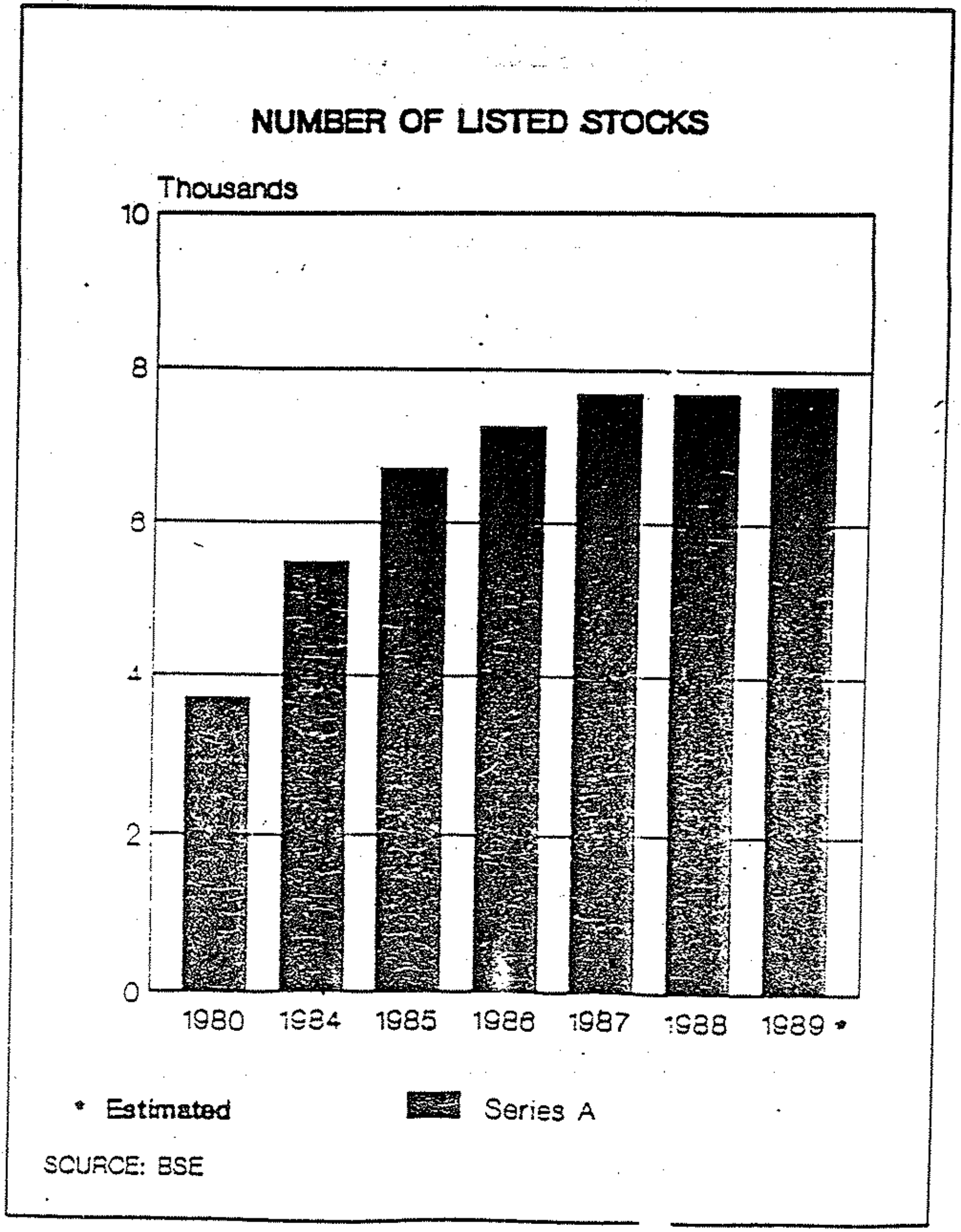


FIG. 2

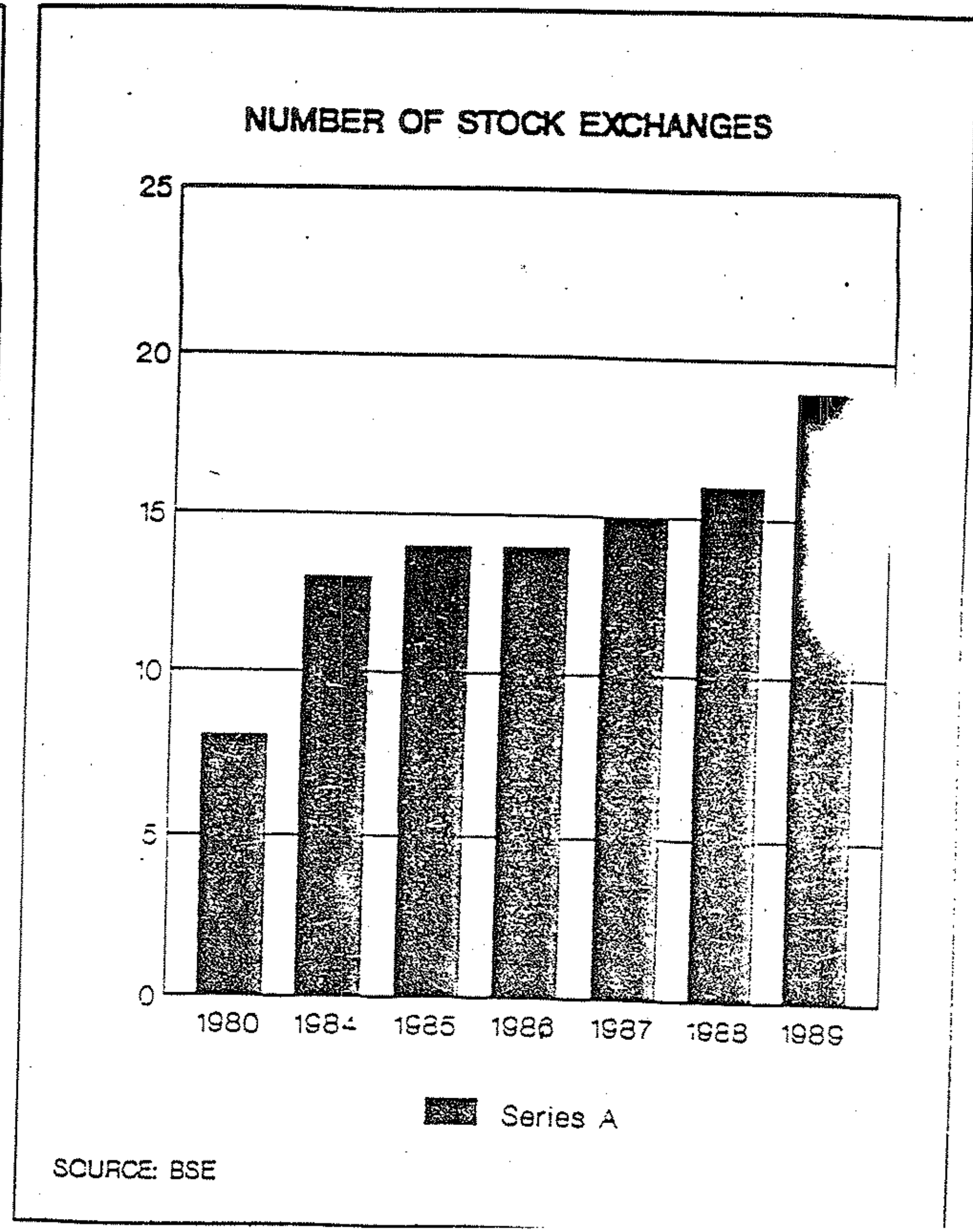


FIG. 3

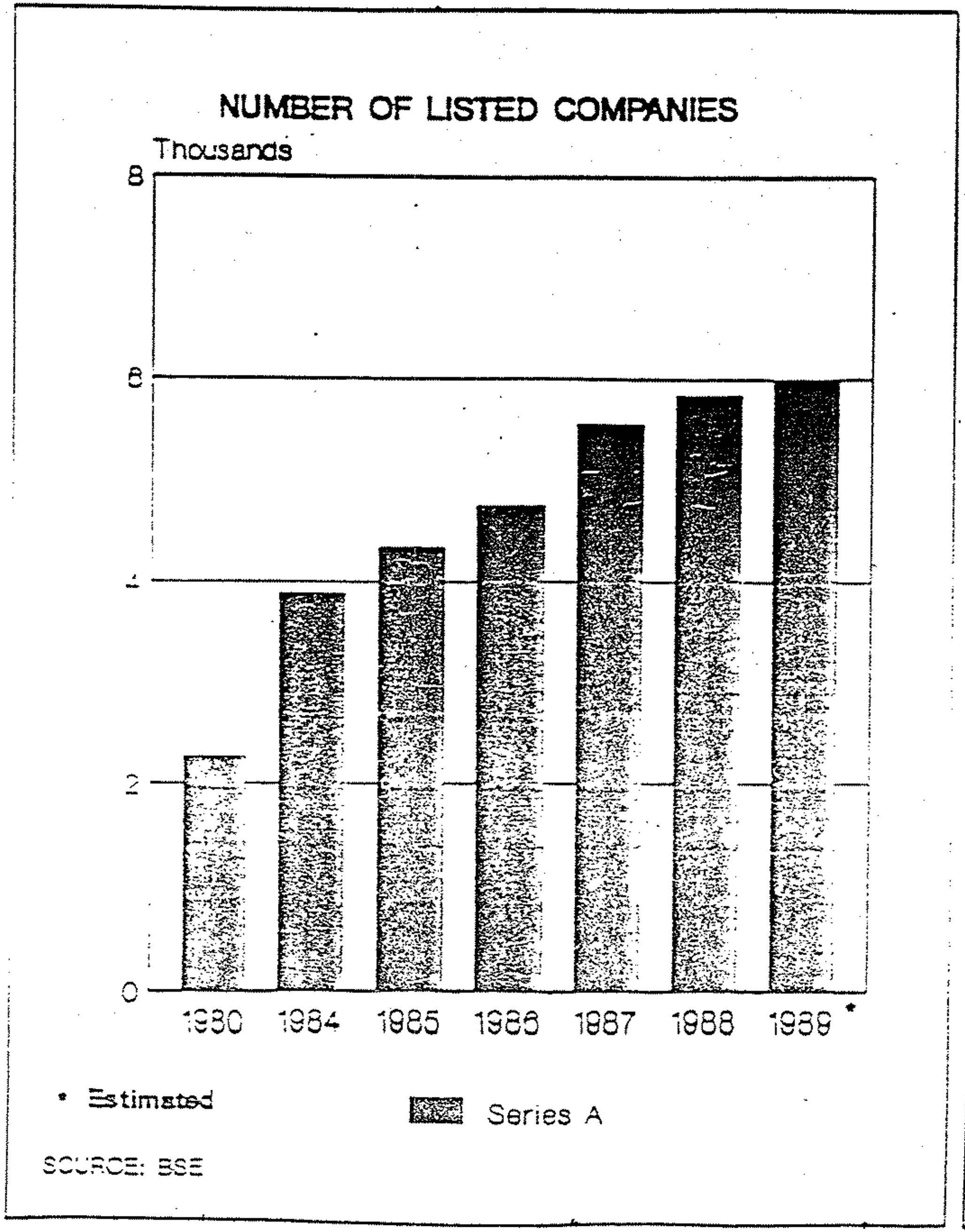

NUMBER OF LISTED COMPANIES
Thousands
8
6
4
2
0
1980
1984
1985
1986
1987
1988
1989 *
* Estimated
Series A
SOURCE: BSE

FIG. 4

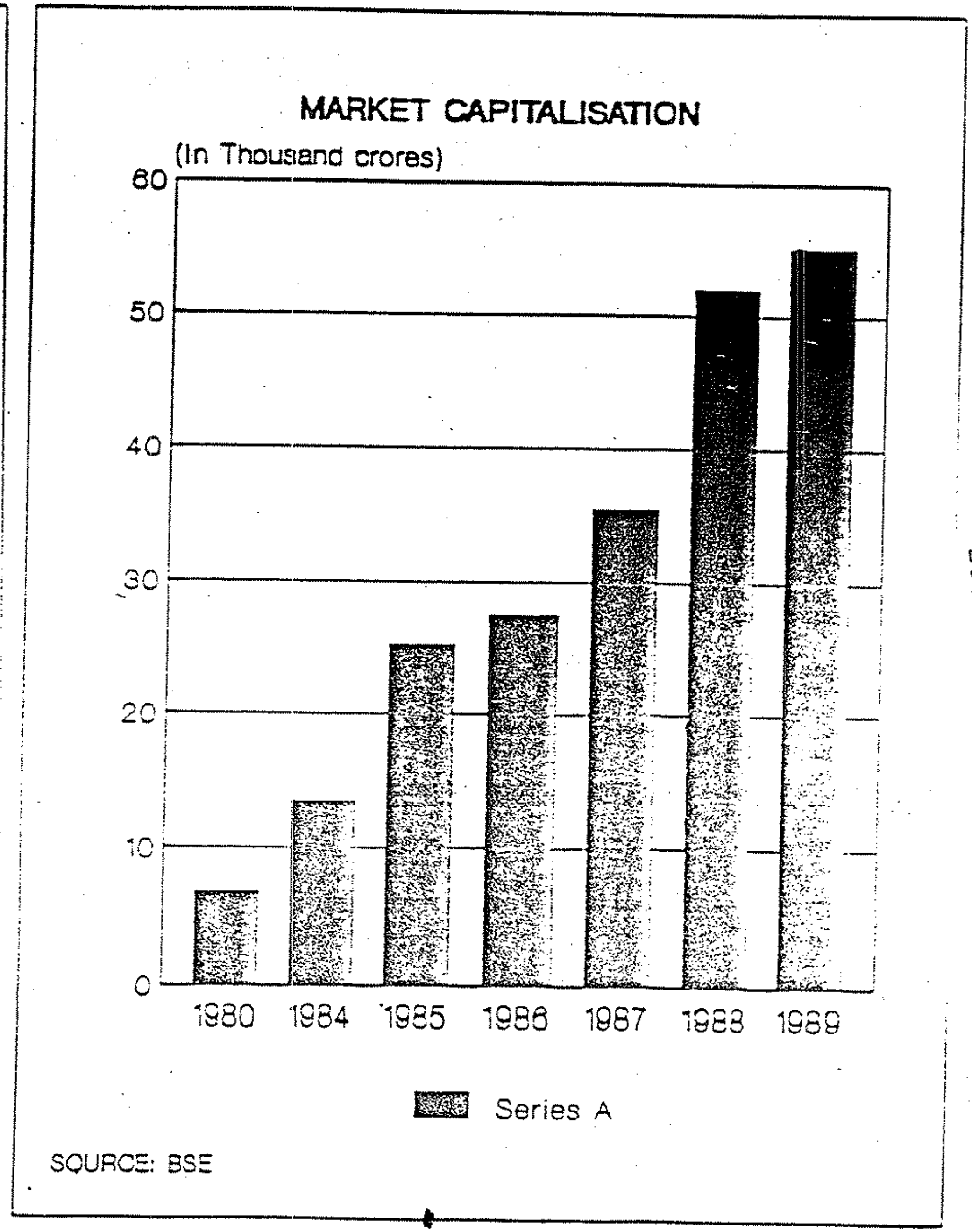
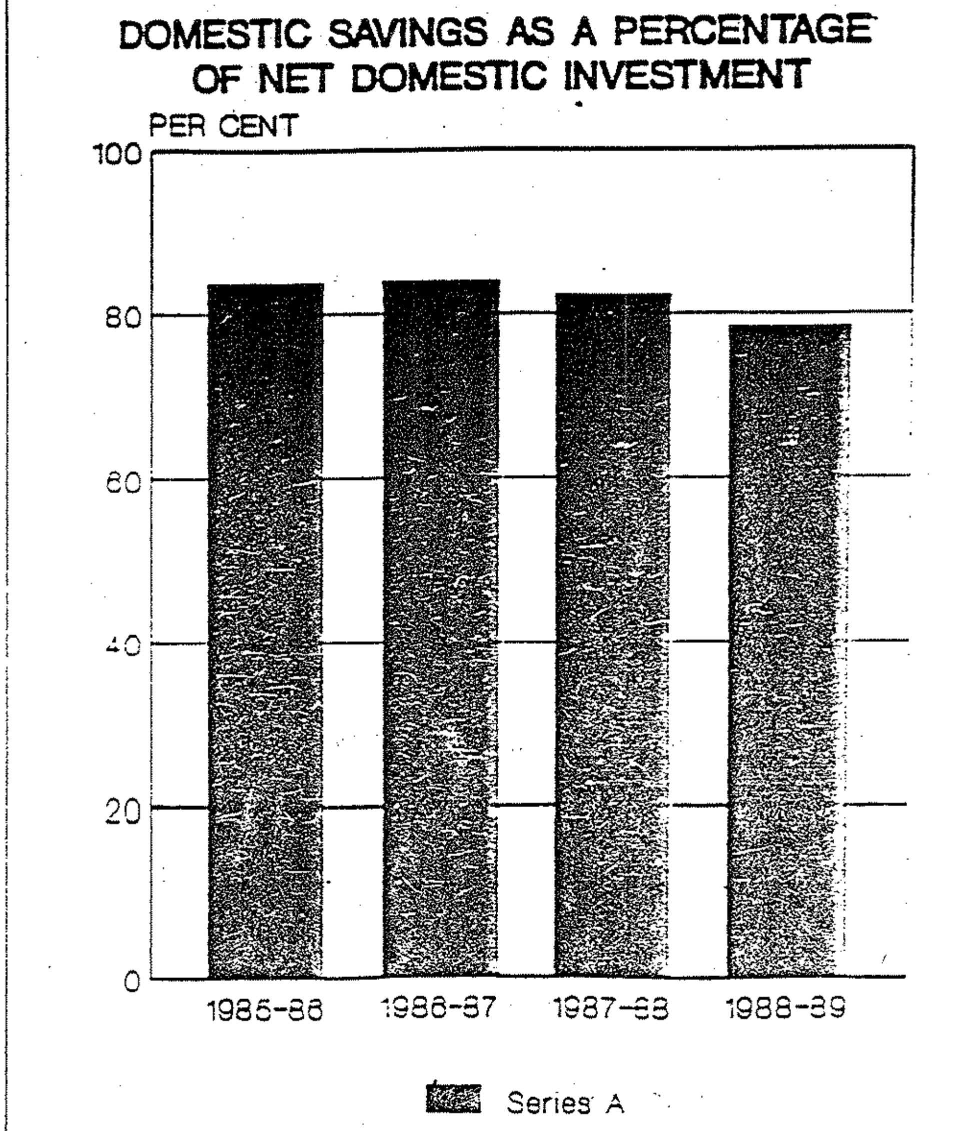
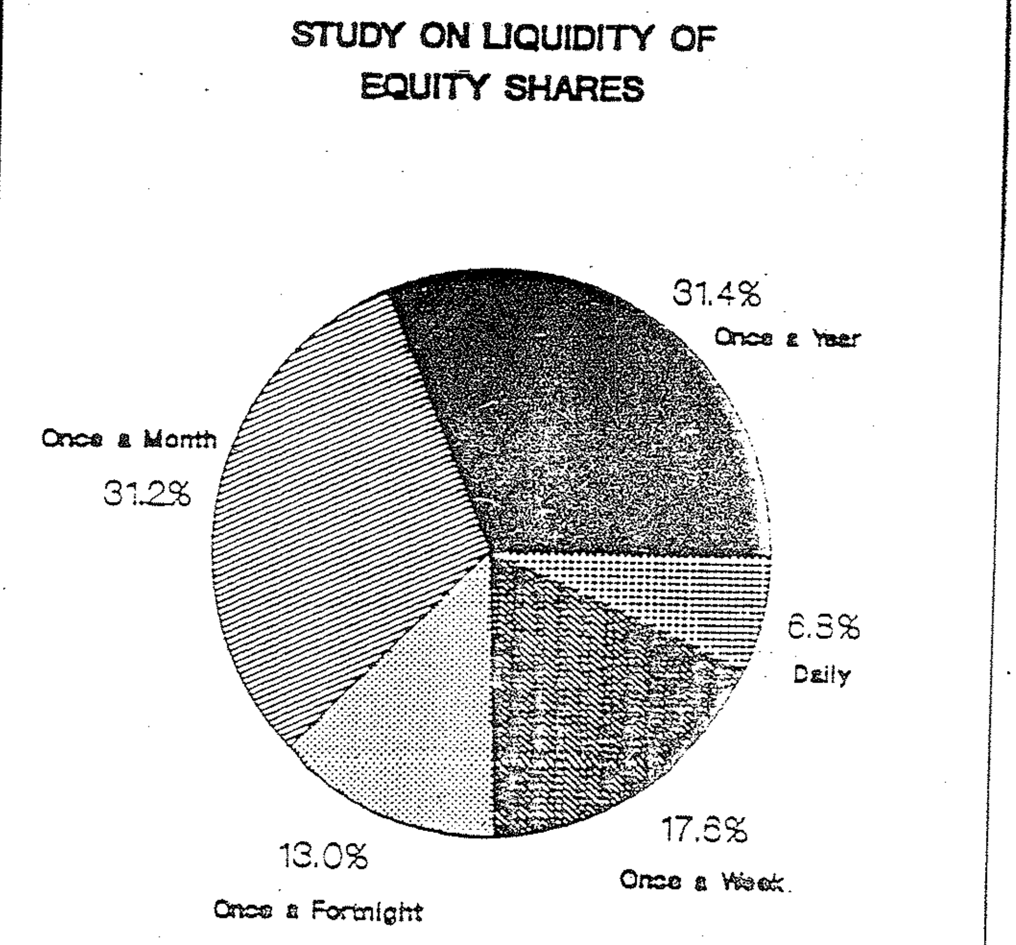

MARKET CAPITALISATION
(In Thousand crores)
60
50
40
30
20
10
0
1980
1984
1985
1986
1987
1988
1989
Series A
SOURCE: BSE

FIG..5



SOURCE: RBI

FIG. 6



Percentage of Listed Shares
Traded per Period

APPENDIX I

CHART IV
Distribution By Issuer

	1983-84	1984-85	1985-86	1986-87	1987-88	1988-89
1. New Companies						
a. Number	651	338	536	246	87	n.a.
b. Amount (Rs billion)	3	3	6	7	3	n.a.
2. Existing Companies						
a. Number	143	133	314	278	136	n.a.
b. Amount (Rs billion)	6	8	11	19	15	n.a.
3. Total						
a. Number	794	471	850	524	223	315
b. Amount (Rs billion)	9	11	17	26	18	31

n.a. Not available.
Source: SEBI

CHART V
Listed Stock in Major Stock Exchanges

Stock Exchange	No. of Listed Stock		No. of Listed Companies	
	31.3.88	31.3.89	31.3.88	31.3.89
Bombay	4,346	4,767	2,137	2,275
Calcutta	3,829	3,942	2,210	2,254
Delhi	2,670	2,830	1,687	1,789
Ahmedabad	949	1,000	590	661
Madras	975	952	532	556

Source: SEBI.

CHART VI
Turnover on the Bombay Stock Exchange
(Rs billion)

Year	Total Turnover	Average Daily Turnover
1984	46	22 (million)
1985	62	29 (million)
1986	136	68 (million)
1987	88	40 (million)
1988	170	82 (million)
1989	280	1.3 (billion)

Source: BSE.

APPENDIX II

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SYMPOSIUM ON CAPITAL MARKET DEVELOPMENT

and

PRIVATISATION

Specific problems of small states in developing securities market

by

Mrs Sharda Dindoyal
Chief Executive
Stock Exchange Commission

13th November, 1990.

Symposium on Capital Market Development and Privatisation

Specific problems of small states in developing securities market

1. Introduction

The key to the overall development of any country is the pace and pattern of development of its financial sector. Developing countries including small states have so far placed little emphasis on the development of this sector in the belief that such development should take place in the later stages of economic development. Recent empirical studies have shown that strategies to develop financial markets in the very stages have produced positive results for a number of countries. It is generally recognized that there is a positive correlation between the degree of sophistication of the financial system and the status of economic development in a country . The greater the breadth, the depth and resiliency of a country's financial system, the more efficient will be the distribution of financial resources throughout the economy and in turn the more rapid the rate of economic growth and development. By contrast, the more "repressed" a financial system is, the less likely, it is that domestic financial surpluses will be utilised efficiently for the development of the economy.

1.1. Contrary to the situation in developed economies, money in many developing countries is the most dominant financial asset with very little financial intermediation beyond commercial banking. The commercial banks are the predominant financial institutions and development of financial systems in these eco-

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nomies has tended to focus on the banking system including development finance institutions. As a result the development of non-bank financial institutions and financial markets kept receiving lower priority. In many instances there are no organised securities markets in these economies.

1.2. In recent years, there is a clear indication that developing countries have been pursuing policies of broadening and diversifying their financial system through the development of securities markets. The emergence of the debt crisis has largely contributed to this change in policy strategies. Governments and policy makers became aware of the limits of foreign indebtedness and the need to mobilise internal resources to offset the shortfall in investment funding.

1.3. During the past 20 years, many developing countries have attempted to establish local stock markets as such an institution, it is believed, will play a key role in the development of efficient securities markets. These attempts have produced mixed results. Securities markets in a number of developing countries have grown substantially in particular for the group of 30 "emerging stockmarkets". Unfortunately, in some cases the evolution of securities markets has had a limited impact in intermediating financial resources for economic development.

1.4. The reasons cited are narrow markets, lack of investor confidence due to poor information , insider manipulation and underdeveloped regulatory framework, the high risk and market imperfections that have hindered the allocation of capital to the most efficient companies.

2. Preconditions for the development of securities markets

The most important preconditions are a favourable political and business environment. Investors are very sensitive to political or economic uncertainty. A developing country which does not have an environment favourable to private entrepreneurship will find it much more difficult to establish successful securities markets. Of course, political stability, continuity in economic objectives, the health of the economy and prospects for growth are all equally important determining factors. This is where Government has a key role to play.

2.1. Fiscal and Monetary policies

Monetary and fiscal policies can influence to a large extent the rate and pattern of development of securities market. In a majority of developing countries, the tax system is not neutral with regard to the proceeds from debt and from equity instruments, thus introducing a bias which may inhibit the development of equity markets. For example in many developing countries, companies having recourse to bank loans can deduct interest for tax purposes whereas there is double taxation on dividends. Another inequality could be the differentiation not only between debt and equity but between specific categories of financial instruments depending on whether they are issued by the public or the private sector or whether they are deposit or non deposit instruments. Interest on savings deposits is exempted from tax while interests earned on corporate bonds and dividends are taxable. These fiscal measures will, in general, favour mobilisation of resources in the banking sector.

2.2. Monetary policies as opposed to fiscal policies have a direct impact on the relative advantages of deposit and non deposit instruments, of banks and non bank financial institutions. Bank loans are normally subject to credit ceilings and lending to some sectors of the economy is concessional. While credit ceilings may have a positive influence on equity financing, the availability of concessional credit for some sectors gives enterprises within these sectors every incentive to borrow rather than float equity. To add to the constraint of the securities market Governments have also been borrowing heavily from banks to meet budgetary deficits, thus crowding out private sector financing requirements. A welcome shift for the debt component of the securities markets has been recently for Governments of developing economies to issue bills and bonds to the public. But these bonds have been issued in several cases at market or quasi market rates with tax exempt yields. Such a measure placed private sector issuers of bonds at a great disavantage as their bonds would not be able to compete with those of Government which have got the added advantage of being virtually risk free.

2.3. Regulated interest rates and reserve requirements on deposits also have a certain influence on the development of a secuin general make the investment by small savers very uncertain. Companies are generally smaller. Small companies in U.K and Canada would in small states be considered as large operations. These small companies are very often family-based and are not interested to go "public". Local tax laws may also be so poorly administered that tax evasion is common. The disclosure required for public offerings acts a deterrent since disclosure may reveal tax deficiencies. Public offerings can also become more expensive than other forms of raising capital as it can take quite a long time to put an entire public offering together in the absence of underwriters or investment bankers as is the case in more sophisticated financial systems.

3.1.1. The price at which the company can sell its new issue of shares is also an important consideration. In some countries, Taiwan for example, the government had asked that the issue price be quite low for companies making public issues. Later in the secondary market, the price of these shares has generally risen considerably. In response many companies have declined to go public.

3.1.2. These constraints limit both the supply of and demand for securities on the primary and hence on the secondary markets. Stock markets in small states are generally confronted with a situation where there are many buyers chasing after too few shares. Such a situation will cause much volatility in price and may in the end deter investors' confidence.

3.1.3. This problem is made worse, as in small states, generally the quality of financial information made available to the public leaves much to be desired. Disclosure alone, however is not adequate to protect the investors as is the case for example in the U.S. The small investor would be unable to understand financial statements and other disclosure requirements. On the other hand, some market participants given the interlocking ownership structure of key enterprises may have access to privileged information and may be in a better position to assess an asset's underlying value.

3.1.4. In Mauritius to minimize the risks of high price volatility and to protect outside small investors all sale and purchase orders are centralised on the Stock Exchange. As far as possible sale or purchase outside the Exchange is discouraged and a price is fixed through confrontation of all orders. A 4% bracket on fluctuations in share prices was also imposed. These measures were taken to prevent wide price fluctuations given the limited supply of securities on the market. Excessive price volatility would jeopardise the success of the Exchange and frighten away investors.

3.2. <u>Securities institutions</u>

The quality of organisation, of the market will depend on institutions that directly service the market - that is the stockbroking firms, institutional investors, commercial banks, The Exchange and the media coverage.

3.2.1. Stock broking firms: The stockbroking firm in small estates is one of the weakest securities market institutions. They suffer generally from lack of capital and professional expertise in modern trading skills. They are essentially a one man professional operation with one or two clerks. The capital base is low and training opportunities in the country almost non existent. These firms do not engage in stockbroking business alone and undertake other businesses. They do not have sufficient capital to undertake major programmes to bring about a significant expansion of security activity. In Mauritius, membership of the Stock Exchange has been restricted to corporate members since individual members are constrained in their capital and professionnal staff development. It was felt that corporate members would bring more capital to market operations thus enhancing the depth and liquidity of the market.

3.2.2. Institutional investors: To generate a stronger secondary market active, participation of institutional investors is also critical as they provide:

(i) a constant flow of funds to the securities market;

(ii) a foundation for long term investors in the securities market, giving it greater stability; and

(iii) professional and analytical ability to evaluate potential investments and support the market in cases of temporary distress.

3.2.3. In small states, institutional investors such as investment companies, unit trusts, pension funds and insurance companies play a very limited role. Though insurance companies and pension funds are significant holders of financial assets, they direct these funds mostly to investment in 'government securities' or in real estate. This lack of institutional infrastructure in general has brought about very low level of intermediation and has resulted in an underutilisation of the securities markets. Such underutilisation can also be largely attributed to the role which is played by the banking sector in small states.

3.2.4. The Exchange: The performance of the secondary market depends on one key institution: the Stock Exchange. In small economies, the main problem confronting the Exchange is one of experienced and qualified personnel and finance. Stockbroking activities were mainly performed by one middleman who acted as the intermediary between buyer and seller. The middleman was not bothered about P.E ratio's ,company's future performance etc. He was merely concerned with striking a bargain. Costs were kept at a minimum and emphasis was placed on commissions. An Exchange, on the other hand, is expected to establish a suitable organisation to govern its activities and also maintain some regulatory power over the conduct of the secondary market. The Exchange must keep the records necessary to provide information on prices on the market and sometimes operate a clearing system to "net out transactions". These activities require investment in skilled human resources as well as advanced technology (modern office equipment and info technology in general). As a stock exchange is generally a private sector organisation and is owned by members of the Exchange; there may be a serious problem of finance. Private sector organsiations are more concerned with the cost factor. They would not wish to incur losses which are sometimes inevitable during the initial stages of the development of the Exchange when few companies are listed and the turnover is limited. Some countries have responded to this problem by having the Exchange owned by a Government agency.

3.2.5. Commercial Banks: Commercial Banks have a commanding position in many small states' financial system. Government may initially prefer to promote commercial banking in the belief that it is easier to control the financial flows of the country through a Central Banking structure. This has stifled in many cases both innovation and competition in the financial system which is essential for the growth of a healthy securities market. As a result an informal finance sector has developed but which is poorly structured and and lacks the critical mass for effective investment.

3.2.6. The Media: The media, in particular the finacial press, plays a very active role in informing and advising the investors both on the performance and prospects of companies and the operation of the market . The media in many cases act as a watchdog and alert public opinion and the stock exchange authorities on suspected fraudulent activities. In small economies where the press does not invest in specialised personnel on financial matters, it is very difficult for the media to educate and assist the investor. In fact the media may be detrimental to the development of a securities market as the information diffused to the public may be misleading, distorted and confusing.

3.3. <u>Regulatory mechanisms</u>

Regulations (self- regulation by the Exchange or overall supervision by a regulatory agency) is a sine qua non condition for the development of securities markets. An efficient regulatory framework will foster investors' confidence and the growth of the securities markets. In the illiquid markets of small states special regulatory attention is needed, as small and narrow markets are more susceptible to manipulation.

3.3.1. Moreover in these small states the law was written at a less sophisticated time than today and legislators have not moved quickly enough to identify precisely the regulations needed for the financial system in their current environment. And yet it is important for the strong and steady development of securities markets that there is continuous institutional and regulatory build up. Without such an active policy of regulation, it would not be possible for securities market in smaller economies to acquire the same confidence which small depositors have for banks. The legal framework must be both cohesive and comprehensive. Rules on trading, information disclosure, have to be incorporated in the country's legislation. The investing public needs to be protected from fraudulent practices and stock market manipulation. Brokers and underwriters must follow professional codes of conduct. Though over regulation may constrain the development of the market, without regulations the securities market would not be able to develop.

3.4. Openness of economies and vulnerability

The need for an adequate fiscal, legal and regulatory framework is much more acute if small states wish to attract funds from the world's capital markets. The trend is now towards globalisation of capital markets and freer movements of funds. For small states to take advantage of these opportunities, it must first ensure that foreign investment on its market would not destabilize the ownership structure of the country.

3.4.1. Credit worthiness and norms for investor protection on domestic financial market are two important prerequisites. Investors expect the same standard of protection on the developing countries markets as they can obtain elsewhere. They will wish to be assured of the efficiency and transparency of these markets. On the other hand, we do appreciate, however, that at the initial stage, it may not be advisable for the country to open up its securities markets. This should be a gradual process and the market can be opened to foreign investment as domestic expertise and market infrastructure becomes more developed.

There is no doubt that in the long run the country will generate additional investible resources through the internationalisation of its securities market.

Stock Exchange Commission
SICOM Building
Port-Louis.

13th November, 1990.

Restricted

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SYMPOSIUM ON CAPITAL MARKET DEVELOPMENT
AND PRIVATISATION

14-16 NOVEMBER, BOMBAY

The Development of Capital Market in Kenya

by
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Commonwealth Secretariat
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London SW1.

October 1990

Restricted

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A. INTRODUCTION AND HISTORY

In Kenya, dealing in shares and stocks started in 1920s when the country was a British Colony. At that time stockbroking was a sideline business conducted by accountants, auctioneers, estate agents and lawyers in a haphazard manner. This business was then confined to the resident British Community since Africans and Asians were not permitted to trade in securities until after the attainment of independence in 1963. It is not surprising therefore that in 1960s and 1970s most indigenous people knew little about the stock exchange and tended to consider it as a gambling institution or an organ to perpetuate foreign interest.

The Nairobi Stock Exchange was constitutionalised in 1954 as a voluntary association of stockbrokers registered under Societies Act. It is one of the most active capital markets in independent Africa. The Exchange follows old British dealing traditions with modifications to suit the local environment. The Nairobi stock market dealt with other international securities market until 1965 when Exchange Control regulations were introduced which reduced it to a regional market for Kenya, Uganda and Tanzania. This East African set-up, centred in Nairobi, ceased in August, 1977 when Uganda and Tanzania were removed from Scheduled Territories for Exchange Control purposes, a factor which further contracted the Nairobi Stock Exchange from a regional to a national stock exchange.

At present the Nairobi Stock Exchange is made up of six member firms which are based in Nairobi. These stockbrokers transact business mainly on local securities and only a comparatively small proportion of business is conducted in foreign securities through overseas agents.

The business of buying and selling investment securities is transacted through stockbrokers who act as agents. They do not take positions as principals but merely earn brokerage fees for services rendered to their clients.

Potential investors, drawn from institutions, individuals or registered agents, contact stockbrokers either by mail, telephone or personal visits and place their buying and selling orders.

The six stockbroking firms hold a daily callover to establish the highest bid and lowest offer. These brokers, acting on behalf of willing buyers and willing sellers, bargain on telephone to strike a deal. Since the Stock Exchange has no physical trading floor, it is essentially a "telephone market". Once a deal is contracted, transfer of ownership is effected and the purchaser is issued with a new Share Certificate.

As a capital market, the Exchange serves five main functions:

a) it helps mobilise domestic savings thereby reallocating financial resources from dormant to active agents, with efficiency and speed.

b) it facilitates the transfer of securities from shareholders to potential buyers.

c) it assists companies to enlist local equity participation and in the process raise extra finance essential for expansion and development.

d) it facilitates public owned corporations to privatise the whole or part of their equity.

e) it enhances local enterpreneurial skills.

The market deals in the exchange of 83 securities drawm from 55 public listed companies and the Kenya Government quoted 39 gilt-edged stocks. The market capitalisation as at December 31, 1989 was Kenya Shillings 8.73 billion (US$380 million). (See Appendix II).

In 1980s the Kenya Government realised the need to design and implement policy reforms aimed at fostering sustainable economic development with an efficient and stable financial system. In 1984 the IFC carried out a study which culminated in a report on "The Development of Money and Capital Markets in Kenya" which became the blue print for structural reforms within the financial markets. In the spirit of these reforms, the Kenya Government created the **Capital Markets Authority** in December, 1989 with the objective of facilitating and overseeing the orderly development of capital markets. The role of the Authority can best be understood through its principal objectives which are:

a) the development of all aspects of the capital markets with particular emphasis on the removal of impediments to, and the creation of incentives for longer term investments in, productive enterprise;

b) the creation, maintenance and regulation, through implementation of a system in which the market participants are self-regulatory to the maximum practicable extent, of a market in which securities can be issued and traded in an orderly, fair and efficient manner;

c) the protection of investor interests;

d) the operation of a compensation fund to protect investors from financial loss arising from the failure of a licensed broker or dealer to meet his contractual obligations.

Some of the issues that the Authority is currently tackling include: improving the process of placement and trading on the Nairobi Stock Exchange, access to long-term capital by business community, privatisation and its overall impact on capital market development, education and market promotion, disclosure considerations in accounting and auditing and the development of investment institutions such as Mutual Funds and Unit Trusts as well as the restructuring of the policy environment to facilitate fast market growth and development.

At the moment the Nairobi Market is characterised with mounting demand for securities arising from local awareness in investment matters, but the supply of listed securities is inadequate. All the recent new issues of shares by way of either private placement or public offerings were oversubscribed (Appendix I). The greatest challenge which the Kenyan market is facing is how to encourage more companies to be listed; to diversify marketable instruments and generally to develop related components of, and interemediaries in the capital markets.

B. ROLE OF GOVERNMENT IN CAPITAL MARKET DEVELOPMENT

One of the most critical challenges of Kenya is the need to improve mobilisation of domestic savings and to increase the efficiency with which these are allocated for the investment required to sustain economic growth. A vital requirement for achieving the desired increase in domestic resources is an improvement in the financial system which can cater for both short-term credit as well as long-term equity and debt finance. It has been realised that it is beneficial for Kenya to develop a capital market as a vehicle: to avail more risk capital to entrepreneurs; to enhance general economic growth as savers broaden their ownership of productive assets; to improve capital allocation and investments through stock market pricing mechanism; and to enlist local equity participation in transnational and large local concerns.

In order to create an enabling environment for successful development of capital market in any country, the Government would be required to carry out a comprehensive and sustained program of measures - economic policy, institutional, fiscal and legal - aimed at creating an atmosphere conducive to the mobilization of long-term savings through securities. In so doing the Government should remove barriers and impediments, provide incentives, or intervene, to stimulate desired action especially increasing the supply of securities, and to introduce new ways of doing things.

Government is a major leader and catalyst in promoting economic growth and development in Kenya. It is important therefore to impress on the Government that the desired economic development can be accelerated through utilisation of the Stock Exchange as a vehicle for mobilisation of local savings and for efficient allocation of investment. Government awareness can be created by seeking for the continued support of top legislative and executive arms. A forum through which constant dialogue is maintained should be created. In this country, the establishment of a Capital Market Development Authority has become a valuable link between public and private sectors with the principal beneficiary being the Stock Exchange.

Lack of Government support sometimes arises from inadequate information and eduction. It is therefore important that training sessions in form of seminary, courses, and overseas educational tours for top-decision makers are conducted. Awareness can also be enhanced by disseminating information through the press and the mass media. Relevant publications should also be made available to targetted people.

International agencies and friendly countries can fund studies in specialised fields. The arising reports and papers drawn by consultants can provide valuable guidelines in the formulation and implementation of government policy.

Where local pressure groups do not create positive impact on local leaders donor agencies can be of great assistance in creating the desired impact.

If brokers/dealers are properly constituted and recognised, their Governing Council becomes an effective vehicle through which the Government can be approached at different levels. The authorities are highly supportive of the Stock Exchange if their endeavours are believed to assist the government in the implementation of stiputated plans and policies.

C. PREREQUISITES FOR A VIBRANT CAPITAL MARKET

The Kenyan market has remained relatively dormant in 1970s and 1980s owing to introduction of Capital Gains Tax (1975-1985); lack of Government support; excess institutional buying support and lack of new issues owing to lengthy approval procedures. It has been noted that for creation and continuation of an active stock exchange an enabling environment must be created. In this connection the following issues should be addressed:

1. Confidence and Accountability

Potential investors must have confidence in the individual enterprise based on full and accurate disclosure of the company's financial conditions under explicit accounting disclosure laws, standards and practices, as verified by recognized professionally qualified auditors. These reports and financial statements must provide information essential to informed investment decisions, for comparing securities and for evaluating corporate performance and prospects.

2. Volume and Variety of Securities

There must be a sufficient volume and variety of shares and stocks available for trading from a minimum number of relatively large companies, organized under the law as public limited liability enterprises permitted to sell their shares in an open market. These securities should offer different levels of risk, maturity and return so as to accommodate the aspirations of varied investors.

3. **Interested Buyers**

There must be sufficient number of potential buyers both individual and institutions, who believe that investments in local companies offer an acceptable profit-making alternative to other potential investment opportunities and who have disposable income readily available for investment purposes.

4. **Trading Mechanisms**

Responsible trading intermediaries must exist in the form of banks, brokers, dealers, and underwriters who are able to provide initial flotation of new issues in the primary market and subsequent trading in the secondary market.

5. **Regulatory Body**

Some regulatory or policing agency must be in place, either in the form of a Capital Markets Authority (Securities and Exchange Commission), or a self-regulating stock exchange council which should be able to establish and enforce the rules governing the issuance and trading of securities, and to monitor the activities of firms engaged in securities trading. This agency would be obliged to set forth accounting and reporting policies and standards of listed companies; and to observe adherence to these regulations.

6. **Political Stability and Health Economic Growth**

Political stability in a country is essential in facilitating both the issuing companies and the investing community to have the confidence needed in making long-term investment decisions. In order to achieve a healthy and steady economic growth finances are required and these necessitate vigorous mobilization of domestic savings.

7. <u>Positive Government Attitude</u>

For the government to create a favourable enabling environment it must: design conducive monetary and fiscal policies; offer proper incentives for public offering; remove excess controls; promote intermediaries; and promulgate laws that can encourage the growth of a capital market.

8. <u>Technical Assistance</u>

Where no local expertise is available, it is inevitable that foreign investment and overseas technical consultants are introduced. Appropriate overseas training programmes to cater for administrators and professional intermediaries must be conducted. Suitable educational materials should also be prepared and disseminated.

In Kenya we have also realised that to create an effective capital market the country must have many borrowers and lenders exchanging financial instruments through well established financial institutions. Not only should there be a primary market for trading these instruments but also an active secondary market to provide liquidity to a wide range of investors. There must also be potential participants usually comprising of individual and institutional investors drawn from private and public sectors seeking for opportunities to invest in financial instruments issued by reputable and financially stable institutions.

Lack of diversity of financial instruments in less developed countries such as Kenya is principally attributable to the unwillingness of commercial banks and financial institutions to provide unsecured credit by accepting papers drawn on them by borrowers. The other retarding factors include: lack of discounting facility; improper pricing and unacceptable interest rate policy on treasury bills and bonds; illiquidity due to the absence of an active secondary money market; lack of specialised intermediary institutions and lack of loan facility to finance discounting of these instruments.

D. INCENTIVES FOR DEVELOPMENT OF A CAPITAL MARKET

In Kenya we have noted that in a free enterprise savings will be employed in areas where economic rewards can be maximised. Private users of savings will on the other hand endeavour to issue more securities if the cost of raising funds are lower than bank borrowings.

Stated below are some steps which can be taken to increase the supply of securities and to maintain demand for securities and encourage savers to invest:

i) Review of the tax system

The tax system should be reviewed with a view to removing any disincentives and to create incentives which attempt to boost the supply and demand of securities and to encourage savers to invest. The short run losses of Government revenue as a result of reduction of taxes are in the long run offset by the benefit of greater availability of long-term finance essential for economic growth.

Some of the measures that the Government can take to stimulate investment is by removing or reducing withholding taxes on capital gains, dividends and interest. Expenses of public offering of securities such as underwriting commission, legal, accounting, printing quotation fees and brokerage should be made tax deductible. Corporations that offer a specified percentage of their equity to a specified minimum number of people through the capital market should be charged a lower corporate income tax rate. Another incentive is to give issuing companies tax credit for investment in public quotation of equity and debt instruments." Contribution towards staff pension and provident funds should be made tax deductible.

ii) Return on investment

In order to have an active market it is necessary that return on marketable instruments be competitive with return on other financial instruments after allowing for risk, liquidity and time. The total economic environment relating to factors such as price controls, exchange control, tax system, legal, regulatory and administrative issues which are perceived to be impediments should be thoroughly examined and eliminated.

It should also be noted that the private users of savings are likely to issue more equity and securities if the cost of raising funds through the capital market are lower or comparable to bank borrowing.

iii) Issue of Government stocks

The Government should also patronise the capital market by issuing gilt-edged stocks and treasury bills through the market. Such Government debt securities should be issued at rates which will offer investors yields competitive with yields on other long-term debt instruments of similar risk and maturity. This will improve liquidity and marketability of these instruments both on the primary as well as the secondary market.

iv) Policy on foreign investments

In order to encourage new foreign investments on the capital market, policies or laws relating to protection, licensing, compensation for compulsory acquisitions, repartriation of dividends, management fees and sale proceeds, and generally all matters relating to the rights, obligations and requirements on foreign investors should be transparent.

Of special significance, foreign investors should be allowed to repartriate proceeds of capital gains on sale of securities but where such proceeds cannot be transferred immediately because of foreign exchange constraints, the investors should be allowed to reinvest their funds as they see fit. Any changes in the market mechanisms should be to encourage the return of the much needed flight capital, rather than facilitate its outflow. At an approrprate moment foreign investors should be encouraged to enlist some local equity participation.

v) <u>Arranging credit facility</u>

In order to encourage the small local savers to participate in a public offering the issuing company can be required to make special credit facility arrangements with commercial banks for indigenous investors providing up to a specified percent of the cost of the shares applied for, the loan being repayable at the ruling bank lending rate over a specified period against the security of the relevant share certificate and signed transfer deed deposited with the lending bank. In Kenya this facility has proved popular in all recent public isssues of shares.

vi) <u>Fostering confidence</u>

The Stock Exchange can enhance its ability to provide orderly and open market, foster confidence in the market and generally remove perception of the mystery about its operations by: accepting qualified persons to join its membership; expanding representation on the Council of the Exchange to include other related interest groups; imposing more self-regulatory procedures; disclosing more market information; and prohibiting improper activities in the market.

It should be useful to provide either a trading floor or alternatively utilise an automated "over-the-counter" system open to the public. As confidence is fostered on the capital market more issuers and investors will patronise the capital market thereby stimulating further investment.

vii) <u>Compulsory Public Offering</u>

As a more interventionist approach the Government might consider certain companies to have public offering. this method should only be applied if all the incentives stated above are not working adequately. Some of the interventionist measures include: requiring foreign companies seeking for protection to offer a certain percentage of their equity to the public; requiring foreign companies of a certain size to have public issues; and allowing limited liability incorporation only if a public offering is made; and restricting access to local bank borrowing unless a company has made a public offering.

E. PRIVATIZATION THROUGH THE STOCK EXCHANGE

Privatization is the process whereby ownership of a public enterprise is transferred to the private sector. Complete privatization involves total transfer of ownership whereas in partial privatization the state retains some control.

The main objectives of privatization are: to reduce the public sector by transferring public enterprises to the private sector; to increase the economic efficiency of the enterprise by removing Government interference by subjecting the enterprise to more competition, by promoting responsiveness to consum r needs, and by instilling greater discipline; to promote wider share ownership; and to raise money for the government.

In 1988 the Government started privatization through the Nairobi Stock Exchange by carrying out a successful public issue of 7.5 million shares or 20 per cent of the equity of Kenya Commercial Bank. The Issue was over-subscribed 2.27 times by 110,000 applicants and only 70,000 of these applicants succeeded to get 100 shares each. The same Bank made a second public issue of 9 million shares in September this year. There are a number of parastatal organisations which are lined up for future partial privatization through the Nairobi Stock Exchange.

Where a stock exchange exists privatization programme can be successfully carried out through **public flotation.** Governments favour public flotation because there are well established procedures for going public and the outcome is consistent with the objective for encouraging widespread share ownership. However the information requirements for public flotation are demanding and therefore in some cases **private placement** and **management buy-out** methods of sale are also used.

On the stock exchange it is easier to privatise an enterprise which is already incorporated under the Companies Act and which has a satisfactory record of profitability. A single entity company is easier to be privatised than a subsidairy or part of a larger organisation and so is an entity with a high degree of market dominance. Sometimes there is need to take time to prepare the organisation, procedures and culture of the company for private commercial world before it is launched on the stock market.

Investors in the private sector are understandably reluctant to become involved in unprofitable public enterprises. They are naturally interested in lucrative companies that have potential for offering a reasonable return on their investment. It is for this reason that privatization has concentrated so far on the profitable elements of the public sector. At the same time new shares have to be priced at some discount in order to make the offer attractive to a wide section of the public and to ensure a successful sale by creating potential for an active initial market in the shares. This has lead to the criticism that publicly owned assets have been sold off cheaply to benefit investors to the detriment of the tax payers.

Before an enterprise can be successfully privatised through the sale of shares potential investors must be made to understand the nature of the business which is being sold and can have confidence in the future prospects of the company. It is also adviseable to test the market for an enterprise being privatised by selling only part of the shareholding in the first stage of say 10-20% followed by further tranches of say 10% or more.

In certain circumstances where privatisation is practised, the government may retain one Special Share or "Golden Share" which effectively gives it a power of veto to prevent change of ownership of a company which has particular national or strategic importance. Although the proceeds from sale of public enterprises are small relative to government expenditure, this source of revenue helps to reduce the level of government borrowing to a certain extent.

At the offset trade unions oppose privatisation programme primarily on the grounds that it is likely to cause job losses. But their resistance can be overcome by designing an attractive employee shareholding scheme and as employees share in the fortunes of the enterprise their loyalty and consequently productivity is highly boosted. Employee share ownership scheme also instils great commitment to the success of the enterprise and frustrates trade union opposition to company policies. Wider share ownership also creates popular capitalism which makes it difficult for another government to nationalise the company.

In the final analysis a successful privatisation programme results in improved performance of enterprise and improved government finance. It also eases external financial constraints, reduces the size of the public sector, attracts higher calibre staff, enables quicker decision making as bureaucracy is reduced and generally develops the capital market by widening the choice of quoted investments.

F. CONCLUSION

In conclusion, the essence of developing stock exchanges in Commonwealth countries is justified as:

a) providing a market mechanism for efficient allocation of capital,

b) expanding the range of investment opportunities available to savers seeking different levels of return,

c) affording the social advantages derived from ownership of private enterprises,

d) encouraging maximum domestic and foreign resource mobilization, and

e) creating a vehicle for the government to implement such policies as privatization, indeginisation and promotion of local enterpreneurial skills.

Policy formulation and implementation requires reliable information which is not readily and sufficiently available in some Commonwealth countries. A facility should be established for collection, analysis, retention and retrieval of information.

The whole process of investing in intangible assets is extremely complicated. There is therefore urgent need for provision of a training institution to specialise in capital markets development disciplines.

Finally, immediate attention should be paid to the establishment of an Association of Commonwealth Stock Exchanges which will be charged with the responsibility of initiating and promoting national, regional, continental and international stock exchanges.

APPENDIX II

NAIROBI STOCK EXCHANGE

MARKET DATA BASE

Annual Data	1980	1981	1982	1983	1984	1985	1986	1987	1988	1989
1. Number of listed companies (end of year)	57	54	54	54	55	55	53	53	55	55
2. Number of listed issued (end of year)	76	72	72	72	73	73	71	71	73	70
3. Market capitalization (end of year) KShs.(bill)	3.03	2.88	2.56	3.24	3.82	4.25	5.08	7.00	8.41	8.73
4. Value of shares traded (annual total) KShs.(mill)	*	*	*	*	*	*	*	*	*	+38.44
5. Number of shares traded (annual total) (mill)	*	*	*	*	*	*	*	*	*	+1.81
6. Number of trading days (annual total)										252
7. Local market index (end of year)	378.3	350.4	349.8	382.7	386.4	421.1	506.0	735.3	858.6	815.85
8. Price-earning ratio for all listed companies (end of year)	6.89	6.32	4.43	4.38	4.99	3.99	3.89	5.80	7.02	*
9. Price-book value ratio for all listed companies (end of year)	0.41	0.33	0.26	0.29	0.32	0.33	0.37	0.45	0.45	
10. Market dividend yield (end of year)	8.31%	9.57%	10.73%	9.67%	13.49%	12.64%	12.15%	8.32%	8.37%	
11. Number of new issues (annual total)	-	-	-	-	1	-	1	1	3	1
12. Value of new issues (annual total) KShs.(mill)	-	-	-	-	11.6	-	80	29.6	228	304.5

Note: All currency values sare in millions/billions of Kenya Shillings

+ shows figures for 4 months from September to December

* Data not complied

Rate of Conversion - 1/10/90: 1US$ = KShs.23

COMPARATIVE DATA OF RECENT NEW ISSUES

	Company	Securities	Type of Issue	Subscription Open	Issue Price	Dividend Yield	Under-writer	Sponsoring Broker/s	Rate of Subscription
1	Jubilee Insurance Co. Ltd.	800,000 Shs.5/= Ordinary Shares	Public Issue	28/5/84 to 13/6/84	Shs.14/50	12.07%	Diamond Trust of Kenya Ltd.	Ngenye Kariuki & Co.	220%
2	Barclays Bank of Kenya Ltd.	5 million Shs.10/= Ordinary Shares	Public Issue	7/4/86 to 21/4/86	Shs.16/=	15.6%	None	Francis Drummond & Co. Ltd. AND Francis Thuo & Partners Ltd.	613%
3	Kenya Finance Corporation Ltd.	2,276,460 Shs.10/= Ordinary Shares	Private Placing	9/6/87 to 31/7/87	Shs.13/=	11.5%	None	Ngenye Kariuki & Co.	103%
4	Kenya Commercial Bank Ltd.	7.5 million Shs.10/= Ordinary Shares	Public Issue	23/6/88 to 19/7/88	Shs.20/=	15%	None	Francis Thuo & Partners Ltd.	327%
5	Total Oil Products (EA) Ltd.	2.7 million Shs.5/= Ordinary Shares	Private Placing	26/9/88 to 2/11/88	Shs.13.25	15.6%	None	Ngenye Kariuki & Co.	106%
6	Nation Printers & Publishers Ltd.	2.5 million Shs.5/= Ordinary Shares	Public Issue	7/11/88 to 30/11/88	Shs.11.50	9.6%	Diamond Trust of Kenya Ltd.	Ngenye Kariuki & Co.	133%
7	Standard Chartered Bank Kenya Ltd.	21 million Shs.5/= Ordinary Shares	Public Issue	16/10/89 to 8/11/89	Shs.14.50	12.07%	None	Francis Drummond AND Ngenye Kariuki & Co.	233%

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AN OVERVIEW OF EMERGING STOCK MARKETS
THE JAMAICA STOCK MARKET EXPERIENCE

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INTRODUCTION

The label "EMERGING STOCK MARKETS" refers to an amorphous grouping; The only common characteristic being their location in developing countries. The INTERNATIONAL FINANCE CORPORATION (IFC) has developed a useful and comprehensive data base on this grouping comprising thirty (30) markets. Included are markets such as Brazil's Sao Paulo market with a 1989 market capitalisation of US$44.4 billion and 592 listed companies; Mexico with a market capitalisation of US$22.6 billion and 203 listed companies; Korea with a market capitalisation of US$140.9 billion and 626 listed companies. At the other extreme are markets such as Zimbabwe with a market capitalisation of US$1 billion and 54 listed companies and Venezuela with a market capitalisation of US$1.1 billion and 60 listed companies.

The Jamaican market statistics are closer to those of Zimbabwe and Venezuela, with a 1989 market capitalisation of US$1 billion and 45 listed companies. It follows that the experience and problems of the Jamaican market which I recount, will be more applicable to the smaller of the "emerging markets" rather than the larger and more developed "emerging markets".

OVERVIEW OF JAMAICAN CAPITAL MARKET

The Jamaican Capital Market infrastructure is impressive, as measured by the array of institutions. The Bank of Jamaica stands at the apex, with responsibility for monetary policy.

There are eleven (11) commercial banks with 167 branches spread across the island. As at the end of June 1990 total assets of the banks were J$16.1 billion, (US$2.15 billion), outstanding loans J$8.1 billion (US$1.08 billion) and total deposits J$11.1 billion (US$1.48 billion).

In the last five years, there has been a dramatic increase in the number of merchant banks, to 21 such institutions presently. Total assets of the merchant banks at June 1990 were J$4.25 billion (US$567 million) while loans and advances at the same period stood at J$2.78 billion (US$371 million).

Complementing the banking sector are five (5) Finance Houses, three (3) Trust companies, nine (9) Life Insurance Companies, eighteen (18) General Insurance Companies, six (6) Building Societies, two (2) Development Banks, two (2) Unit Trusts, ninety-one (91) Credit Unions and a newly established Venture Capital Company.

A spattering of NATIONAL INCOME STATISTICS may be instructive before beginning my overview of the Jamaican Stock Market experience. Gross Domestic Product (GDP) at the end of fiscal period 1989 in current dollars was J$22.3 billion (US$2.97 billion) in constant 1974 dollars GDP was J$2.1 billion. Current inflation is 21.4% (Sept - Sept) and the prime lending rate is 30% - 31%.

THE DEVELOPMENT OF THE JAMAICAN STOCK MARKET

Organised trading in corporate securities dates back to 1961 when the Kingston Stock Market Committee was established under the auspices of the Bank of Jamaica. The committee comprised two stockbroking firms and commercial banks:

1. Annett & Company of Canada Ltd - a subsidiary of Annett & Company Ltd of Toronto - which commenced business in Jamaica in 1961.

2. W. C. Pitfield & Company Ltd - a branch of W. C. Pitfield & Company Ltd of Montreal.

3. Officers of five (5) commercial banks, then operating in the country.

The committee met once per week to trade and exchange information about dealings and prices and prepared a weekly report on the state of the market for publication.

THE JAMAICA STOCK EXCHANGE

The Jamaica Stock Exchange (JSE) was incorporated as a private limited liability company on August 14, 1968 and formal trading begun in January 1969. The Exchange is owned by its broker/members. Presently there are nine (9) registered members, one of whom is inactive, but should commence business in January 1991.

The Exchange is governed by a Board/Council, comprised as follows:

1. The Governor of the Bank of Jamaica or his nominee
2. A Representative from the Ministry of Finance
3. Up to six broker/members
4. Three members of the public

TRADING HISTORY

There are 44 companies listed on the Exchange, an increase of eight(8) since the inception of the institution. During this period, however, there were 23 new listings and 15 delistings. The majority of delistings arose as a result of mergers and acquisitions by other listed companies and the nationalisation of some companies. We definitely would like to see the number of listed companies grow rapidly and would welcome suggestions as to how this can be achieved in a relatively short time period.

Three (3) types of securities are listed and traded on the Exchange:
39 ordinary shares, 11 preferences, and 7 corporate bonds. Trading is concentrated in the ordinary sector. There is very little activity in the preference and bond sectors.

SECONDARY MARKET ACTIVITY

In looking at the JSE's experience, one must always recognise the economic environment in which the market operates/operated. The market's general performance is measured by an index, which was first calculated in June 1969 (100). The index is based on the ordinary shares listed on the market, weighted according to their relative market capitalization. Table 1 shows the transactions details of the market, from inception to October 1990.

In the decade of the 70's (particularly 1972-1980) there was very little activity on the market. The index slipped from 94.51 at the beginning of 1970 to 53.71 at the beginning of 1980, reaching an all time low of 35.84 in February 1978. The performance of the market mirrored the performance of the domestic economy. During this period there was uninterrupted negative growth in the economy (1978 excepted).

In the 1980's there was economic revival. The free market economic model governed and there was a resurgence of confidence in the political, social and economic life of the country. Activity on the secondary market began to pick up. Volume and value of traded securities and the index began to rise. Trading in shares was, however, still confined to a few private investors and fewer institutional investors.

A bull market which was evident from 1982, really intensified in 1984. Volume, value and the index rose 87%, 164% and 92% respectively in that year. The year 1985 was even better, volume increased by 286% to 37.6% million units, value by 350% to J$117.1 million and the index 104.2% to 941.5 points.

Interestingly enough, in both of these years GDP fell marginally, however, corporate after tax profits of listed companies increased by an average of approximately 30%.

THE GOVERNMENT'S PRIVATISATION PROGRAMME

In 1986 new life was injected into the market via the government's privatisation programme. A central tenet of the government's structural adjustment of the economy was the privatisation of a number of commercial and industrial companies owned by the Government.
In 1986 and 1987 three (3) of the largest business entities in the country were sold to the public. Beginning with the National Commercial Bank (NCB) in 1986, 31 million shares were sold at an issue price of J$2.95 per share. This issue was an overwhelming success, it was in fact 175% oversubscribed. Next the Caribbean Cement Company (CCC) was divested. The public subscribed for approximately 80 million shares at J$2.00 per share. The most recent divestment was the Telecommunications of Jamaica Company Ltd (TOJ). There again, approximately J$111 million was subscribed by the public.

One very important feature of the TOJ issue was that it was the first time in the history of the market that local financial institutions underwrote a public issue. This is a development which we hope will continue.

From a market perspective, a number of concrete benefits have accrued from the divestment programme:

1. The massive media blitz (cum public education) which was an integral part of the programme, brought an awareness of the "stock market" and "securities" to a vast number of Jamaicans.

2. An additional estimated 20,000 new individual shareholders has resulted. Recent market research suggests that there are approximately 40,000 shareowners in the market.

3. Very importantly it has underscored the fact that the market is a viable source of capital to fund economic development. In excess of J$300 million was raised.

4. It has had a positive impact on the liquidity of the market. Market turnover as a percentage of market capitalisation was 12.69% in 1986, 11.57% in 1987 and 9.4% in 1989 compared to an average of 4.6% between 1980 - 1985.

PRIMARY MARKET PERFORMANCE

The record of the market as a source of capital for the financing of investment projects is disappointing. Table 2 below cites public issues over a 27 year period. Interestingly during the 1963 - 1970 period nine companies raised capital in the market to finance investment projects. It is paradoxical that in a high interest rate economy such as ours, the market isn't being utilised to raise cost effective equity or debt capital.
Some factors accounting for the market's limited capital raising function may be:

a) the historical dominance of the commercial banking sector in financing businesses, coupled with the prevalence of interlocking directorates, which facilitates access to bank credit by the bigger companies.

b) the fact that small and medium sized companies may not be sufficiently well known in the country to successfully market a public issue.

c) the fiscal bias towards debt as opposed to equity financing. Interest charges are tax deductable.

REGULATORY FRAMEWORK

The Jamaica Stock Exchange is the primary regulatory body in the Jamaican Market. There is no securities legislation such as the US Securities Act of 1934 and no institution like the Securities and Exchange Commission. As a self-regulatory body the JSE's Code of Rules and Regulations as well as its Memorandum and Articles are used to govern broker-members, and listed companies. The Exchange has no jurisdiction over members of the investing public. We think that this is an appropriate time to introduce securities legislation. The Jamaican Companies Act (1965) speaks to the "Incorporation of Companies and Matters Incidental Thereto". It does not address the subject of "Insider Trading" and other important aspects of market governance.

FOREIGN PORTFOLIO INVESTMENT

Foreign exchange flows in and out of Jamaica are governed

by the Exchange Control Act. Foreign participation in the market is not prohibited. However, foreign exchange inflows to purchase securities, must be registered with the Bank Of Jamaica, to guarantee the repatriation of principal and income (dividends and capital gains). Dividends are subject to a 33 1/3% withholding tax. There is no tax on capital gains. Recently we have been having enquiries from foreign fund managers. We hope that some foreign money will flow into the market. The recent establishment of a Commonwealth Equity Fund is an encouraging development.

CONCLUSION

The Jamaican market like a number of emerging markets of similar size suffers from problems affecting the supply of securities and the demand for securties. On the supply side, the number of listed companies is relatively small, while the number of shares available for trading is limited, hence the market is relatively illiquid. Increasing the supply of securities can have a wide range of benefits which includes:

a) greater availability of securities
b) widespread shareownership of companies
c) improved corporate equity bases
d) improved market liquidity

Simultaneously the demand side of the market must be impacted i.e individual investors' interests must be stimulated, by increasing the general level of awareness about the securities market. The task of improving the demand side and supply side of the market must consume our energies in the years ahead.

FIGURE 1

STRUCTURAL FRAMEWORK OF THE JAMAICAN CAPITAL MARKET

AS AT OCTOBER 1989

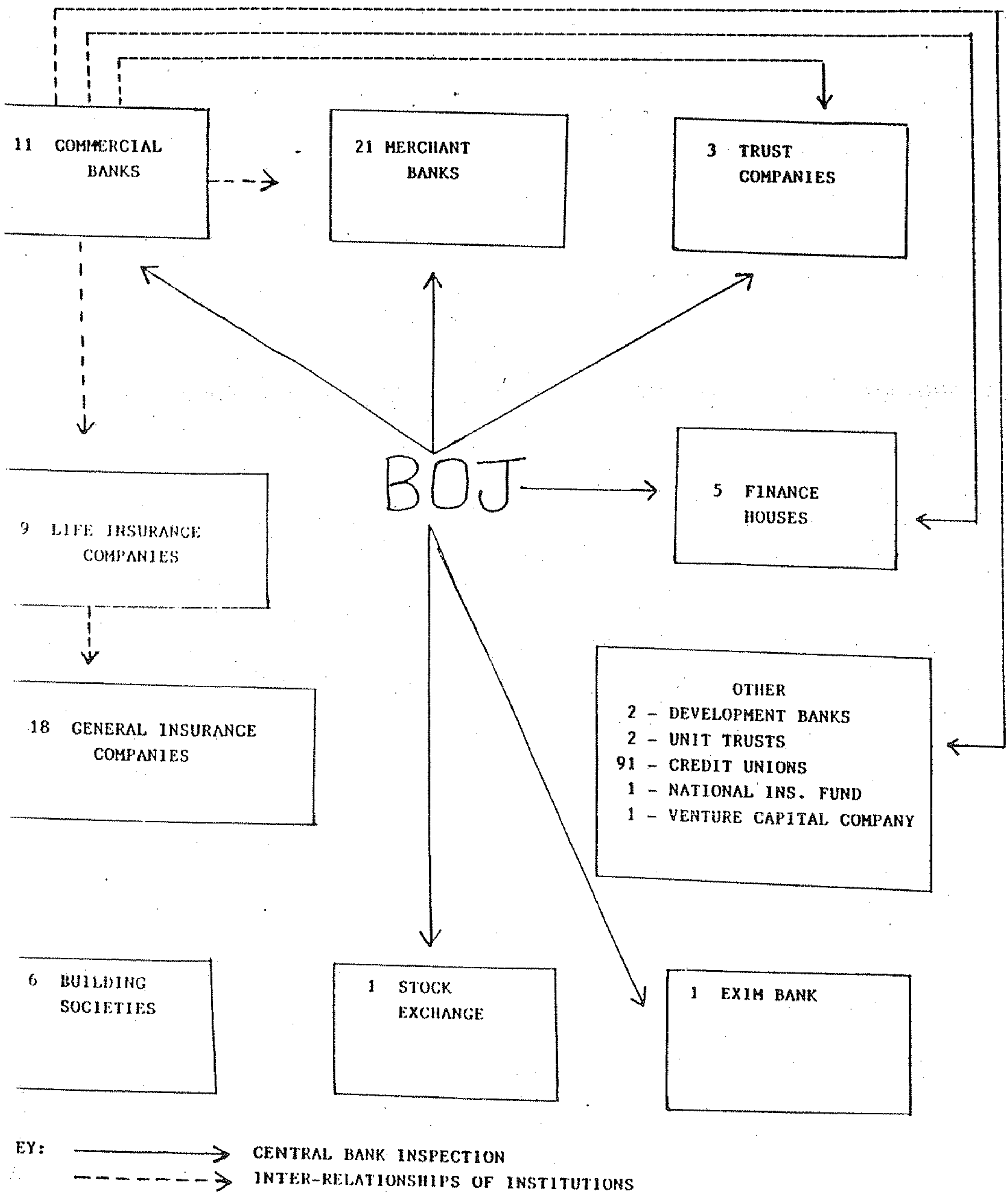

TABLE 1

TRANSACTION DETAILS 1969-OCT. 1990

YEAR	NUMBER OF TRANSACTIONS	VOLUME (000')	VOLUME (J$000')	CLOSING INDEX	CHANGE OVER	%
1969	5,526	7,356	6,589	94.51	-	-
1970	3,756	4,537	3,510	85.51	- 9.00	- 9.5
1971	3,779	6,677	6,538	91.55	+ 6.04	7.1
1972	6,259	11,964	11,477	101.00	+ 9.45	10.3
1973	4,525	9,450	6,178	93.49	- 7.51	- 7.1
1974	2,679	19,361	10,683	67.49	- 26.00	- 27.9
1975	2,104	6,738	5,345	63.19	- 4.30	- 6.3
1976	1,170	5,613	2,826	49.27	- 13.92	- 22.0
1977	458	2,185	1,293	38.87	- 10.40	- 22.1
1978	583	13,818	10,093	41.59	+ 2.72	6.9
1979	420	4,833	2,117	59.28	+ 17.69	42.5
1980	502	7,390	5,101	69.83	+ 10.55	17.8
1981	799	4,198	3,332	152.23	+ 82.40	118.0
1982	1,375	5,542	10,156	211.16	+ 58.93	38.7
1983	1,566	5,185	9,820	240.38	+ 29.22	13.8
1984	2,117	9,744	26,017	461.10	+ 220.72	91.8
1985	3,049	37,640	117,146	941.50	+ 480.40	104.2
1986	6,691	59,252	374,617	1,499.86	+ 558.36	59.3
1987	11,187	71,877	399,971	1,515.09	+ 15.23	1.0
1988	6,446	43,522	136,739	1,439.22	- 75.87	- 5.0
1989	13,892	95,202	516,456	2,075.85	+ 636.63	+ 44.2
OCT. 1990	7,097	31,635	152,746	2,358.70	+ 282.85	+ 13.6

N.B. ALL TIME HIGH 2592.30 SEPTEMBER 7, 1989.
ALL TIME LOW 35.84 FEBRUARY 10, 1978.

TABLE
CAPITAL RAISED IN THE JAMAICAN STOCK MARKET

COMPANY	YEAR	$ VOLUME
Carreras Group Ltd.	1963	420,000.00
Carib Steel Co. Ltd.	1964	95,000.00
Goodyear Jamaica Ltd.	1966	96,000.00
Jamaica Flour Mills	1966	200,000.00
Jamaica Citizens Bank Ltd.	1967	200,000.00
Pan Jamaica Inv. Ltd.	1968	750,000.00
CMP Industries Ltd.	1969	618,000.00
Pegasus Hotel Ltd.	1969	120,000.00
Life of Jamaica Ltd.	1970	760,000.00
Workers Saving & Loans Bank	1973	500,000.00
Guinness Jamaica Ltd.	1973	775,000.00
Gleaner Company Ltd.	1978	4 million
Royal Bank Jamaica Ltd.	1982	2.92 million
Carreras Group Ltd.	1982	3.16 million
Seprod Group Ltd.	1986	62.5 million
*NCB Group Ltd.	1986	90.6 million
*Caribbean Cement Co. Ltd.	1987	157.4 million
Hardware & Lumber Ltd.	1987	8 million
CIBC Jamaica Ltd.	1988	31 million
*TOJ Ltd.	1988	111.3 million
Mutual Security Bank	1989	32 million
Jamaica Citizens Bank	1990	20 million

*GOVERNMENT'S PRIVATISATION ISSUES

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SYMPOSIUM ON CAPITAL MARKET
DEVELOPMENT AND PRIVATISATION
14-16 NOVEMBER, BOMBAY

Capital Market Development and Privatisation - The Case of Trinidad and Tobago

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October 1990

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CAPITAL MARKET DEVELOPMENT AND PRIVATISATION - THE CASE OF TRINIDAD AND TOBAGO

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October 1990

Introduction

During the past decade there has been a renewed interest in the promotion and development of capital markets in developing countries. At the same time the issue of privatisation has been gaining prominence in policy discussions and economic strategies in both industrialised and developing countries. The growing attention to these two policy phenomena derives largely from a disenchantment with state capitalism and an increasing awareness among government planners that market forces must be given greater play in the process of economic revival and development.

2. The policy initiatives in the areas of capital market development (particularly securities or equities markets) and privatisation are quite often used to achieved the same economic objectives of greater efficiency in the utilisation of resources and increases in output. Very often also, the success of one of these sets of policy initiatives, depends on the success of the other. Yet, privatisation initiatives are seldom adopted with the primary objective of capital market development. So far, the experiences of most developing countries show that such development in relation to privatisation, tends to be a fortuitous-by-product. The case of Trinidad and Tobago, however, provides one instance in which the privatisation exercise was consciously linked to capital market development as aa policy objective.

The Concept of Privatisation

3. The concept of privatisation has attracted much attention in the literature, and there is an as-yet unresolved debate on its definition. The

distinction is made between privatisation and economic liberalisation, although the two concepts are so closely inter-related that it is often difficult to draw the line of democration. Privatisation has been variously defined as the transfer of the whole, the majority, or a minority interest in state owned industrial assets or corporations to private individuals and/or organisations. Economic liberalisation is seen as the deregulation of economic activity or the introduction of market principles in the operations of state-owned corporations. For the purposes of this study however, privatisation is defined simply as the divestment of equity in state owned or controlled corporations to private individuals or organisations.

Principle Motives for Privatisation

4. Governments generally adopt privatisation initiatives for very pragmatic reasons. The principal reasons relate to the need for cut expenditure or raise revenues and to stimulate economic efficiency and output growth. It is almost universally accepted that the privately owned and run enterprise tends to be more efficient and competitive than the state run corporation. It has therefore become almost fashionable for governments to privatise state-owned enterprises in the hope of increasing economic efficiency. In recent times, also, the stimulus for Governments in developing countries to adopt privatisation programmes has been intensified as international lending agencies and some donor countries make the adoption of such programmes part of the conditionalities attaching to financial assistance. Capital Market development is only a secondary motive for privatisation.

The Experience of Trinidad and Tobago

5. The Government of Trinidad and Tobago has played and continues to play a central role in the establishment and development of the local securities market. This role has encompassed those of initiator, regulator and participant and includes the establishment of the principal market institutions by Acts of Parliament. In addition the growth of activity on the market has been directly and greatly influenced by two areas of Government policy initiatives: those of localisation and divestment.

The Issue of Divestment

6. The development of the privatisation process in Trinidad and Tobago falls into two distinct phases: the first covering the period up to 1986, and the second thereafter. In the first phase, privatisation or divestment formed an integral part of the strategy of the Government for the achievement of certain policy objectives. These were national control of the commanding heights of the economy and the transfer of ownership of the producing assets of the country to a wide cross-section of the population, and in particular to workers.

7. In a 1972 White Paper on Public Participation in Industry, the Government stated that one of its primary reasons for such participation was to accelerate the transfer of ownership of business enterprises into local hands. At the same time the Government also announced that it considered "its shareholding as a trust held on behalf of nationals and that it will release these holdings to the wider national public as circumstances permit." The White Paper went on to state that this release would take place through a process of divestment.

8. In the second phase of the privatisation/divestment process, the motivating factors shifted in emphasis. While the view that Government's shareholding was being held in trust for nationals remained valid, the primary motivation was no longer the need to achieve a broad-based ownership of the producing assets of the country. Instead, the divestment exercise was cast in terms of the rationalisation of the state enterprises sector with particular reference to the reduction of the level of Government transfers to these enterprises, and to raising their levels of efficiency and competitiveness. The ideological or philosophical stance which under-pinned Government's involvement in industry and consequently the issue of divestment, also changed. The issue was no longer that of Government as a medium for accelerating national control of the economy, but the question became: What was the legitimate role of Government in industry?

The Process of Divestment and the Impact on the Market

9. The process of divestment has impacted on the development of the securities market both in terms of institutional development and the level of activity. In the earlier phase of the divestment process the primary concern was the widest possible distribution of the Government's shareholding, particularly to workers. In that period however the Government did not proceed with its divestment programme to any great extent because of the behaviour of the market.

10. In the period under reference, the Government, as part of its strategy to transfer ownership of business enterprises to nationals, actively encouraged foreign-owned enterprises to 'localise', that is to transfer part of their sharesholdings to nationals. Public issues or offers-for-sale were the preferred method of accomplishing such transfer. In this process, and in order to ensure a broad-based participation, the Capital Issues Committee, the then Government regulatory body for the market, established certain guidelines with respect to public issues or offers-for-sale.

11. Essentially, those guidelines were as follows:

(i) A portion of the issue (usually 10%) was reserved for workers of the issuing enterprise;

(ii) Individuals were placed at the head of the pecking order in the allotment process - locally firms, foreign residents, etc. followed in order of priority;

(iii) In the allotment process, each category of subscriber had to be fully satisfied before, others would be entertained; and where there was over-subscription in a category, there would be a proration among subscribers;

(iv) The issue prices of shares were determined by the Committee and set at a level which was expected to guarantee a yield of not less than 6% to 9%.

12. The result, however, was that in a situation of strong demand, public issues were consistently over subscribed by individuals, many of whom immediately re-sole their shares on the after-market at inflated prices. In addition, some individuals submitted multiple applications, or used other individuals as agents, thereby securing for themselves substantial portions of the issue. Thus while there was an initial widespread ownership and market participation, these were reversed within a short period of time with a consequent concentration of shares in the hands of a few.

13. This characteristic of the market prompted the Prime Minister and Minister of Finance to announce in his 1977 Budget Speech that it was "one of the reasons why the Government has been cautious in pursuing is divestment policy". The Prime Minister and Minister of Finance re-affirmed the Government's position that its shareholding would continue to be held in trust for the people until appropriate institutions could be developed "to facilitate a planned equitable distribution". A Unit Trust and a Stock Exchange were identified as two appropriate institutions.

14. In 1979, the Government appointed a Committee to consider the issue of the divestment of its shareholding and to submit proposals for such a programme. The report of this Committee supported the view that the establishment of a Unit Trust and a Stock Exchange with the necessary supporting legislations were required preconditions for the successful implementation of a programme of divestment with widespread onwership. The Committee's Report was accepted by the Government. Subsequently, in 1981, the Parliament approved the Securities Industry Act which established the Trinidad and Tobago Stock Exchange and provided a legal framework for the operation of the securities market. At the same time the parliament also approved the Trinidad and Tobago Unit Trust Corporation Act which made provisions for the establishment of the Trinidad and Tobago Unit Trust Corporation.

15. The initial impact of the privatisation process on the development of the securities market in Trinidad and Tobago was thus somewhat unique in its greater effect on the institutional development of the market, rather than in the level of activities. Indeed in the first phase of the divestment, the Government divested part of its shareholding in one company only. Divestment was more of a statement of policy intent rather than an activity.

Nonetheless, the divestment objectives continued to influence the operations of the market as the guidelines relating to the allotment of shares remained in effect after the establishment of the Stock Exchange.

<u>The Further Impact of Divestment on the Market</u>

16. It has been noted that the approach to divestment changed in the period after 1986. This change in approach and the consequential impact on the market can best be illustrated in the following manner. In the period 1981 to 1986, after the establishment of the Stock Exchange and the Unit Trust, there was no divestment of Government shareholding. The principal reason for this was the poor financial condition of most state enterprises. In 1987, however, in the case of one company, the Government restructured the capital of the company by way of the capitalisation of its outstanding debt to the Government. The capital of the company was then reduced and a partial divestment was made by way of a public offer for sale in early 1988. The company was considered to be still over-capitalised and a further reduction of its capital was made, using the Government's shareholding. This restructuring had the effect of considerably enhancing the attractiveness of the company as an investment, and a second public offer of shares was made, thereby reducing Government's shareholding to less than one third. The cost of such divestment to the Government was however, relatively high. It is also to be noted that in restructuring process, the main product of the company was price-deregulated.

17. Since 1986, the only activity on the primary equities market resulted from Government's divestment of its shareholding in two state enterprises. These offers were all over-subscribed by individuals. Another offer is expected to be placed on the market before the end of 1990. The potential impact of Government's divestment programme on the market in the short to medium term, is therefore very promising. Notwithstanding, the over-all effect of the divestment programme on the supply of securities on the market has been relatively small. Only shares in two state enterprises have been divested so far, and these divested shares account for approximately 11% of shares listed on the Exchange at the present time.

Factors Affecting Divestment and the Development of the Market

18. The two principal factors which continue to affect the potential effects of the divestment/privatisation process and the development of the capital market are, the Government's policy on divestment, and the eligibility of companies targeted for divestment, to be listed on the Stock Exchange. The potential for the development of the market will also be affected by the criteria used to select the candidates for divestment.

Government's Current Policy on Divestment

19. The policy environment for privatisation or divestment has been considerably enhanced since 1987. In that year, the Government established a Committee to review the operations of state-owned enterprises and to make recommendations for their restructuring or divestment, as appropriate. This Committee has made extensive recommendations. Essentially the conclusions of the Committee were that where the Government's involvement in an enterprise could no longer be justified in terms of the need for pioneering investment; the inability of the private sector to participate because of size of investment; or strategic economic importance, such investment should be divested. Where Government's investment was to be retained, steps were to be taken to improve the operating efficiency and competitiveness of the enterprise. The recommendations of the Committee were almost entirely accepted by the Government.

20. In the implementation of the recommendations on divestment the Government, in late 1989, established a Standing Committee on Divestment with the following terms of reference:

(1) to oversee the divestment of individual enterprises

(2) to submit specific recommendations on such matters as timing and pricing and other incentives attaching to new issues or offers for sale of stocks in State Enterprises.

21. In addition, under the terms of a Structural Adjustment Loan negotiated with the World Bank, the Government has established a Co-ordinating

the Monitoring Unit in the Ministry of Finance to oversee the implementation of recommendations made with respect to the restructuring of state enterprises, including, in some cases, divestment. The Standing Committee and the Co-ordinating Unit have been working in close collaboration on the privatisation of state enterprises:

22. The main elements of the policy guidelines which inform the work of the Standing Committee are as follows;

(1) To seek the widest possible distribution of divested shares;

(2) To obtain the best possible returns on divestment;

(3) To recommend retention of some level of Government shareholding where this is considered justifiable;

(4) To consider the conversion of wholly Government owned private companies to public companies, prior to divestment, where feasible.

23. The preferred route of divestment remained a public offer for sale even though this could mean a reduction in the return on divestment. Further foreign participation is not excluded from the divestment process. Indeed, the recent passage of the Foreign Investment Act has served to remove most of the barriers to foreign participation in the divestment exercise. This Committee has been holding discussions with a number of state enterprises with a view to establishing a divestment schedule.

Selection of Companies for Divestment

24. While the policy framework for privatisation has been improved, its appears unlikely that the companies selected for divestment would easily qualify for listing on the Stock Exchange. Indeed, it has been noted that one of the principal motivating factors in the promotion of privatisation, was the need to reduce Government's expenditures with respect to the State Enterprises Sector. The majority of these companies had become, inefficient, uncompetitive, and over-burden with debt. More-over, the size and scope of

operations of the majority of these companies did not lend themselves to wide public participation. The cost of restructuring these companies and bringing them to a state where they represent feasible investment opportunities for the public, is extremely high. For example, in one case, the net cost to Government of selling the assets is some $6-8 million TT. This is after Government incurred costs of some $10 million TT in debts which were written-off. There are however some companies, which are targeted for divestment and which would be eligible candidates for wide divestment over the next year.

25. In the contrast the more profitable companies, of which there are sufficient to significantly enhance the supply of securities on the market, are involved in areas of strategic economic importance. The forces for the retention of Government's shareholding in these cases however, remain very strong.

Conclusion

26. The process of privatisation in Trinidad and Tobago has impacted on the development of the capital market, both in terms of its institutional development and the level of activity. The more profound impact however, has been in terms of the institutional development. The early impetus to the market development provided by the localisation policy, also greatly influenced the pace and direction of this development. It is very unlikely that the continuation of the privatisation process will result in any further institutional development of significance. Also, the probable impact on the level of activity in the short to medium term is relatively promising.

27. It has been postulated in this paper, that the impact of privatisation on the development of the capital market in Trinidad and Tobago has been somewhat unique. This conclusion has been based on the peculiar manner in which the privatisation/divestment process was designed and used as part of an over-all strategy of achieving a broad-based national control and ownership of the producing assets of the country, and the perception that the existence of the market institutions were necessary to achieve these objectives. The strategy of economic development which under-pinned the early phase of the Trinidad and Tobago's experience, has been losing credence in the

present environment of structural adjustment. Indeed privatisation has come to represent almost a reversal of that development process.

28. In applying the Trinidad and Tobago experience to the wider developing world, in the present economic circumstances, it appears that the potential impact of privatisation on the development of capital markets, particularly securities markets, is limited. The principal reasons for this conclusion are that Governments in developing countries today are primarily motivated to privatise state owned corporations in order to cut costs arising out of the inefficient operations of these enterprises which are most often poor candidates for public participation. The more efficient operations tend to be in areas of strategic economic importance and the forces for retention by Government are usually very strong. Further, where the motivating factor is increasing efficiency of operation, this is often best achieved through the participation of a single or a limited number of firms. A strong relation between privatisation and capital market development in developing countries is therefore likely to remain unrealised under the present circumstances.

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SYMPOSIUM ON CAPITAL MARKET
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Regulatory Frameworks for Stock Markets - Indian Experience

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REGULATORY FRAMEWORKS FOR STOCK MARKETS- INDIAN EXPERIENCE

By

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The cardinal principles underlying the operations of stock markets the world over are that the markets must be fair, broad and liquid and transparent and that the interests of the investors are duly taken care. Progressively, the Indian stock markets are attuning themselves to move close towards these principles.

India - A Growing Market

India has a long experience of trading in securities, being the oldest stock market in Asia. The Stock Exchange, Bombay - the oldest in India - was established as far back as in 1875. Stock markets no doubt grew over years but rather haltingly. Mid-eighties, however, witnessed a sea change in stock market activities propelled basically by the policy of deregulation pursued by government. While there were only eight stock exchanges in India till 1978, there are today 19 stock exchanges with prospect of an equal number or even more stock exchanges being set up before the end of the century. As against about a million shareholders a decade ago, the country has at present about 12 million shareholders with about two to three million new shareholders being added every year. Offerings in the primary market by the private corporate sector have also zoomed from an annual average of less than Rs. one billion to over Rs.60 billion in 1989-90. Daily turnover in the secondary market on the Bombay Stock Exchange which accounts for about two-thirds of the business in the country has rocketed from about Rs.100 million about ten years ago to over Rs.2.5 billion currently. Equity index as compiled by the Reserve Bank of India which rose by a meagre two per cent in the sixties and by about 60 per cent in the seventies has spiralled by over 500 per cent from the beginning of eighties. As a result, India today is an important market among the emerging markets of the world. With a sharp decline in prices in global markets contrasted by a more than 100 per cent rise in the prices of Indian stocks since the beginning of 1990, the current market capitalisation of the Indian stock markets of about Rs.one trillion i.e., about $ 60 billion is perhaps the highest among the emerging markets of the world.

It is proposed to deal in this article issues relating to disclosure and financial reporting,trading,regulation and shortcomings.

Disclosure and Financial Reporting

The regulatory framework relating to disclosure and financial reporting in India can broadly be classified under three headings, viz.,

(i) disclosure in Prospectus/Offer Letters relating to issue of securiries,

(ii) disclosure of the financial performance of listed companies on a periodical basis, and

(iii) ongoing disclosure about various events affecting the market price of the securiries of a listed company.

Section 2 (36) of the Companies Act,1956 defines Prospectus as 'any document described or issued as a Prospectus and includes any notice, circular, advertisement or other document inviting deposits from the public or inviting offers from the public for the subscription or purchase of any shares in, or debentures of, a body corporate'. The object of issuing a prospectus is to invite the public to invest their moneys in a company. In order to enable the potential investors to take a well informed decision in the matter, the Act spells out in some detail the information be given in a prospectus. Schedule II of the Act sets out the matter to be included in the Prospectus which covers,inter-alia, the history and business of the company and of its promoters and management, particulars of the projects including its cost and means of financing, business prospects, status and profitability, audited accounts,material contracts, particulars of the securities to be issued, information about the issue, etc. Furthermore, to ensure that the information required to be stated in a prospectus is truthfully disclosed, the Act prescribes severe penalties, civil and criminal, for untrue statements in a prospectus. These provisions also apply to brochures, pamphlets and other publicity material advertising the issue of securities. Unfortunately, the safeguards provided against prosecutions are so wide that hardly any worthwhile case has so far been instituted against untrue statements.The recent decision taken by the government that while directors, promoters and every person who authorises the issue of prospectus shall bear full responsibility for the contents of the prospectus, merchant bankers shall exercise due diligence independently varyfying the contents of the prospectus and reasonableness of the views expressed therein and certify to this effect to the Securities and Exchange Board of India - the newly established watch-dog of the securities industry is ,however, expected to improve the system.

In fact, the problem about the prospectus is not with regard to untrue statements but about inadequate disclosure of material facts and risks. Many of the issue highlights, like 'latest or proven technology', 'assured market,' 'low breakeven point','assured dividend' that allure unwary investors require adequate substantiation. Various factors that should guide a prospective investor in making investment decisions like existing and expected market for the product of the company, market competitors and their performance, anticipated performance/contribution expected from the project, risks associated with project, etc.,are all ignored. These factors necessiate widening the scope of disclosures in prospectus so that an investor has sufficient data to analyse the prospects and risks involved in investing in a company. Further projection, together with details of all material assumptions thereto, could be added provided such projections are vetted by financial institutions appraising the project and the merchant bankers acting as managers to the issue and licensed in this behalf by the Securities and Exchange Board of India.

The investor decision is unfortunately based more on pamphlets,circulars and other publicity material that are circulated by various brokers and investment agencies. The guidelines issued by government that the company entering the capital market prepares a plain matter of fact explanatory statement based on the prospectus and no other literature other than this plain matter of fact explanatory statement is mailed is observed perhaps only in breach. Punitive measures need to be taken against any one found indulging in false or motivated propoganda. Also monitoring regarding the promises and subsequent events in a company needs also to be initiated to prepare test cases for untrue statements in prospectus.

Perhaps the most important influence in investment decision is that on the newspapers and more particularly investment magazines and periodicals. All sorts of unsubstantiated claims and projections are given in the media about a company's future prospects and working which has an undue influence on innocent investors. There is an imperative need for a code of conduct with suitable punitive measures if a meaningful investor protection is to be achieved.

All listed companies are required to immediately inform the stock exchange about the audited accounts of the company as soon as they are approved by the Board of Directors. Particulars of turnover, major expenditure heads and profitability disclosed by the company are displayed by the stock exchange on the notice board which amounts to public notice.

In 1986, the listing agreement was amended to provide for announcement of unaudited financial results on a half-yearly basis by listed companies within two months of the expiry of the period. These results apart from being furnished to the stock exchange are also to be announced for investors. The intention of making companies publish these results was to keep investors informed of the performance of companies and reduce insider trading. These requirements apply uniformly to all listed companies. However, there is need to increase the frequency of such publication of results in case of large companies having substantial public shareholding and volume of trading and make it quarterly as in the U.S.A. Also on quite a few occasions there are wide variations between audited and unaudited results. This also needs to be looked into with punitive provisions being made for variations which are unreasonable.

The format of the accounts, the disclosures to be made therein and the auditors' report thereon are prescribed in the Companies Act. The accounts are to be prepared on a mercantile basis so as to give a true and fair view of the state of affairs. However, very often companies indulge in various accounting adjustment practices which do not confirm to accepted accounting standards. Though the auditors duly qualify their report and the impact of these adjustments are given in the notes to the accounts, the common investor is unable to analyse its true impact on the profits stated in the accounts. As a result, misleading pictures of the companies are given to the investors. It is essential that the accounts must be prepared based on uniform standards of accounting principles and no deviation therefrom should be permitted eventhough it is legally permissible. The question of amending the Companies Act suitably,therefore, needs consideration. This would result in a real, true and fair disclosure of the company's working.

In 1988, the Companies Act was amended to permit companies to send bridged accounts to their shareholders in order to reduce the cost of publication of accounts of the companies. However, this has resulted in highly inadequate information being communicated to the shareholders and investors. It is, therefore, essential that provisions relating to abridged Balance Sheets be removed and full set of accounts be sent to shareholders.

The Companies Act requires a Directors' Report to be submitted along with audited accounts. This report must cover, inter-alia, material changes and commitments, if any, affecting the financial position of the company which have occured between the end of the financial year of the company to which balance sheet relates and the date of the report. Also material changes which have occured during the financial years in relation to the company's business or the class of business in which the company has an interest must be disclosed. It has been noticed that there are many companies, wherein Directors' Report is extremely brief, touching upon only those matters which are legally required to be disclosed. They do not adequately elucidiate the working of the company nor of its future prospects. The format of Directors' Report should be changed so that it can offer maximum information to the shareholders.

The listing agreement requires a listed company to give advance notice of its board meetings to be held for declaration of dividend,right or bonus issues or issue of debentures. The company also has to notify the stock exchange immediately after the decisions are taken in such meetings. Any cancellation/redemption of listed securities have to be informed as also any proposal in the general character of any of its business or any change in the management. The company is also required to inform the exchange of all material events such as strikes, lock-outs, closure on account of power cuts, etc., both at the time of occurence of events and subsequently after its cessation in order to enable the shareholders and the public to apprise the position of the company and to avoid the

establishment of a false market in its securities. The object of such notifications is to ensure that the investors at large are informed in time of any material event affecting the market prices of listed securities.

Classification of Securities

Trading in Indian stocks is broadly categorised into two groups, viz., specified shares and non-specified securities. Equity shares of didivend paying, growth-oriented companies with a paid-up capital of at least Rs.50 million with a market capitalisation of at least Rs.100 million and preferably having more than 20,000 shareholders are normally put in the specified group and the balance in the non-specified group. Stock exchanges located at Bombay, Calcutta, Delhi and Ahmedabad only have at present this facility of a two-tier market with the rest of stock exchanges conducting trading only under the category of non-specified securities. Equity shares of 80, 58, 40 and 18 companies are classified as specified shares at the Bombay, Calcutta, Delhi and Ahmedabad stock exchages respectively. With 68 shares being common among them, the number of companies whose equities are traded as specified shares is 128.

All trading is basically conducted as hand delivery contracts, i.e., for delivery and payment within the time or on the date stipulated when entering into the contract which shall not be more than 14 days following the date of the contract. In the case of specified shares, however, delivery and payment can be extended by further periods of 14 days each so that the overall period does not exceed 90 days from the date of the contract. Contracts in specified shares can be closed during the settlement period by purchase or sale, as the case may be, or carried over to the next settlement period and only those contracts which remain outstanding have to be performed by delivery and payment. The system of trading in specified shares is thus an amalgam of cash and futures. The

Indian stock markets do not yet have any separate segments for futures and options although option trading in a few leading shares in the specified group is being unofficially and illegally conducted. In the case of non-specified securities, by and large, contracts are performed by payment and delivery.

Trading Pattern

Indian stock markets continue to operate in the age old conventional style of face-to-face trading with bids and offers being made by open outcry. At the Bombay Stock Exchange, there are about 3,000 persons milling around in the trading ring during the trading period of two hours from 12.00 Noon to 2.00 P.M.

Indian stock markets are basically quote-driven markets with the jobbers standing at specific locations in the trading ring called trading posts and announcing continuously the two-way quotes for the scrips traded at that post. As there is no prohibition on a jobber acting as a broker and vice versa, any member is free to do jobbing on any day. In actual practice, however, a class of jobbers have emerged who generally confine their activities to jobbing only. As there are no serious regulations governing the activities of jobbers, the jobbing system is beset with a number of problems like wide spreads between bid and offer, particularly in thinly traded securities, lack of depth, total absence of jobbers in a large number of securities, etc. In highly volatile scrips, however, the spread is by far the narrowest in the world being just about - 0.1 to 0.25 per cent as compared to about 1.25 per cent in respect of alpha stocks i.e. the most highly liquid stocks, at the International Stock Exchange of London. The spreads widen as the liquidity decreases being as much as 25 to 30 per cent or even more while the average touch of gamma stocks i.e., the least liquid stocks at the International Stock Exchange,London, is just about 6 to 7 per cent. This is basically because of the high velocity of transactions in the active scrips. The first five most volatile scrips on the Bombay Stock Exchange, viz., Associated Cement Co. Ltd., Bombay Dyeing and Manufacturing Co. Ltd.,Baroda Rayon Corporation Ltd., Indrol Lubricants Ltd., and Apollo Tyres Ltd., had their equity capital traded 15.81,5.63, 5.04, 4.57 and 3.65 times respectively during the year 1989-90. In fact, shares in the specified group account for over 75 per cent of trading in the Indian stock markets while over 25 per cent of the securities do not get traded at all in any year. Yet, it is significant to note that out of about 4,200 securities listed on the Bombay Stock Exchanges, about 1,200 securities get traded on any given trading day.

Automation of Trade

The question of automating trading has been under the active consideration of the Bombay Stock Exchange for quite sometime. It is now almost finally decided to have trading in all the non-specified stocks numbering about 4,100 totally on the computer on a quote-driven basis with the jobbers, both registered and roving, continuously keying in their bids and offers into the computer with the market orders getting automatically executed at the touch and the limit orders getting executed at exactly the rate specified. Hopefully, this will be completed by the end of 1991. The question of extending the facility of screen-based trading to the specified group will be considered thereafter depending upon the success achieved and the experience gained from the system that would be established for the non-specified groups. Since the volume of turnover is larger in the specified group, the question of switching over to the order-driven market could also be considered. The Bombay Stock Exchange is thus moving towards a ringless trading system as is the case in most of the developed markets of the world. This would incidentally also facilitate easy handling of the fast growing volume of business in the market.

The above development would also help in injecting transparency into the operations of the Bombay Stock Exchange. This is particuarly important for investors who have to be content at present with a bare statement of net to pay in respect of purchases and net to receive with regard to sales, the brokerage amount being added to the former and deducted from the latter, without indicating separately the quantum of brokerage. yet another major benefit of the change would be to generate real time trade information, the volume of turnover being constantly displayed alongwith the movement of prices indicating thereby the depth of the market at every turn in prices.

PTI Stockscan Service

A landmark in the history of the Indian stock market was crossed in August,1987 when PTI Stockscan Service was established linking up the Bombay, Calcutta, Delhi, Madras and Ahmedabad Stock Exchanges for the purpose of instant display of prices prevalent at these exchanges as also market related information. The Sensitive Index of the Bombay Stock Exchange related to 30 scrips traded on it and the BSE National Index involving 100 scrips traded on all the five stock exchanges mentioned above are continuously displayed with revisions being made every two minutes. The Stockscan Service, which presently gives, inter-alia, the movement of prices of about 800 shares, is available not only at these five stock exchanges but also at other stock exchange centres. The PTI Stockscan Service has rightly been called the forerunner of the National Market System in the country.

Regulatory Measures

There are no net capital requirements in the Indian stock markets, linking up the volume of business of a firm with its funds as in the developed markets of the world. Yet a system of checks and balances have been evolved over a period of time which not only tend to control and regulate the volume of business of individual firms but also of the market as a whole. These are mainly confined to specified shares as the speculative pressures are normally concentrated in this group. The principal instruments deployed are discussed below. First, there are the margins. They are of three types, viz., daily margins normally payable in respect of every contract outstanding at the end of the day generally at the rate of 5 to 10 per cent of the contract value which can be hiked to higher levels depending upon the volatility of the market, the higher rates being made applicable to bulls in a rising market and to bears in a falling market, carry-over margins payable on every contract carried forward from one settlement to another at rates varying from 3 to 5 per cent and ad hoc margins collected from members having unduly large positions. Currently over Rs.360 millions are being collected by the Bombay Stock Exchange as margin money. Secondly, limits on the movement of prices pegged at 5 to 10 per cent for a day and 10 to 20 per cent for a settlement period of 14 days are imposed. This is currently kept in abeyance as it is felt that markets should be left free to decide the price levels. Thirdly, limits are also imposed on the outstanding business that can be carried forward by a member from one settlement to another and also at any point of time in a settlement. These are currently pegged at Rs.30 million and Rs.40 million respectively. Transactions that result in actual delivery are, however, excluded from the latter. Fourthly,limits are also imposed on the extent of jobbing by a membr. Fifthly, whenever the outstanding volume of business in any particular scrip exceeds a particular level considered to be dangerous, which normally is five per cent of the outstanding capital of the company, trading in the scrip is permitted only on a spot delivery basis i.e, for delivery and payment on the same day or on the day following the day of the contract. Normal trading is permitted to be resumed only after the outstanding business gets reduced to a reasonable level. Sixthly,on critical occasions, even the outstanding business in a scrip is ordered to be liquidated by certain percentage points, say, 15 or 20, in every settlement. Seventhly, speculative transactions i.e., transactions that do not result in delivery, popularly known as short sales and long purchases, are prohibited. Finally, maximum and minimum prices are occasionally fixed for temporary periods.

The above measures are designed not only to keep the speculative excesses under check but also to regulate the movement of prices. As a result, the Indian stock markets have displayed a remarkable degree of poise and stability. The all-India equity Index Number compiled by the Reserve Bank of India fluctuated by an annual average of 25-0 per cent during the decade of 80s as against the corresponding figures of 23.8 per cent and 25.2 per cent at the International Stock Exchange, London and the New York Stock Exchange respectively and an average of 34.1 per cent in respect of ~~xxx~~ 15 leading stock markets of the world.

Settlement of Transactions

Settlement processes at the Indian stock markets are still matters of concern. At the Bombay Stock Exchange, settlement of transactions by way of delivery of securities and payment of price virtually takes a fortnight or even longer both in respect of specified shares and non-specified securities. This is basically because of the system of batch processing of the transactions wherein the matching of the reported sales and purchases is inevitable. It is now proposed to have an on-line system of processing of transactions reported directly from the screen to be operative alongwith the automation of the trade. This will help us to reduce the period required for settlement of transactions. We may, in respect of non-specified securities, reduce in the first instance the period of trading from 14 days to 5 days; Monday to Friday, with the settlement being effected the following week and later on move over to a rolling settlement system of T+5 i.e., the settlement being effected on the fifth trading day following the date of transaction, to be eventually replaced by T+3 as recommended by the global Group of Thirty. The question of extending the concept of T+3 to the specified group of shares,however, needs detailed consideration as such an extension would also need development of options and futures markets.

Share certificates and dated transfer deeds constitute a major hurdle in the growth of the securities business. A two-stage attack on the system is,therefore, planned. First is the immobilisation of the securities. A beginning has already been made with the establishment of Stock Holding Corporation of India which handles the shares of financial institutions. The Bombay Stock Exchange has also, in association with Bank of India Ltd. - a leading nationalised bank of the country - which currently runs the Clearing House of the Exchange, established BOI Shareholding Ltd. This will initially act as a depository in respect of shares involved in carry-forward transactions in specified shares worth about Rs.5 billion with the shares moving by book-entries only. Later on, the services of the depository will be extended to other activities of stockbrokers and also of investors. The second stage is to develop a certificateless society as has already been done in Norway, Denmark and France and as is being planned in U.K. by the proposal to establish TAURUS. In fact, a proposal in this behalf was put forward by the Bombay Stock Exchange way back in 1979. Serious attempts are now being made to put this proposal into operation.

The Indian stock markets are also beset with a number of other problems like insider trading, manipulations, take-overs, odd lots, defaults, etc., and attempts are being made to solve all these problems.

Insider Trading

Insider trading i.e., trading in securities by persons in possession of material non-public information relating to such securities, which is price-sensitive, still remains totally uncontrolled. Strangely there is no law as yet prohibiting insider trading in this country. The provision contained in Section 307 of the Companies Act requiring shareholdings and debentureholdings of directors to be recorded and kept open for inspection of any shareholder or debentureholder during the period of 14 days before and 3 days after the Annual General Meeting of a company has proved to be obsolutely ineffective in controlling such trading. Publication of half-yearly results by listed companies required by the new Clause 41 of the Listing Agreement has also not minimised such trading. It is,however, expected that the comprehensive legislation relating to the securities industry providing statutory powers to the Securities and Exchange Board of India will embody provisions prohibiting insider trading.

Manipulation

Manipulation of stock prices is quite a common occurrence on Indian stock markets. Strangely, there is not as yet any effective deterrent provision against the same. Expunging manipulated quotations and taking disciplinary action against members of stock exchanges by the stock exchange authorities are the only available measures and even these are rarely resorted to. Drastic penal provision, including institution of criminal procedings in courts of law against those indulging or attempting to indulge in manipulation of stock prices, be they members of stock exchanges or not, on the lines of similar provisions embodied in the statutes of several advanced countries is,therefore, called for to control effectively this growing menance.

Take - overs

Take-overs which have griped the western world has now spread to this country too. The only safeguard for the non-management shareholders the country has is by way of a provision in the Listing Agreement incorporated pursuant to a directive issued by government in Aprill 1984. According to this, any acquisition of the shares of a company beyond 25 per cent of the voting capital of the company or securing the effective control of management of the company by acquisition of the shares of the existing directors and others who effectively control or manage the company, irrespective of the percentage of their holdings, should be preceded by an offer to the remaining members of the company to acquire their shares at a price not lower than the price at which the shares of the company are being acquired subject, however, to the public shareholding not being reduced to less than 20 per cent of the voting capital of the company.

The above provision has not prove to be effective due to reasons like acquisition of the shares being limited to 24.9 per cent of the voting capital of the company, change in the management of the company not being clearly discernable as say with only four out of the eight directors changing following acquisitions of the shares, change in the effective control of management of the company being brought about not by any change in the shareholding pattern of the company but by a change in the pattern of shareholding of the parent company holding shares in the company, acquisition of shares ostensibly taking place at a price much below the ruling market price but in actuality at a much higher price,with the difference being settled privately, etc. The listing provisions were, therefore, amended by government in May,1990 providing that acquisition of shares beyond 10 per cent of the voting rights in a company should be accompanied by an offer to the remaining members of the company to purchase their shares at a price not lower than either the highest price during the immediately preceeding six months or the negotiated price, The amendment has also provided for notification to the stock exchanges of any acquisition of shares above 5 per cent of the voting capital of the company. The latter provision relating to notification is on par with the similar provisions in U.K. and U.S.A. The level of acquisition of 10 per cent for a mandatory offer is in fact quite low compared to U.K. where mandatory offer becomes effective only when acquisition reaches the level of 30 per cent of the voting rights of a company. The U.S. laws do not require any mandatory offer to be made to the non-management shareholders.The effect of the new measures is yet to be felt.

Odd Lots

Odd lots constitute a major bugbear for the investors in this country. Out of a total market capitalisation of about Rs. one trillion, equities worth over Rs.150 million are in odd lots. Investors normally receive 15 to 20 per cent less than the market price for their sales and have to pay 15 to 20 per cent more than the market price for their purchases of odd lots. Public sector institutions like the New India Assurance Co. Ltd., Canbank Financial Services Ltd., Unit Trust of India, etc., and also some companies have announced schemes to buy odd lots. The Bombay Stock Exchange and a few other stock exchanges have appointed authorised odd lot dealers with norms for their operations and are also having separate trading sessions for odd lots. All these attempts at solution have only touched the fringe of the problem. Permitting companies themselves to purchase the odd lots of their own shares, preferably at the ruling price with the safeguard of approval by the general body to prevent any misuse by the Board of Directors and then to re-issue them, if need, in market lots on the lines of similar provisions in U.K. and U.S.A. can perhaps provide a lasting solution to this problem. This needs an amendment to the Companies Act,1956.

Defaults

Under the Rules and Bye-laws of stock exchanges, as they are today, the net assets of a member of a stock exchange who is declared a defaulter are utilised to satisfy first the claims of the exchange and the clearing house run by the exchange and then the admitted claims of the members of the exchange on a prorata basis. Only if any surplus is left thereafter, the claims of the clients of the defaulter member are considered by the Defaulters' Committee dealing with the matter and generally there is practically no surplus left. The clients can, no doubt, go in for arbitration in respect of their claims and obtain awards in their favour and get the same filed in a Court of Law for decree. The decrees, however, do not generally get executed as the defaulter invariably disposes of all his assets before he is declared a defaulter.

Lack of protection to the clients is a serious lacuna in the Indian stock markets. The Ministry of Finance, therefore, directed stock exchages of the country to set up Customers' Protection Funds. The Bombay Stock Exchange was the first to set up such a Fund. Established in October,1986, the Fund is patterened on the lines of the Securities Investor Protection Corporation of the U.S.A. Financed partly by way of a levy on the turnover of members collected at the rate of one rupee for every Rs. one million and partly by way of contribution from the listing fees realised at the rate of two per cent of these fees, the Fund has at present over Rs.3 million after having already distributed about Rs.0.35 million to the clients of one of the defaulter members. There is a limit of Rs.10,000 that may be paid to any single client from this Fund. It is, however, proposed to raise this limit with the inflow of more money into this Fund. The limit for payment to a single customer under the Securities Investor Protection Corporation of the U.S.A. is as high as $ 500,000, out of which claims for cash as distinct from claims securities would not be more than $ 100,000.

Conclusion

The various solutions suggested above are part of an on-going exercise to develop healthy and orderly stock markets in India so that investment in industrial securities is rendered not only safe, sound and liquid but also generate adequate returns. With rising levels of savings in the economy and the policy of deregulation persistently being followed by government, stock exchanges of the country can act as instruments for fostering growth of the economy with equity by spreading the cult of equity to the four corners of the country.

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THE ROLES OF UNIT TRUSTS, MUTUAL FUNDS AND OTHERFINANCIAL INSTITUTIONS IN DEVELOPING EQUITY OWNERSHIP

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THE ROLES OF UNIT TRUSTS, MUTUAL FUNDS AND OTHER FINANCIAL INSTITUTIONS IN DEVELOPING EQUITY OWNERSHIP

By Mr M. D. Nor Ahmad
Malaysia

1. INTRODUCTION

'Unit Trust' is a term equally applicable to the term 'mutual fund'. The term 'mutual fund' is referred to in the United States while the term 'unit trust' is frequently used in the United Kingdom and other countries. The only difference, if at all, is in respect of their legal status. Unit trust is not a legal entity. Legally it is a trust created by a trust deed. Mutual fund on the other hand is a legal entity incorporated under companies legislation. Hence, when we talk about the roles of unit trusts in equity ownership development, we are also talking about the roles of mutual fund.

2. WHAT IS A UNIT TRUST

A unit trust is a cost-effective trust fund which conveniently allows investors to invest indirectly in the capital market. By pooling of the funds, it not only enables investment on an economic scale but also reduces risks and opens up greater opportunities for profits. The basic function of a unit trust is to pool and combine capital from investors for the purpose of establishing a fund. A management company, which acts as fund manager, will administer and invest the fund in the securities of the companies. The pooling of financial resources from the investors is made by the selling of the units of the fund. The investors make the purchase on the units, but not the securities invested by the fund. Each unit represents indirect ownership of all the securities available in the portfolio of the fund.

3. DEVELOPMENT OF UNIT TRUST IN MALAYSIA

In Malaysia, the unit trust industry has been a relatively stagnant industry. Despite growing awareness among the public, the growth of the unit trust industry in Malaysia has been sluggish as compared to the growth in the United States and the United Kingdom. Equity ownership is still dominated by direct acquisition of securities in the open market or through primary issues. Though Malaysia has successfully used the trusts as an instrument for increasing equity ownership of Bumiputra or indigenous communities in the corporate sector, and may claim to having the world's largest unit trust scheme in terms of the number of unitholders, the popularity of unit trust as a means of getting a decent piece of action in the equity market is still not up to expectation.

4. ROLE OF UNIT TRUST IN DEVELOPING EQUITY OWNERSHIP

Despite its sluggish growth, the unit trust industry plays an important role in developing equity ownership. The concept of unit trust is based on sharing of interests. Interest in equity can be acquired directly. But we must have the surplus financial means to do so. Given the higher price of the shares in the market together with the regulation on the minimum number of shares that can be purchased, ownership in corporate stake is normally associated with the 'haves' only. For instance in Malaysia, budding investors cannot hope to own 1000 quality shares on the stock exchange unless he has at least M$3000 in hand. To acquire a blue chip is way beyond his means and he most likely will end up with his spare cash as bank deposit instead. Even if a person has a means to acquire the shares direct from the market, he may not want to do so as he may find it dangerous to dabble in the market, especially these days where shares change hand at breath-taking speed, and prices swing wildly.

Unit trust is the answer to the above problems. It is a means of sharing interests. Unit trust, which can be purchased in units of as little as M$100 is a practical and efficient way for people with similar investment objectives to pool their money together to own equity indirectly for their mutual benefits. By doing so, they are not only able to get a piece of action in the stock market, but also able to spread their risk over a wide range of securities. This is because their capital will be combined for investment in a diversified portfolio of securities and managed by professional managers.

In Malaysia, a good example of how a unit trust can be used to develop and cultivate the habit of equity ownership is the National Unit Trust Scheme for the indigenous communities. Established in 1981, the scheme has been successful in mobilising funds from the relatively low income indigenous communities and increasing their share of equity ownership in the corporate sector. At the end of its first year of establishment, the total number of unit holders was only over 800,000 with the unit value of over M$370 million. However, by end of 1989, the number of unit holders had increased to over 2,000,000 with the unit value at over M$6 billion.

5. PROTECTION OF UNIT HOLDERS

In a developing country like Malaysia, equity ownership through a unit trust scheme is normally aimed at and would be appealing for those who are in the lower income group. The single most important difference between equity ownership through direct investment and equity ownership through investment in unit trust is that in the latter case, the ownership is for the purpose of revenue and profit only and not for the purpose of exercising control. As such, there is a need to ensure that unit trusts are at all times managed properly and professionally. Adequate measures must be taken to regulate the fund and disseminate information to the public to ensure that there are no malpractices and that the public understand fully how the trusts operate and the risk involved in investing money in the fund.

Realising the importance of the role played by unit trusts as one of the means to mobilise funds from the public, the authorities in Malaysia, through the Informal Committee On Unit Trust Funds have issued certain guidelines governing the operation of unit trusts. The objective of these guidelines is to monitor the activities of unit trust funds in order to ensure that they expand in an orderly manner and that the interests of unitholders are protected. The role of the Informal Committee, which comprises representatives from the Registrar of Companies, the Ministry of Domestic Trade and Consumer Affairs, the Public Trustee and the Central Bank was initially to coordinate the approval process for the establishment of unit trust funds. Its function has since been expanded to include overseeing the establishment of unit trust funds and subsequent development of the unit trust industry. Proposals for the following are required to be submitted to the Informal Committee:

i) Establishment of unit trust funds;

ii) Launching of new trust funds by existing unit trust management companies; and

iii) All other matters relating to unit trust funds.

Following are some of the guidelines issued by the Informal Committee:

(i) A unit trust fund must invest in authorised Malaysian assets which are as follows:

(a) Securities of Malaysian companies listed on The Kuala Lumpur Stock Exchange (KLSE);

(b) Units of unrelated property trust funds listed on the KLSE;

(c) **Malaysian government securities, Treasury Bills, Central Bank's Certificates and Government Investment Certificate;**

(d) **Malaysian currency balances in hand, Malaysian currency deposits with commercial banks and finance companies;**

(e) Government mortgage bonds and bankers acceptances.

(ii) A unit trust fund should not invest more than 30% of the value of the fund in non-trustee securities. This is to ensure that the fund would not be affected very much by adverse market condition. Non-trustee stocks are those stocks which are normally subject to heavy speculation.

(iii) Investment by a unit trust fund in the securities of any one single company shall

(a) not exceed 5% of the total value of the fund or M$250,000, whichever is the greater; or

(b) 10% of the issued and paid-up capital of the Company,

whichever is lower.

(iv) Investments by a unit trust fund in any group of companies shall not exceed 10% of the total value of the fund.

These guidelines are intended to prevent imprudent concentration of investments in any one company or group of companies which could adversely affect the performance of the fund.

(v) Size of unit trust fund - the initial size should not be more than 50 million units.

(vi) Management companies of unit trust fund, which must be 70% owned by Malaysians, shall be subsidiaries of financial institutions and have a paid-up capital of at least M$250,000 where the aggregate approved size of the funds managed is less than M$100 million, or M$500,000 where the aggregate approved size of the funds is M$100 million and above.

This guideline will ensure that the managers have the necessary financial backing and their operation of the funds are closely supervised. It also will see greater innovation and sophistication, all of which will better serve the investing unit holders.

6. UNIT TRUST AND EQUITY MARKET DEVELOPMENT

The existence of unit trust industry definitely gives a positive contribution to the development of equity market. First on the liquidity of the market. The stock market of a developing country has often been described as not having liquidity. By liquidity here is meant the ease with which one can get in and out from the market. The market is said to be liquid if there are always buyers when we want to sell and sellers when we want to buy. The investment activities of financial institutions like unit trusts would definitely enhance the liquidity of the equity market.

Another aspect of the equity market of the developing countries which is sometimes causing concern to the regulatory authorities is that it tends to be highly speculative in nature. A healthy and orderly market is the one which shows a good balance of speculative activity and long-term investment. To develop such a market requires not only the presence of good and efficient regulatory systems, but also a good investment

discipline on the part of the investors. Since investment of unit trust funds are normally for long-term and managed by professional fund managers, their activities and presence will contribute towards achieving a healthy and orderly equity market.

7. CONCLUSION

Prospects for the unit trust or mutual fund industry are bright and there is plenty of room for it to grow. The growth of the industry will be a compliment to the development of the equity market. The gap between saving and investment can be reduced further with the growth of the industry. For the investors in unit trusts, such an investment ~~would~~ may not be as exciting as direct investment in the securities but they are assured of good yield, security, regular income distribution, benefit of professional management and above all, spread of risk.

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ROLE OF MUTUAL FUNDS IN CAPITAL MARKETS

BY R. VISWANATHAN

ROLE OF MUTUAL FUNDS IN CAPITAL MARKETS

Mutual funds play a significant role in developing the ownership of equity, quasi-equity and debt instruments, by a wide cross-section of people. In India, the first Mutual Fund was set up over 25 years ago by the Unit Trust of India (UTI) a Public Sector institution. While the UTI has been growing over the years, a sudden burst of activity was witnessed in the past 3 years with the setting up of a number of Mutual Funds by Public Sector Banks and the Life Insurance Corporation of India. The resources and activities of UTI also shot up phenomenally during the last 5 years. It is proposed to outline, in this paper :

a) The Raison d'etre of Mutual Funds;

b) The Growth of Mutual Funds in India;

c) Issues that have surfaced so far in the operation of Mutual Funds.

2. RAISON D'ETRE OF MUTUAL FUNDS

2.1 The household sector in India provides virtually the entire domestic savings which, at over 20% of GDP, are one of the highest in the world. The macro level data indicates that during the last decade there has been a perceptible shift towards financialisation of our domestic savings. The share of financial assets has gone up as compared to physical assets and within the financial assets the amounts invested in shares, debentures and units have nearly doubled from 3.6% to 6.9%. An increasing number of investors are now looking for investment avenues other than those available in the shape of post offices or banks in order to get higher returns and are even prepared to trade off partly, features like liquidity and high degree of security. Many of these investors have neither the detailed information about the markets they are seeking, nor means to interact with them. Mutual Funds (MF) provide an investment vehicle for such investors. The main objective of a MF would be to provide alternate investment avenue to small investors including those from rural and semi-urban areas. Extending the reach of MFs to cover rural, semi-urban and hitherto untapped centres is going to be increasingly relevant not only from the view point of tapping savings potential of these areas but more significantly to provide an access to investors from these areas to growth opportunities offered by capital markets. In the process, funds are channelised for the growth of corporate sector, industry and the economy.

2.2 An Intermediary .... :

MFs collect money from a large number of investors in even small lots, pool them together and invest the funds, in bulk, in shares and other securities, which are traded in the Stock Markets. MFs are thus an important intermediary in the capital market. The small investor derives many advantages from MFs, some of which are :

(a) Funds are invested and the investment is constantly churned by a team of Professional Managers and thus the investor gets the maximum possible return on his investment. He is able to tap professional expertise and is also freed from operational chores of following up a portfolio of his own.

(b) **Even with a small investment, the investor gets the benefit of a diversified portfolio, thereby spreading the risk.**

The above primary benefits far outweigh the cost of management services payable to MF, which incidentally do not amount to more than 1.5 to 2.0% of the corpus of a MF.

2.3 <u>..... And Facilitates Disintermediation</u> :

2.3.1 MFs in India also facilitate the process of disintermediation, in a way. Before the proliferation of MFs in the recent past, the small investors had to put their savings primarily in commercial banks and to a small extent in Life Insurance, UTI, etc. Deposits with Banks did not yield market related returns essentially because Banks were obliged by Law & Regulatory Authorities to invest the funds in low yielding but socially oriented investments. Banks in India are thus required by Law to block one half of their deposits in investments in low yielding Government Securities. Of the remaining half, a substantial portion is also required to be advanced to small and potentially vulnerable borrowers, at low interest rates. Intermediation by banks thus became somewhat expensive.

2.3.2 **MFs, by tapping funds from a large body of savers and investing the money in high yielding securities and money markets instruments, ensure that the savers get market related yields for their investments. More important, by channeling the funds to equity shares, in** some of the MF schemes, members of the public are being initiated into the equity cult. Over a period of time, direct investment in equity by savers would thus be facilitated. This process of disintermediation would get a further shot in the arm when MFs or their associates start providing investor advisory services, which are on the anvil. Thus investors would be encouraged to take risks and reap the rewards from such risks.

2.4 Potential for enlarging investor base :

In India, investment in equities is still largely a metropolitan and urban phenomenon. Available data indicates that 12 major cities account for nearly 80% of shareholding population and out of these, the four metropolitan cities alone account for nearly 60%. There is clearly a need for making the share-holding pattern more broad based. The total investor population in India is now estimated to be 14 million which is a little above one percent of population against 25% in case of USA and 19% for Japan. The potential for enlarging equity ownership is only beginning to be tapped, in India. Equity cult is yet to spread to semi-urban and rural India and still to fully take roots at many urban centres.

2.5 Creating investor awareness :

The reasons for the narrow base of equity ownership are essentially lack of widely available information on capital market related investment opportunities and also lack of infrastructure to interact with such opportunities. This also leads to apprehensions about new investment instruments, creating psychological barriers to entry, specially since in case of stock market securities the risks involved are high as compared to secure products like bank deposits or post office savings. MFs have a significant role here in creating investor awareness about non-traditional investment opportunities. The banking sector MFs have the advantage of extensive branch network of the parent bank which gives them a reach to investors all over the country including those in semi-urban and rural areas. Talking of mobilisations the question becomes not only "how much" but also "from whom". The initiation process for investors through MF route would probably start from assured income products (hence the need for such products in the first place) then move to high risk growth products followed by investors venturing on their own into primary and secondary markets, possibly in that order.

2.6 Providing an investment vehicle :

There is also a growing number of investors, so far largely from metro-politian and urban areas, who are aware of the growth opportunities offered by capital markets but find it difficult as far as secondary market operations are concerned, ~~to continuously follow the markets and~~ corporate performances on their own. MFs provide an investment vehicle to such investors with the added advantage of a diversified and balanced portfolio. During last decade the share of corporate securities and units of MFs, in the deployment of house-hold savings, has nearly doubled growing from 3.6% to 6.9%, which is a pointer towards the changing preference of investors from household segment. Many investors specially from such urban centres which, do not have a stock exchange may find growth products from MFs an attractive option as compared to investing in the stock market on their own. Thus the trend for such market segment may be a substitution of direct equity investment by individual investors with indirect investment through MFs. However, it is a reasonable expectation that primary market investments by this investor segments may continue without any substantially altered preferences.

3. GROWTH OF MUTUAL FUNDS IN INDIA :

3.1 The growth of MF activity can be analysed from two perspectives :

(a) Growth of MF institutions;

(b) Nature of MF products offered.

3.2 Unit Trust of India (UTI) :-

UTI came out with its first scheme in 1964. However, the UTI's activity really galloped only during the last three years; UTI's mobilisations during these three years alone have been nearly 3 times the total investible funds at the end of the first 23 years.

	31/3/87	31/3/90
Investible funds	Rs.4563 crores	Rs.17500 crores
No. of investors	29.8 lacs	60 lacs

(Note : Lacs = 100,000

Crores = 10,000,000)

The sudden spurt in the recent past was accounted for largely by the corporate sector which found units a profitable medium for deploying short term surpluses specially in view of income tax rebate on yield for units for corporate investors. With a conscious shift in focus towards small investors, carried out by UTI this year during July 1990 mobilisations from corporate sector are estimated to be only Rs.350 cr as against Rs.2350 crs. last year. The target no. of investors by Dec. 91 is 10 million which are expected to be largely individual investors.

3.3 Public Sector Commercial Banks :

3.3.1 The first MF in India promoted by a commercial bank was SBI Mutual Fund which made its debut in November 1987. Since then a number of banks have entered the fray. The major strength of commercial bank promoted MFs is the extensive branch network and their direct access to investors as part of commercial banking activity. Canbank Mutual Fund closely followed SBI MF and launched its first scheme in December 1987. After this the next entry of commercial bank promoted MFs was in the year 1990 when Indian Bank, Bank of India and Punjab National Bank launched their MFs.

3.3.2 **The growth of banking sector MFs has been as under :**

	1987-88	1988-89	1989-90	1990-91 (till Aug)
No. of funds at year end	2	2	3	5
No. of schemes during the year	3	3	6	7
Amounts mobilised during the year (Rs. crs)	250	172	891	615

Aggregate Rs.1928 crs

Details of scheme-wise mobilisations are as per annexure.

No. of investor wise, SBI Mutual Fund has built up an investor base of over 4.5 lacs. The total no. of investors being serviced by banking sector MFs is estimated to be already over one million. While most of the banking sector MFs have largely focussed so far on individual investors, Canbank Mutual Fund has also been operating two open-ended schemes for the Corporate sector offering 12.25 to 12.5% assured return. The total sums invested in these schemes are reported to be large, the corpus being a fluctuating one, due to the short term nature of investments.

3.4 Financial Institutions :

Life Insurance Corporation of India, a public sector monopoly in the Life Insurance business, launched its first scheme in July 1989 and from its 5 schemes has collected Rs.410 crores by June 90. The sixth scheme closed on August 31, 1990, and is estimated to have garnered around Rs.100

crs. LIC's agent network is a major marketing strength for its MF products. General Insurance Corporation of India, again in the Public Sector, has announced its plans to launch a MF shortly. LIC promoted MFs offer under some of the schemes, life insurance cover and income tax rebates under (one scheme from UTI viz. ULIP also offers similar benefits). GIC also proposes to link insurance cover with its MF products.

3.5 <u>Off -Shore Funds</u>

3.5.1 Off-Shore Funds are essentially cross border mutual funds. Foreign investors desiring to participate in the growth opportunities offered by a country's capital markets invest in an off-shore fund which is then invested in the target country by professional fund managers. Indian stock markets are increasingly attracting foreign investors in view of the good track record of economic growth during the past decade, promising future prospects and comparatively low price to earnings multiples for Indian stocks vis a vis some other markets in South East and Far East Asia.

3.5.2 Foreign investors have two options for investing in Indian equities

(a) Direct equity participation usually up to 40% (higher participation also possible in specifically approved cases) which has to be accompanied by technology transfer except for oil exporting countries for whom direct investment is allowed even without the technology transfer clause.

(b) **Investment through the off-shore fund route where an off-shore investment company, in which foreigners have shares, invests in a dedicated mutual fund set up in India.** The country funds provide valuable foreign exchange inflows helping to bridge the BOP position, have longer maturities than commercial borrowings and in some cases are even perpetual in nature.

3.5.3 The growth of country funds in India has been as under:

1986-87	\$ 110 mn (75 mn stg)	UTI's India Fund (In association with Merrill Lynch, USA)
1987-88	-------	--------
1988-89	\$ 60 mn	UTI's India Growth Fund (In association with Merrill Lynch, USA)
1989-90	\$ 225 mn	SBICAP'S \$ 156 mn India Magnum Fund (In association with Morgan Stanley USA) - this is the largest privately placed country fund so far. Plus India Fund rights of 41 mn stg.
1990-91	\$ 112 mn	Can Bank MF's \$ 100 mn Himalayan Fund (In association with Indo-Suez Hongkong) and SBICAP'S \$ 12 mn Indian Tranche of ADB Manila's \$ 63 mn convertibles fund.

A second tranche of \$ 50 mn of India Magnum Fund has been raised recently. Some other funds are also expected to come to the market soon.

3.6 Mutual Fund Products

3.6.1 MFs in India, in a majority of cases, have so far come out with assured income products unlike in the economically advanced countries, where MFs do not assure any minimum return but share with their investors the risks and rewards of their investment management skills. Probably to begin with such assurances were needed to give confidence to uninitiated investors testing the mutual fund concept for the first time. However, it is a reasonable expectation that having made the initial break-through the future MF products would increasingly shift away from offering schemes, partaking the nature of bank deposits.

3.1.2 The present range of products can be broadly classified as under :

(A) Income oriented schemes

These schemes aim at giving an assured return at a regular periodicity with some end-of-scheme bonus. Some such schemes offer a cumulative option where the entire amount is paid at the end of the scheme and a minimum maturity amount is assured.

So far UTI, SBIMF, LIC and BOIMF have come out with monthly income schemes. Canbank MF, BOIMF and LICMF have launched cumulative income schemes. A deferred income scheme by UTI is currently on. The details of various schemes are as per the annexure. In terms of investment mix of funds,

bulk of investments in all income oriented schemes would be in fixed income securities like debentures and bonds and a small portion of around 20% or so in equities. Income products are generally not listed on stock exchanges and liquidity is provided through repurchases by the mutual fund itself.

B. <u>Growth Scheme</u>

The growth schemes do not assure any minimum return and aim at rewarding the investors by giving attractive capital appreciation at the time of redemption or sale by the investor. Suitable annual dividend may also be paid. The growth products are generally listed on stock exchange and the investments of these funds are largely in equities.

UTI's Mastershare, Canbank MF's Canshare and Cangrowth and Indian Bank's MF Ind Ratna fall under this category.

Some of the growth schemes have special features enabling tax savings on sums invested, provided the MF invests only in shares of new companies having income tax rebates.

c. **Balanced funds or income cum growth funds :**

This most popular product of mutual funds as of now, incorporates elements of both a regular income and some capital appreciation. Almost all the mutual funds have come out with such schemes. In terms of investment mix, the fixed income securities would again have a larger share than equities; however vis a vis pure income schemes, income growth schemes would have a slightly larger share of equities in total portfolio.

3.6.3 Closed vs Open ended Schemes :

Mutual funds products can also be classified as 'open ended' or 'closed ended' ones. An open ended fund does not have a fixed corpus size and units are available all the time. Investors can also encash the units any time by selling them back to the fund. Such funds are usually not listed at the stock exchange. The 'closed ended' funds on the other hand have a fixed corpus size, units of which are offered to investors during a specified period and the fund has a fixed duration at the end of which the units are redeemed. An investor desiring an earlier encashment can sell the units through stock exchange in case the fund is a listed one; in other cases the encashment facility is normally provided by the fund itself. While UTI offers essentially 'open ended' funds, Banks have been by and large operating 'close ended' funds.

4. MAJOR ISSUES

4.1 Regulatory Framework

4.1.1 **With the sudden outburst in the activities of MFs, the regulatory framework in India is yet to take a concrete shape. The first MF, UTI is governed by its** own statute and there was therefore no felt need for an overall regulatory framework for MFs. However, when banks started operating MFs, the country's Central Bank viz. Reserve Bank of India laid down a set of guidelines governing the operating of bank-managed MFs. Subsequently, with LIC joining the fray, the Government of India issued guidelines for MFs. Presently, therefore, there are two sets of guidelines which, on many important respects, are similar.

4.1.2 The formation of a separate Supervisory Authority viz. Securities and Exchange Board of India (SEBI) for capital markets is intended to centralise all supervisory functions of the various players in the capital markets. SEBI's primary role is to ensure due protection to the lay investors and also to oversee that the different players in the same market function without any discrimination or privileges i.e., they operate in a "level-playing" field. Viewed in this context, it is necessary that MFs run by all the institutions including UTI are governed by the same set of rules and broad procedures, irrespective of who the

Managers of MF are. SEBI is proceeding in this direction, although they are yet to be given statutory authority; presently, they derive their powers from administrative orders issued by the Government of India from time to time.

4.1.3 One regulatory authority for all MFs is highly desirable. However, it is quite appropriate that the Reserve Bank of India may wish to have an overall control over the activities of MFs run by banks as part of their role in maintaining consolidated supervision over the functions of the banks. In other words, RBI have to ensure that no single activity of a Bank has any major delitirious effect on the liquidity and solvency of the Bank as a whole.

4.2 Public vs Private :

4.2.1 So far all MFs in India are sponsored and managed by Banks & Institutions in the Public Sector. Private Sector entities are not allowed to enter the field although private sector is active in the financial services sector such as merchant banks, leasing companies, etc. One reason for barring entry of private sector in MF activity could possibly be that being a highly sensitive business with heavy fiduciary responsibility attached to the managers of MFs, the authorities had deemed it fit to entrust the responsibility to Public Sector concerns, to start with. This decision is being contested both by the financial services companies in the Private Sector as also ~~by the private corporate sector in general~~.

4.2.2 **Financial services companies in the private sector feel that they are mature and responsible enough to be entrusted with the management of MFs. While much can be said in favour of this argument, it has to be conceded that the decision to confine this activity to** Public Sector in the initial stages, when the prudential norms and guidelines and being evolved, is sound in the overall context.

4.2.3 Captains of Industry are also increasingly voicing a concern about the growth of MFs in the Public Sector. They contend that these MFs garner substantial resources from the public and invest them in shares of private sector companies. They anticipate that with the substantial voting power thus gathered by MFs, the management of Private Sector, could be 'destablised' at the "whim" of the Government in power. Such an allegation is not borne out by any concrete evidence. However, there is merit in the demand that the overall holding of all MFs and other public sector entities in a private corporate entity should not exceed a particular percentage of the Company's equity capital; in other words, the industry's viewpoint that Public Sector financial institutions (especially those who are mere custodians of private sector funds) should not have a controlling or major interest in the shareholding of private sector companies needs to be given due consideration.

4.3 Income vs Growth

4.3.1 MFs in India have, by and large, been income-oriented, ie., a vast majority of them assure a minimum yield either monthly or annually to the investors. Since the concept is new, MF schemes providing for regular income have attracted a large number of investors. To get a regular income, MFs, in turn invest in fixed income securities. Thus, roughly 75 to 80% of all MF money is invested in Debentures of companies and bonds issued by Public Sector undertakings. The balance 20 to 25% is invested in shares. Some of the MFs have floated schemes which are intended to be invested in shares and these schemes do not assure any yield.

4.3.2 While providing regular income can be a genuine and feasible objective of a MF, the fact that almost all such schemes in India, barring the schemes managed by UTI, assure a MINIMUM or EVEN FIXED INCOME has been a matter of concern for the regulatory authorities. SEBI feels that, in the fitness of things, MFs should never assure any return because the very concept of MF means that the savings of a large number of investors are pooled and invested in the best possible manner by a Manager. It is neither desirable nor feasible for the Manager to guarantee that the investor's capital would at all be times safe, much less to promise that the capital will generate a stated minimum income. The Chairman of SEBI has voiced the view that quite apart from not assuring an income, the managers of MFs must explicitly state that even the capital could be at risk. The investors must be told clearly that the manager of MF would operate the MF on a best effort basis and the rewards and risks are on the account of the investors. Such a procedure is adopted in USA and other developed countries. It is expected that similar procedures will be adopted in India too in the near future.

4.4 Settlor, Trustee & Manager

In India, the MFs are organised as Trustees with a Settlor, a Board of Trustees and a Manager. All these three functions are performed generally by the same Bank or Financial Institution either directly or through wholly owned Subsidiaries. SEBI has been voicing concern at this development as it is felt that there can be conflicts of interest, more so as the Bank/F.I. also operate in the money and capital markets. A fully satisfactory resolution to this problems is yet to be hammered out. However, all the Banks/F.Is. operating MFs endeavour their very best to ensure that the operations in MFs are done at an "Arm's Length" basis vis-a-vis their other operations ie., a "Chinese Wall" is sought to be put in place between MF and other activities of the Bank/F.Is.

5. CONCLUSION :

Mutual Funds have been an important segment of the capital market in India in the recent past. They generate a better yield to the investor with lesser risk compared to other similar financial products. MF products have grown exponentially during the past 3 years. In times to come, the MF industry is bound to grow further. With rapid growth, however, the prudential norms and guidelines governing the operations of MFs are bound to be made more stringent, with a view to protecting the investors. Thus the aim of the authorities would be, to quote Shri G.B. Ramakrishna, Chairman, Securties and Exchange Board of India "The upshot of all this would not, however, be that fools are protected but that genuine people are not made fool of".

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MUTUAL FUND PRODUCTS : (As on 31/8/90)

(Rs. in crores)

Name of fund	Income Schemes Monthly		Income Schemes Cumulative		Growth Schemes		Tax Saving Schemes		Income Cum Growth		Total
UTI	12 schemes	3500	Deferred Income (90)	Open	Mastershare	225	-	-	Unit 64	8500	
									Children's growth, ULIP Parent's gift, Capital Gains Units	5275	
		3500				225				13775	17500
SBIMF	MMIS 89	155	-	-	-	-	MTSS 89	80	MRIS 87	131	
							MTSS 90	150	MRIS 89	56	
									MRIS 90	140	
		155						230		327	712
* Canbank MF	-	-	Candouble 89	250	Canshare 87	18	80 CC 89	36	Canstock 87	101	
			Canstar 90	Open	Cangrowth 89	48	80 CC 90	148			
				250		66		184		101	601
Ind Bank MF	-	-		-	Ind Ratna 90	35	88 A 90	Open*	Indgrowth 90	105	140
BOIMF	RMI 90	100	Double Square 90	300	-	-	-	-	-	-	400
PNB MF	-	-	-	-	-	-	-	-	RIS 90	75	75
LIC MF	Dhanvarsha 90	80	Dhanvarsha 81 Dhanvridhi 89	120	-	-	80 cc 90	40	Dhanshree 89 & 90	270	510

* excluding CANCIGO and CANGILT schemes for Corporate Sector

RESTRICTED

"COUNTRY FUNDS AND EXTERNAL PORTFOLIO INVESTMENT IN EMERGING EQUITY MARKETS"

BY

S. A. DAVE
CHAIRMAN
UNIT TRUST OF INDIA

*****

(1) The Distinction and Merits of Country Funds :

Previous speakers have between them covered certain basic conceptual aspects of investing in emerging country stock markets, the role and development of stock markets and the development and growth of domestic mutual funds in the Commonwealth Countries.

Since the canvas for the session that I am leading is extremely broad since it spans investment attitudes and expectations across the globe, I would briefly discuss the background and rationale of such investments and offer my views on this currently popular form of attracting capital flows across national boundaries. In the process I shall offer some comments on the motivation which drives individuals and institutions to invest in new and widely scattered stock markets and why it continues to be attractive for governments to open its capital markets on a reasonably liberal basis to international investors. I would also like to hazard a guess as to what direction Govt. might go in the future.

Lastly as I go along I will also touch upon the growth and structural change of the capital markets and the Indian experience.

Much attention has been focussed on the benefits that Fund Managers can achieve from International portfolio diversification. Investment professionals and academic researchers have been using extensively developed databases on foreign stock markets to make the point that country funds have become an easily accessible mechanism for cross border diversification of otherwise domestically invested portfolios. These investment vehicles offer global exposure of varying amount without the resource or risk tolerance required of a stock by stock strategy for overseas trading. A growing body of research indicates that share price changes across country stock markets are substantially less than perfectly correlated with each other. Despite some strong debate on direct access to markets as against access to country capital markets through country funds it would be generally correct to say that the addition of foreign shares to a domestic equity portfolio reduces volatility while maintaining the desired ex ante return.

While most developed countries observed the rapid development of domestic unit trust and mutual fund industry in third world countries, the benefits of diversifying into foreign stock markets was unattainable to them with a variety of protectionist barriers to a free flow of portfolio investments - high transaction costs, the insularity of markets, lack of information (reliable) and knowledge. It is here that the investment industry and investment professionals stepped in by responding with specialized packages that understood the vagaries and attractions of a particular offshore capital market. In this I must pay my special tribute to these modern day Columbuses for <u>not only</u> discovering the EXOTIC markets but also hardselling them to professional domestic Fund Portfolio Managers who had hitherto never dreamt of parting with their money across borders to their lesser known counterparts in the new markets. The basic driving forces have been:

- Increasing internationalisation of securities markets;

- Associated awareness by portfolio managers of diversification through excellent growth opportunities offered by fast growing economies of industrializing countries;

- Longer term opportunities and orientation. Sharp increase in Funds at the disposal of institutional investors in the U.S, Europe, Japan and Far East reaching over USD 3 trillion;

- The big swing of 1980s towards the bull market in equities worldwide;

- More liberal investment attitudes of Institutions, Investment Houses and Fund Managers were in addition to above looking much beyond reducing risk through diversification and expanding opportunities to a more basic/primary motivation of - ADDING VALUE at the margin through greater opportunities for capital rewards as compared to the domestic capital markets. This overshadowed the early motivation of reducing risk which would still be a strong subsidiary factor. The real skill lies in spotting which of the dozens of flyblown bourses around the world are poised to spring to life and separate the emerging from the still dormant markets. Given that most emerging country stock markets have very low or negative correlation for quite some time with top 5 - 6 developed country stock markets that move in tandem. What are needed are continuous search and high grade analysis and perception.

For certain international institutions the thought that such investment can make a real contribution to the development of the world could have been a motivating factor. While this is difficult to quantify, one senses this more in some countries in Latin America and Asia. In some countries the extreme popularity of country funds could be traced to increased direct investment of capital in the development of domestic industry by capital rich countries wishing to relocate manufacturing facilities offshore or invest abroad. In the same context, for some reason countries on the geographical rim of the developed countries attracted the big first flush of offshore funds despite that fact that some of those markets could not have efficiently supported large portfolio investments.

(2) Benefits to Host Country Economy:

However, not all these factors would have opened the emerging capital markets to sustained capital flows, but for the fact that several governments during the late 70s and through the decade of 80s took steps to liberalize their capital markets and encourage foreign investment. Let us look at what could be considered salient factors which underscored the vast capital inflows in these countries.

- For most Latin American States and some countries in the South East Asia it was the onset of the LDC debt crisis in 1982.

- External funding by way of soft loans and easy commercial loans of the early 80s became progressively harder to come by prompting countries to foster nil and low interest bearing domestic instruments such as equity and convertibles. Most Asian and Latin American countries took major moves to promote their equity markets and encourage foreign investment. India which was in the early 80s a fortress but for rigidly controlled direct investments permitted portfolio investment by non-resident

Indians and has gradually liberalised the procedures for direct and portfolio foreign investments.

- Keeping in view the trend towards financial globalization, Government were more willing and able to overturn isolationist financial and economic policies and find a new place for itself in the International markets. In effect these emerging markets removed the country's historical lack of competitiveness through removal and dilution of obstacles to foreign investment particularly equity which does not burden corporate and national finances with fixed repayment obligations.

- The rapid economic growth trends in the Pacific Rim and Asia became visible through the growth of capital markets. Most Asian economies grew 2 - 4 times the world average in the 80s. While some Asian countries permitted domestic corporations to raise larger capital through the Eurobond markets, others like India permitted greenfield projects to tap domestic equity markets for capital needs.

- Partly as a consequence of these reforms the total capitalisation of emerging markets grew from USD81 billion in 1983 to USD 611 billion in 1990.

- In line with this growth returns of emerging markets also generally outperformed those of more established markets over the period. Besides having good growth characteristics for the better part of 1980s, emerging markets were extremely inexpensive in terms of price/earnings and price/book ratios. While many markets were undervalued relative to the rest of the world markets today these markets seem to be returning to their older and more attractive valuations.

- The growth of emerging markets in the 1980s was reflected in the increased issuance of country funds. These have grown more than tenfold in size from USD 700 million in 1985 to over USD 7 billion in 1990. According to Lipper Analytical Services, there are over 150 emerging market funds to choose from and the number is climbing rapidly. However, a number of newly listed country funds are those that would invest in already open markets like Germany, France and U.K. While institutions have increased their exposure in absolute terms it still remains marginal in terms of percentage which is variously put at between 0.1% - 0.2% of their assets.

(3) Appeal of Emerging Markets to Investors:

For many institutions and specially individuals, investing in mainstream markets is itself a new experience. Investing in junior and new emerging markets requires a good deal of education and confidence building. Apart from the fundamental reason of adding value at the margin that every sentient investor looks at whether country funds are a superior alternative to direct portfolio investment is a matter of continuing debate. However, considering some hard data InterSec Research Corpn. estimated that non domestic pension assets rose by a factor of over 10 between 1980 to 1988 and projects this figure to more than double between 1989 to 1993. It would not be surprising to see assets of over USD 1000 billion invested outside their own borders by the turn of the century and of this at USD 100 billion through country funds.

Considering this, Pension Funds are only one part of the equation we must include also Insurance Funds, Investment Companies, Government Agencies and Private Investors. With U.S. Institutions average international investments far below 4%, Japan and Europe under 2%, UK at 20% there are still large fund pockets which are not permitted even investment in domestic equity, let alone international.

- Institutional investors over the last 3 - 4 years have accepted emerging markets as a separate class largely on the basis of performance.

- Pension Funds often use country funds as a way of building up expertise in markets which they believe will one day be open. Thus a few USD100,000 is a tiny amount compared to overall assets under management and the tremendous learning it imparts.

- The smaller emerging markets tend to fly when a closed market with high real interest rates is opened to foreign investment. In these markets P/E ratio could rise rapidly as offshore capital invests in local equity and encourages investment. Further a small amount of investment in these economies could lead to disproportionately large productivity gains. The result is rapid rise in company earnings and investor expectations. These factor could trigger a re-rating of P/E ratios, which rerating could be explosive. The Korean, Thailand, Taiwan, Indonesian and to an extent the Indian model could be cited.

- Structure of the fund and quality of its management, its operating costs and the characteristics of its target market. For some markets like India, country funds are the only choice - India, Turkey, China, Korea and Taiwan to some extent. In countries where foreign portfolio investment is permitted, country funds, through using local fund managers can avoid the hassles deriving from inadequate information and cumbersome settlement of repatriation procedures.

- Some countries such as Malaysia, Thailand and Indonesia have granted certain closed end funds tax and other benefits in consideration of their nature of stable long term investors.

- International diversification reduces the risk in a portfolio. Portfolios combining different markets have historically generated higher returns at lower risk exposure.

- While U.S. markets have more than doubled in the past 8 years, most other markets are up anywhere from four to ten times with Asian markets at the higher end of the range.

- U.S. slice of world market capitalisation has contracted from 70% in 1970s to 28% (1989). During the same period a significant transfer of wealth has occurred. U.S. from a creditor is the largest debtor nation in the world. Investors are forced to look at 70% of global investment possibilities.

- Closed end country funds can help generate superior risk adjusted performance - without the drawbacks of international investing like poor liquidity, indifferent settlement, political risk and poor financial disclosure. These investment vehicles are good for executing country allocation strategies.

COUNTERCYCLICALITY

The hallmark of emerging markets is that by definition and with the exception of Mexico which is the U.S. backyard they remain on the edges of Wall Streets gravitational fields. If Wall Street or a major market sneezes, the markets of the host country do not catch cold. However, recent interesting research by Warren Bailey and Joseph Win of Cornell University analysing Korean Funds performance indicate that "General movements in U.S. stock markets are becoming important determinants of Premium to NAV".

- Country funds can complement the existing activities of the U.S. investor who is unwilling or unable to absorb the added search, analytic and monitoring costs of global investing by local fund managers having a stronger knowledge of foreign markets and economic conditions abroad.

- For small and closed foreign markets, a listed country fund provides a liquidity, a kind of ADR for fast growing regions of the world. Funds provide early and specialised access to stock which may be the international name in a decade.

OTHER FINANCIAL CHARACTERISTICS :

Closed end funds are priced by the forces of supply and demand and hence tend to quote/sell at discounts to NAV's. Consequently discount analysis and the study of interplay between share prices and NAV with home/foreign markets are important to investment decisions. Thus the INVESTOR has two sources of RETURNS:

(1) Those associated with the performance of underlying portfolio.

(2) That associated with the variance between the premium or discount between price and value. On many occasions discounts could be substantial as they are today. Discounts could be a product of short term or long term internal/external factors and also the funds' liquidity.

- Deep or persistent discount or sub-standard performance could make a Fund vulnerable to takeovers and/or may force share redemptions at net asset values.

- Closed end country funds which are listed are good albeit not perfect proxies for their underlying markets.

- Within the universe of country funds we now have products with special characteristics that make it tax effective - single v/s. diversified funds all aimed at increasing total return and protecting down side risk and volatility.

- Funds result in additional flows and do not replace portfolio investment and may assist in reducing the savings, investment gaps, introduce risk capital into stock markets and strengthen corporate and national balance sheets.

- Certain fund management structures would add substantially to improving quality of LOCAL RESEARCH - HIGHER PROFESSIONAL STANDARDS being imposed on intermediaries such as Brokers and agencies such as Custodians and Accountants. Overall it may (in fact in India it has) set a long curve of learning in the domestic regulators.

- Recipient country governments are often comfortable with the knowledge that foreign portfolio investment channelised through funds will not result in foreign control of domestic companies.

- What may be reassuring is the STABILITY of foreign investment through closed end funds in times of greater volatility, external or internal markets as against direct investments which may disappear overnight and cause disequilibrium in the often illiquid emerging markets.

Very little evidence was available till recently. However, the experience of several countries indicates that stability may not be what a country looks for in a fund investing in its markets. Indonesia, Turkey and Thailand are typical recent examples hurt by the Gulf crisis. This is a major issue over which I would request the session to debate. It is certainly not clear whether investors and fund managers are long term profit maximisers or does performance measurement in a competitive environment puts pressure on fund managers to take a short term attitude, however much they pay lip service to the long term. Concentration on the short term plus the perception that active investment managers have in recent years found it difficult to add value has led a major push to <u>Indexation</u> products - international portfolios account for over USD20 billion from the U.S. alone.

This also explains the strong preference for closed end funds to open end ones. Whereas a few funds have been converted to open ends. Countries have generally kept away because of the possible destabilising effects on the market and the negative consequence on their own portfolios.

Another factor that country governments could keep in mind is that before country funds are permitted the stock markets should have adequate liquidity and supply of securities and a transparency through disclosures. Otherwise without this minimum market size and infrastructure a large injection of foreign pure equity funds could send second market valuations.

India has, in my view, followed this slow and more conservative process of selling its equity markets very carefully.

(5) Prospects and Scope for Newer Markets :

The spectacular multifold growth of domestic and offshore mutual fund assets of the last decade may not probably be matched in percentage terms in the developed world. However, I am certain that the domestic Indian mutual fund industry would continue to grow at a healthy clip during the decade of the 1990s. India, unlike most of South East Asian countries has seen a strong spurt in growth of domestic mutual fund industry. In addition to tapping individual savers and convesting passbook holders - Indian mutual funds have attracted large sums of corporate surpluses. Upto 1987 UTI was the sole offerer of mutual funds. In these three years India has seen at least 7 new offerers of mutual funds. With mutual funds still closed to the private sector India saw the coming of age of the Banker in the securities business. With Indian banks pushed into a corner in terms of outflow of deposits and forced to improve declining profitability, banks logically entered the mutual fund business. Banks across the country are coming to the belief that their industry is destined to evolve into a major distribution channel for mutual funds. Owing to their sheer numbers banks will be over time prominently involved in both sides of the issue regarding the merits of distribution versus management of mutual funds.

I have dealt with this issue at some length since it underscores an important point that of the optimal solution to the problem of developing and when - domestic or offshore mutual funds industry. The Indian experience suggests that a country develops strong local fund management and distribution experience before offering services to offshore funds. Few Asian emerging markets parallel this development. There are examples of similar course of development in certain Latin American States eg. Mexico.

India made a slow beginning in 1981-82 by relaxing the local foreign exchange rules to permit direct investment by non resident Indians and OCBs into the Indian equity markets. The process was hemmed by a regime of tight controls on repatriation of proceeds, sale of securities. In addition there were controls on the percentage of shares that could be owned by the Investor. In the wake of this development and amidst a generally weak regulation on the securities industry - came a series of controversial purchases and transfers of shares by NRIs. These purchases were triggered by sloppy takeover guidelines and were aimed at control of management. What followed was a tightening up of rules and procedures and a general setback to the progress of the earlier thinking of a slow opening up of markets. The portfolio investment scheme despite attracting small amounts particularly in new issues of capital was a relative non starter.

Thus with the exception of India, Korea and Indonesia, very few Asian emerging markets held on to a tight exchange control mechanism into the mid and late 80s. Indonesia freed its exchange markets in 1988. Other Asian countries have selectively dropped controls that hampered movements of foreign (offshore capital) into their securities markets. Several countries such as Thailand and Indonesia created special equity classes for offshore investors or put in artificial plugs or levels of upto 49% which the foreign investor could hold. With emerging markets looking undervalued and strong, international investors swarmed into these markets preferring the country fund structure over the direct route. With the Asian region participating strongly in the economic resurgence which the world witnessed in the 1980s - the capital markets of these countries occupied centrestage and each year of 1980s gave the investors in the developing world a new market. Valuations and trading volumes increased frenetically. The Indian market which remained relatively "CLOSED" also participated in the strong momentum witnessed by the Asian markets.

Since 1986 trading volumes have quadrupled and market capitalisation has doubled at the Bombay Stock Exchange in India. While growing steadily India did not participate on the rapid stimulus that caused several emerging markets to overheat and as quickly scale back to what appear to be reasonable levels. India was helped here by a couple of factors:

- Insignificant offshore investor interest and therefore largely insulated.

- An equity holding pattern where more than a third each of the issued stock was held in strong hands of investment institutions, promoters and investors. Thus the market though skewed in terms of paucity of stock was damped for any shock.

- A growing investor demand for holding his savings in corporate paper rather than banks and the availability of good volume of new offerings.

While the sceptics may have strong reasons to disagree the Indian market largely survived the imbalances caused by wrenching volatility witnessed by several emerging markets recently.

Those who disagree might say that some emerging markets are showing signs of a classic speculative bubble but others are growing at a steady pace and still others might decline. This, however, is not unlike classic stock market behaviour everywhere. Some equity markets did attract inflows of money that they could not instantaneously digest - particularly due to the narrow base of the domestic equity markets. But these are matters of intertemporal policy adjustments. Indian capital markets, for example, in the same time grew in dimension with new supply of primary capital feeding the demand but basically demanding further liberalisations and structural changes and not merely traditional extrapolations.

India has since 1986 successfully offered four country funds which invest in the Indian securities markets in addition to at least 3 - 4 other funds that invest in India as part of Asia. At least 2 India funds have gone in for additional issues increasing their size. Long term prospects for absorption of fresh Indian paper are bright in view of the past performance of the India funds. Indian capital markets and the newer funds are relying on making the vehicles tax advantageous by using special tax structures. Unit Trust of India is dealing actively with issues relating to innovation and performance as also building an infrastructure for high standards of Fund performance and introducing the state of art in portfolio management. The Unit Trust of India has been relentlessly contributing to increasing the skill base required for fund managers and contributing to increasing the overall standards required by a growing industry. One of the significant positive fallouts of mutual funds is the increasing awareness of better disclosures, stronger accounting rules and procedures. It has also led institutions to become aware that there are almost no providers of services to the mutual funds industry which could match even basic standards in the more developed markets. Emerging markets could become the next focus for developing a string of services which are so prominent elsewhere.

FUTURE SUPPLY AND DEMAND:

Before I close I would like finally to try and make a guesstimate of at the balance that may evolve/is likely to evolve upto the end of the decade between supply of emerging stocks and the possible demand for them.

On the **SUPPLY** side total market capitalisation of emerging markets is around $600 billion. Industrialised countries could be expected to grow through the 90s at say 2% - 2.5% in terms of per capital GDP and the developing countries as a group to grow more than 3% (which is not unreasonable keeping past experience in view and is lower than World Bank projections for the first few years of the 1990s). Market capitalisation could grow at say 10% per annum.

Let me, in light of the above assumptions, pose some thoughts.

- Emerging markets once conjured up certain exotic images. Things are not so simple any more. Most of the traditional "Emerging Markets" seem to have well and truly emerged. Look at South Korea and Taiwan - nervous and depressed, Hong Kong - uncertain and therefore unacceptable, Indonesia - temporarily weary due to the hectic bull run of 1988-89 and the effects of digesting so much paper, Singapore and Malaysia - thin trading. Nevertheless Mexico, India, Venezuela, Turkey, Spain, Sri Lanka, Pakistan and China.

- The hottest markets are no longer solely Asian. While Asian indices recorded 450% rise during 1984-89 the steepest recent rise has been recorded by the Latin American Index with Asian indices witnessing declines (India was till recently an exception). New markets are already opening up in Eastern Europe - Latin America and Africa.

- Prior experience shows that opening the country's stock market is not necessarily a simple matter of rewriting the relevant statutes. Countries may have to tackle serious attitude problems before investors flock in, say, China. In Brazil and

Argentina raging hyperinflation effectively closes a legally open door. Any serious program to tackle inflation could lead to rerating of the markets.

- More of the developing world economies will pass into the hands of the public e.g. through a structured programme to hold the private sector ahead of public in the development process and through privatisation. Political and economic stability could return. The move will be to look for open economies, economic policies encouraging growth pressure of strong institutions and clearly demarcated rules for domestic and foreign investment.

LESS GOVERNMENT CONTROL/PRIVATISATION WIDER

Korea		Bangladesh
Thailand		Taiwan
Portugal		Philippines
Turkey		Singapore
Jamaica		Mexico
Chile	INDIA!!	Malaysia

- Emotive economic nationalism is being less of a factor. It is increasingly felt (India) that many industries belong more appropriately to the private sector. Private sector will continue to have a healthy appetite for equity financing. Fund could look at investing in greenfields and funding venture capital.

- Capital markets will become more open and there will be greater cross border participation.

- Values placed on corporate earnings may well rise.

Adding up these various assumptions the total emerging market capitalisation by year 2000 may be USD 4500 billion implying a 10 year growth rate of approx.22.5% per annum. The free float could be 25% across the Board suggesting a potential supply of over USD1000 billion by the year 2000.

Turning now to the **DEMAND** side. The demand will come from both domestic and international institutions and to a lesser extent from individuals. Even in a market which most analysts define these days as 'OVERCROWDED' and suffering from 'INDIGESTION' as a result of greed, there are a long list of institutions who have not even thought about investing in emerging markets. The believers are there to stay but there is still a considerable long process of education to overcome the fear of unknown within institutions and the natural caution of fiduciaries.

Given this, demand should grow steadily rather than dramatically. Although, say, for India it could be very fast coming as it is from a low base. InterSec estimates total foreign investment to be about USD122 billion which would represent 3.5% of total capitalisation or about 13% of the free float with pension funds projected to growth of 8% - 10% from USD217 billion in 1988 to USD1100 billion in year 2000. It would not be unreasonable to estimate foreign demand to grow to USD170 billion or 4% of the estimated emerging markets capitalisation at USD45000 billion.

Before concluding I would come back to a set of nagging issues which the panelists could discuss:

(1) Investing in emerging markets is not a quick fix. One of the primary ingredients for success in this field is PATIENCE. Aggressive foreign investors sometimes

encourage unrealistically high valuations locally ruing local investors to some painful short term experiences.

Current events culminating in the sharp drop/extinguishment of sizeable premium forces us to re-examine whether investors/country fund managers are long term maximisers of growth/return or are as short term in their attitudes as local speculative investors. We can look at the recent experiences of KOREA, TAIWAN, THAILAND AND INDONESIA and to some extent INDIA.

(2) Is the international market passing through a period of indigestion having gobbled too much of a good thing? The rare exception to this general Asian phenomenon being India. Has the policy of launching closed end funds to invest in open markets damaged the concept of country funds.

(3) Lack of innovation and a fee driven attitude in some deals has had its impact too.

(4) One of the problems has also been niche marketing. With newer placements coming up, fund sponsors have been driven to the same institutional market which has become smarter and somewhat choked as a result. There has been little attempt to effectively market the product down at the retail level which new evidence suggests is probably the more stable side of the market. While both UTI India Funds had substantial retail/individual interest, it slowly whittled down.

(5) In one of their recent reports IFC calls attention to an entirely new aspect.
"The success of country funds and the discovery of attractive returns outside their markets in North America, Europe led investors to change the way they judge Fund Managers. The emphasis is now on global performance."

The new conventional wisdom calls for global asset management and the performance of individual portfolio managers is measures against internationally diversified portfolios and not just in terms of local market indices.

(6) Innovations, intense competition and capital needs will require countries to lower their tax and exchange control barriers. By the turn of the century most undiscovered emerging markets would open up permitting capital flows to and fro. Is it, therefore, much easier today to envision and sketch a true global financial market or again is it not?

Like any other market and product the country fund market may be right now sailing through a severe supply demand imbalance with supply outstripping demand.

However, I am optimistic that the 1990s will provide an opportunity for global expansion of emerging markets. The race for discovering will be won by those who are willing to discover ways to meet traditional needs by new concepts and those understanding the need for capital and matching the risk taker with those who are risk averse. Equities and semi-equities are likely to surge in the 1990s. Investors may shy away from individual securities and complicated derivative products or to be more precise opt more for diversification through professional management as complexities grow in the markets. International exposure may assist in elevating fund management standards. On the way, however, investors may see some roof crashes but then they see them happen everywhere in New York, Tokyo, London. If the perception turns really long-term, and long term yield overweighs short term greed, investors would not be disappointed.

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COUNTRY FUND DIVERSIFICATION

Correlation of target marks with U.S. market

CORRELATION WITH TARGET MARKET	Below Average	Above Average
Below Average	ASA Ltd. Chile Fund Korea Fund ROC Taiwan Fund India Growth Fund Taiwan Fund Portugal Fund	Templeton Emerging markets Spain Fund
Above Average	Germany Fund Austria Fund Brazil Fund Italy Fund	Malaysia Fund Clemente Global UK Fund Worldwide Value Helvetia Fund Thai Fund Mexico Fund First Australian

REGIONAL BREAKDOWN

	Highest Diversification	Least Diversification
Australia and Asia:	India Growth Fund ROC Taiwan Fund	Malaysia Fund First Australia Fund
Europe	Austria Fund Italy Fund	UK Fund Helvetia Fund
Central and South America	Brazil Fund	Mexico Fund
Diversified Funds	Templeton EMF Clemente Global	Worldwide Value

FUTURE EMERGING MARKETS

* Asia:	China, Pakistan, Papua, New Guinea, Sri Lanka, Nepal
* Latin America:	Argentine, Chile, Colombia, Venezuela
* Mid East:	Jordan, Morocco, Turkey
* Africa:	Ivory Coast, Kenya, Nigeria, Zimbabwe, South Africa
* Europe:	Hungary, Poland, Czechoslavakia

SELECT EMERGING MARKETS - MOVEMENTS

10 YEAR CORRELATIONS - TO 31 DECEMBER

	USA	JAPAN	BRAZIL	GREECE	INDIA
[illegible]	0.00				
[illegible]	0.02	0.04			
[illegible] E	0.20	0.03	-0.25		
	0.03	-0.01	-0.11	0.04	
[illegible]	0.15	0.09	0.07	0.02	0.01

[illegible] re is very little correlation and indeed negative correlation in some cases suggesting [illegible] nafacie that emerging present efficient divesification opportunities.

SELECT EMERGING MARKETS FIVE YEAR CORRELATIONS

ASIAN EMERGING MARKETS

5 YEAR CORRELATIONS TO 31 DECEMBER

	USA	JAPAN	KOREA	MALAYSIA	PHILIPPINES	THAILAND
USA						
JAPAN	0.07					
KOREA	0.29	0.08				
MALAYSIA	0.51	0.08	-0.01			
PHILIPPINE	0.16	0.01	0.16	0.25		
THAILAND	0.30	0.04	-0.14	0.47	0.05	
TAIWAN	0.07	0.03	-0.21	0.14	-0.20	0.55

EUROPEAN EMERGING MARKETS

	USA	JAPAN	GREECE	PORTUGAL
USA				
JAPAN	0.07			
GREECE	0.26	0.06		
PORTUGAL	0.18	0.10	0.54	
TURKEY	0.33	0.43	0.10	0.35

EMERGING MARKET CAPITALISATION

US $ BILLION AT 31 DECEMBER

	1989	1999	10 Year Growth Rate %
Total	600	4,500	22.5
Free Float (taken as 25%)	150	1,125	
Foreign Demand	20	170	24.0
as a % of total	3.3	3.8	
as % of free float	13.3	15.1	

Source: InterSec Estimates, Genesis Estimates

CORRELATION OF FUNDS' STOCK PRICE AND US STOCK MARKET

1	Clemente Global	70.8
2	Worldwide Value	69.8
3	UK Fund	66.8
4	Malaysia Fund	65.8
5	Helvetia Fund	62.3
6	Templeton EMF	59.4
7	Taiwan Fund	54.7
8	ASA	41.9
9	Thai Fund	41.8
10	Italy Fund	41.1
11	First Australian	38.3
12	Korea Fund	30.0
13	Austria Fund	29.4
14	Mexico	25.7
15	Germany	23.4
16	Portugal	20.2
17	ROC Taiwan	17.3
18	Chile	14.1
19	Brazil	10.5
20	Spain Fund	8.6
21	First Iberian	7.1
22	India	4.1
23	First Philippine	na
24	Turkish Inv	na
25	New Germany	na
26	Growth Fund of Spain	na
27	Future Germanu	na
	Average	36.6

CORRELATION OF FUNDS' NAV AND STOCK PRICE

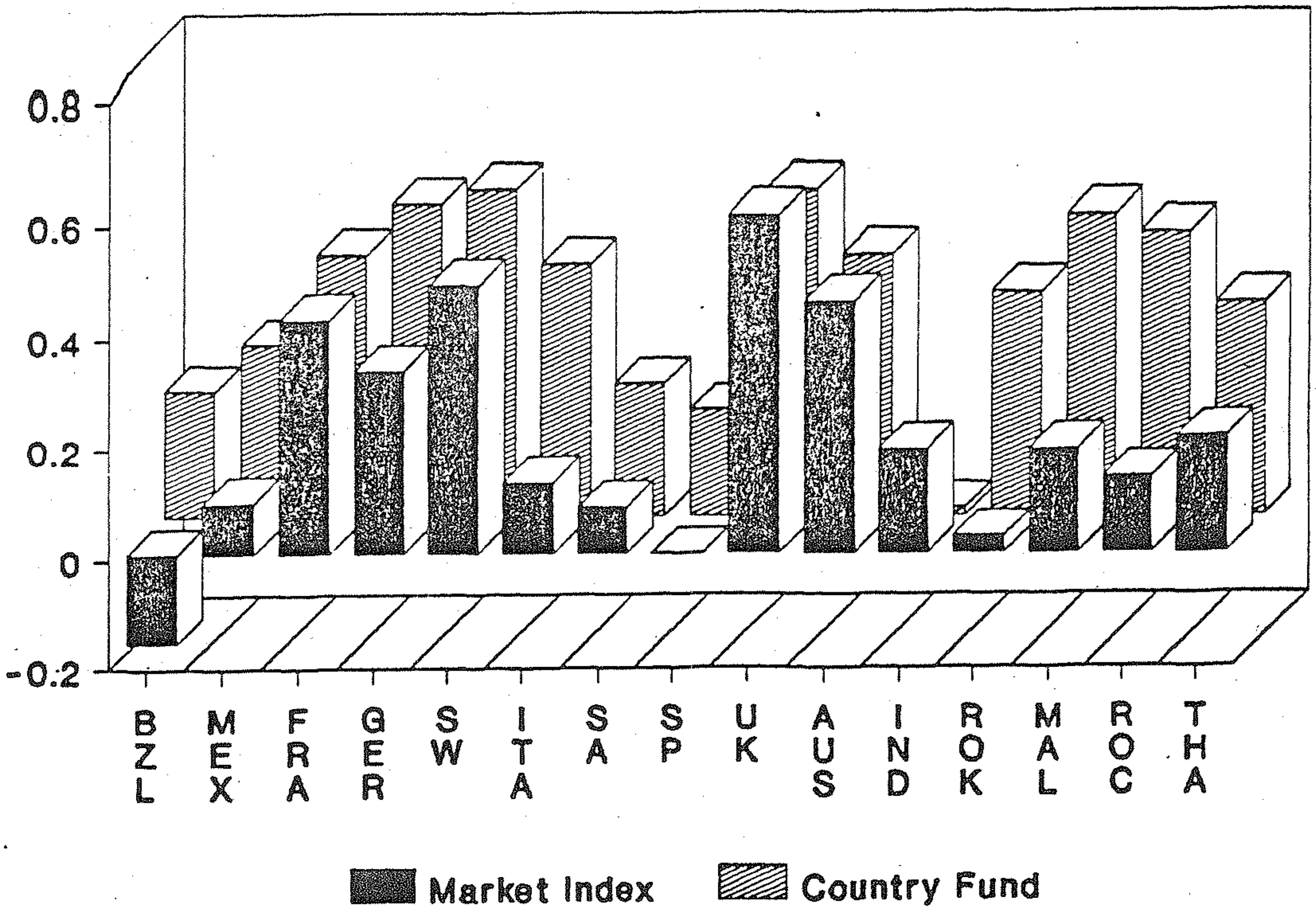
1	Clemente Global	79.9
2	UK Fund	77.2
3	Malaysia Fund	76.0
4	Worldwide Value	75.6
5	Brazil	73.1
6	ASA	70.1
7	Germany	67.0
8	Templeton EMF	66.9
9	Helvetia Fund	62.8
10	First Australian	61.8
11	Mexico	57.9
12	India	51.4
13	Thai Fund	45.9
14	Italy	39.8
15	ROC Taiwan	37.4
16	Portugal	37.0
17	Korea	32.2
18	Chile	28.6
19	First Iberian	28.1
20	Taiwan Fund	28.1
21	Austria Fund	10.6
22	Spain Fund	5.5
23	First Philippine	na
24	Turkish Inv	na
25	New Germany	na
26	Growth Fund of Spain	na
27	Future Germany	na
	Average	50.6

PREMIUM/DISCOUNT TO NAV

26TH OCTOBER 1990

		Net Asset Value	Stock Price	% Diff
1	Emerging Mexico Fund	11.18	10 1/8	- 9.44
2	First Australian	9.24	7 1/4	-21.54
3	First Iberian	9.84	8 1/4	-16.16
4	First Philippine	9.78	7 1/4	-25.87
5	France Growth Fund	11.19	9	-19.57
6	Future Germany Fund	14.88	12 7/8	-13.47
7	Germany Fund	11.58	12 1/8	+ 4.71
8	Growth Fund Spain	10.97	8 1/2	-22.52
9	**India Growth Fund**	**f16.60**	**14**	**-15.66**
10	Indonesia Fund	11.91	10 5/8	-10.79
11	Irish Investment Fund	10.10	7 1/4	-28.22
12	Italy Fund	b14.10	10 7/8	-22.87
13	Jakarta Growth Fund	9.28	7 1/4	-21.88
14	Korea Fund	12.38	15 1/2	+25.20
15	Latin America Inv Fund	13.35	9 5/8	-27.90
16	Malaysia Fund	12.62	11 7/8	- 5.90
17	Mexico Equity Inc Fund	11.53	9 1/2	-17.61
18	Mexico Fund	b15.27	13 3/4	- 9.95
19	New Germany Fund	13.40	11 1/8	-16.98
20	ROC Taiwan	7.93	7 5/8	- 3.85
21	Scudder New Asia	17.08	14	-18.03
22	Scudder New Europe	11.12	9 1/4	-16.82
23	Singapore Fund	b11.16	9	-19.35
24	Spain Fund	12.79	12	- 6.18
25	Taiwan Fund	b16.74	20 3/8	+21.71
26	Templeton EM Mkts	b12.76	13 1/8	+ 2.86
27	Thai Fund	16.12	17 1/2	+ 8.56
28	Turkish Inv Fund	13.67	10	-26.85
29	United Kingdom Fund	11.36	9 1/2	-16.37

Weekly Correlation with New York Index



CAN PRIVATIZATION SUCCEED? ECONOMIC STRUCTURE AND PROGRAMME DESIGN IN EIGHT COMMONWEALTH COUNTRIES[1]

by

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1. Introduction

The last two decades have witnessed a major re-assessment of the role of the state in the economy. An intellectual resurgence of market-oriented political thinking in the industrialised countries, based on convictions about the failure of *dirigiste* macroeconomic policies has created a climate in which a collection of ideas known loosely as "privatization" has emerged. During the 1980s the political philosophy of privatization has filtered rapidly throughout the world. Regimes of varying disposition now embrace these ideas, to the point almost where the perceived superior efficiency of the private sector in the provision of goods and services in an economy has become virtually axiomatic.

Privatization in a broad sense is a label for any expansion of the scope of private sector activity, or the assimilation by the public sector of efficiency-enhancing techniques generally employed by the private sector. In this respect privatization has come to be viewed as a goal in itself rather than as a means to an end. We prefer to consider privatization in the narrower sense of a transfer of ownership and control of assets from the public to the private sector.[3] Importantly, this narrower definition differentiates privatization from (a) the host of state-owned enterprise (SOE) reform policies (such as the introduction of private sector style management and operations systems) and (b) similarly, from macroeconomic policies such as price, import tariff, and foreign exchange liberalization. Both sets of policies expose public enterprises to greater private sector commercial pressures, but they do not fundamentally alter control and ownership structures in the economy.[4]

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[3] A more comprehensive discussion of the link between privatization as an end state and as a policy instrument is contained in Appendix I.

[4] In this paper we focus primarily on the outcome and effectiveness of privatization as a <u>policy</u> and make no judgement as to the desirability (or otherwise) of privatization as an objective (ie an end-state) for development).

Privatization in the industrialised countries has taken its lead from the United Kingdom where, by the end of 1989, proceeds from asset sales totalled US$ 50bn,[5] cumulatively accounting for almost 6.5 percent of GDP.[6] The British lead was rapidly taken up across Western Europe and in Japan. Privatization has however not been confined to the developed economies, but has now assumed as central a policy role in developing countries. Though the focus of the international debate has shifted towards the developing world and non-market economies of the Eastern bloc, its intellectual stimulus still emanates from industrialised countries. Consequently, many of the conditions and assumptions underpinning the privatization debate remain firmly grounded in the specific economic structures of advanced economies. These include: a competitive and efficient private sector; a deep and effective capital market capable transmitting shareholder control over management; regulatory capacity of government to guard against the creation and maintenance of excessive monopoly profits; and a less skewed distribution of wealth, income and asset ownership than that prevailing in developing economies.

Moreover, consideration of the methods of privatization has tended to be dominated by the high profile programmes of the UK, France and Japan, where the most favoured method has been public asset sales through capital markets. This however obscures the importance of other methods of privatization which include direct sales to domestic or foreign companies, employee share ownership schemes, long term asset leases, foreign joint ventures, and management contracts,[7] which, as this paper will illustrate, assume a much greater role in developing countries.

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[5] Excluding the sale of public sector housing. Source: M.R. Bishop and J.A. Kay, "Privatisation in the United Kingdom: Lessons from Experience", World Development, Vol. 17, No. 5, (1989).

[6] The British Government has privatized not only commercial and manufacturing enterprises, but has also led the way in the sale of utilities such as British Gas, British Telecom, the Water Industry, and soon the Electricity Supply Industry.

[7] Liquidation is often included as a method of privatization: we prefer to think of it as a method of reform and state shrinkage rather than privatization in the strict sense.

Thus our evaluation of the privatization experience in eight selected countries[8] is placed within the framework of two fundamental questions: (i) whether the implicit economic and political environment underpinning the case for privatization is applicable to the developing world, and (ii) whether the modes of privatization commonly employed in the DCs are appropriate to developing country conditions and institutional structures.

This paper, attempts to address these questions in the following manner. Section 2 identifies the stated objectives of privatization in a developing country context, and in particular emphasises the extent to which these differ from the commonly accepted objectives of privatization. Section 3 looks at the pattern of privatization to date in the countries studied, while Section 4, which forms the core of the paper, draws directly on the country studies to analyze the way in which the specific economic and political structure of developing countries tends to shape and constrain the privatization initiative. Importantly we find that, in a number of cases, privatization is compromised by structural factors which the policy itself was expected to address. In the light of these factors, Section 5 focuses on the appropriate role for privatization programmes in small, adjusting economies and identifies methods through which the objectives of privatization can be achieved more effectively. Section 6 concludes.

2. Privatization Objectives

In the third world, privatization and public enterprise reform emerged as policy issues amidst the debt crisis and the worsening of fiscal performance faced by many developing countries in the early 1980s. Both measures were rapidly incorporated in the adjustment policy canon, especially in Latin America and Sub-Saharan Africa. For example, as Table 1 shows, the decade to 1989 saw the World Bank involved in 143 lending operations directed towards SOE reform, 52 percent of which included

[8] The countries visited were Jamaica, Kenya, Malawi, Malaysia, Papua New Guinea, Sri Lanka, Trinidad and Tobago, and Zimbabwe.

privatization components. To a significant extent this paralleled the independent creation of review bodies and the development of policy statements on privatization in a large number of countries.[9]

Whereas the objectives of privatization in the developed economies have been dominated by issues of revenue raising, microeconomic efficiency, widening of share ownership ("popular capitalism"), and prevailing political preferences, those of developing countries have been somewhat broader. Six key objectives appear to dominate in the adoption of privatization as an economic policy. These are : (a) public finance improvement, (b) efficiency gains, (c) private sector development, (d) capital market development, (e) income re-distribution, and (f) meeting adjustment conditionalities.

The first and often dominant objective has arisen from the public finance imperative. Privatization has been promoted by governments to reduce net budgetary expenditure on SOEs, in terms of operational subventions, transfers, and external debt guarantees. The 1988 World Development Report notes that for a sample of 25 countries the median SOE contribution to overall public sector deficits was 48 percent, with a sizeable number of countries experiencing SOE deficits greater than the total public sector deficit - implying that the rest of the public sector was in surplus net of transfers.[10] A similar picture emerges on the SOE share of external public debt, which in 1986 accounted for almost 20 percent of the total, much of which was on less concessional terms than debt contracted directly by government. In the face of this significant resource flow to the

[9] For example a number of such bodies and reviews were instituted our sample countries, including the Jamaican Divestment Secretariat; the Kenyan Task Force on Divestiture; the Malawian Commission on Statutory Bodies; the Privatization Masterplan in Malaysia; the Presidential Commission on Privatization in Sri Lanka; the Rampersad Committee(s) in Trinidad and Tobago; and the Justice Smith Commission into Parastatal Performance in Zimbabwe.

[10] See also G. Nair & A. Filippides, "How much do State Owned Enterprises contribute to public sector deficits in developing countries - and why?" World Bank Working Paper Series No. 45 (1988). It may be noted that there are some countries where the SOE sector is in overall surplus. This is particularly so in mineral and oil exporting countries.

parastatal sector, privatization is seen as a way of reducing net recurrent outflows in terms of budgetary transfers and eliminating contingent external debt liabilities. Moreover, with governments under pressure to meet short-term budget deficit targets, privatization proceeds generate valuable capital revenue, easing the pressure for expenditure cuts in other areas, and also reducing the adverse effects deficit financing can have on the domestic investment climate.[11]

The second set of objectives can broadly be described as those of improved efficiency. The key belief underlying these objectives is the assumed superiority of private over public ownership in promoting economic efficiency. Efficiency considerations embrace two main issues: internal or managerial efficiency, and economic efficiency in terms of the allocation of resources through competitive market mechanisms. With reference to internal efficiency, it is argued that incentive structures faced by managers in the public sector are inadequate in enforcing commercial discipline, hence the appearance of various inefficiencies within the SOE, and/or inappropriate, resulting in managers pursuing incorrect objectives, often over sub-optimal time-periods. Furthermore, experience suggests that SOEs by their nature are open to government interference in decision-making such that commercial objectives are replaced by political goals. Such interference has classically taken the following forms: constant intervention in management appointments; determination of wage and employment levels; controls on output pricing; the prescribing of input purchasing; and directions on the timing, location and size of investment decisions. The impact of such interference forms much of the standard litany of complaints about SOE performance, namely the dilution of managerial quality, the institution of "crony" management open to a government's bidding, low levels of labour productivity, inappropriate capital/labour ratios, the inability to generate a profit or often even to cover operating costs, and the poor quality of new investment.

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[11] As discussed in Appendix I, privatisation ceteris paribus does not alter the net revenue flows to government but merely represents a capitalization of future revenue flows.

Combatting these weaknesses, privatization is seen as a useful device for exposing enterprise managements to the discipline of private sector ownership. With this exposure it is argued comes labour and capital productivity gains, technological innovation, the reduction of managerial slack, and the elimination of rent-seeking activities. The transmission mechanism by which these improvements are realised is private shareholder control over management, which, motivated by profit maximization objectives, enforces a greater degree of performance monitoring and discipline on enterprise management than does the state *qua* shareholder. Also, privatization has the effect of curtailing some of the interventions that governments can make in an enterprise by strengthening the barriers between politicians and managers.[12] [13]

With reference to the resource allocation issue, the transfer of an asset into a private, competitive market, it is argued, will, in a static sense, promote economically efficient pricing of goods and services through the elimination of monopoly profits. This argument is clearly less precise than the former, relying as it does more on market structure than on the nature of enterprise ownership. Any enterprise operating in a market in which it wields no significant price-setting, entry-deterring, or predatory power, will be exposed to competitive forces regardless of its ownership structure. Furthermore, in a dynamic sense, competitive market structures and private ownership are expected to engender greater flexibility of the economy to often rapidly changing external economic conditions than has been the case with public ownership.

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[12] Frequent confusion is made in discussion of this point between privatization and liberalization. There are many interventions a government can make which affect the running of the firm after privatization, which include output price controls, penal taxation, interest- and exchange-rate policies etc. It is often assumed that these will be removed during the privatization process, but there is no necessary reason why they have to be. Thus, the removal of government interference as a goal of privatization must restrict itself to the removal of more direct, firm-specific interventions.

[13] It is sometimes the case that technocratic arms of government have used, or intend to use, privatization as a method of removing SOEs from parts of government (especially line ministries) they consider to be more prone to interference.

A third objective for privatization is the use of public sector divestiture to "crowd in" a nascent private sector. Privatization represents a shift of commercial risk and reward away from the state, with the expectation that this will create an appropriate environment for private sector investment and entrepreneurship. Once again, "crowding in" through privatization is intrinsically linked to the broader issues of state-shrinkage, and in particular to financial liberalization policies aimed at promoting higher domestic investment.

Fourth, as an extension of the previous point, privatization is viewed in a number of smaller countries, as a means through which local capital markets may be developed and domestic resource mobilization enhanced. A commonly perceived problem of many of the smaller emerging capital markets is the shortage of tradeable stock, and augmentation of the supply of stock through the sale of Government equity, has been seen as a possible way in which the capital market may be effectively "kick started" into action.[14]

Fifth, is the objective of changing the income distribution to one more acceptable to the government. Though frequently an implicit rather than explicit objective, privatization is seen as a mechanism through which this re-distribution of income and wealth can be achieved.[15]

Finally, privatization may be pursued as an objective in response to external pressures, both official and commercial. Privatization has rapidly been assimilated into the corpus of the policy conditionality of the donor community, such that the apparent implementation of a privatization policy is a necessary condition for the continuation of external aid flows. Similarly, adherence to a privatization programme sends strong

[14] This objective can be identified in the privatization programmes in a number of our sample countries including Jamaica, Malawi, Papua New Guinea and Sri Lanka.

[15] It is worth noting that this implicit objective also motivated thinking on the expansion of the SOE sector in many countries.

signals to foreign investors, and enhances a government's reputation of providing a benign investment climate.

3. The Progress of Divestiture

As has been widely noted in the literature on privatization in LDCs, progress in divestiture has been relatively slow. This is confirmed by the eight country studies, various aspects of whose privatization experience has been summarized in Tables 2 - 9. As far as overall progress is concerned, only 80 enterprises have been privatized through sale or leasing (with a further 18 closures) out of approximately 2,000 SOEs in the eight countries concerned (of which over 1,000 are Malaysian)(Table 2). Activity has tended to be concentrated in the smaller enterprises leaving the larger concerns untouched. In short, privatization has to date only skimmed the surface of state sector holdings.

As a corollary, the proceeds from privatization have not generally been large (the only possible exception to this being Jamaica). Privatization proceeds to date from the eight countries total a mere US$ 503 million, of which US$ 392 million is accounted for by Jamaica and Malaysia (Table 3). As a proportion of GDP, only in Jamaica and Trinidad and Tobago have the accumulated sum of privatization proceeds reached a proportion of GDP greater than 1 percent: it is interesting that in what is seen as a "major privatizer" such as Malaysia, the accumulated sum is still only O.6 percent of GDP.

One reason for this relatively weak outcome is that in a number of cases, privatization programmes are more cosmetic than real in the sense that much is spoken about privatization, and little is done. Clear cases of this phenomenon are in Kenya, Papua New Guinea and Sri Lanka, where despite policy documents and statements on the issue (often made in policy commitments to the major multilateral lenders), the programmes to date remain extremely modest or, in Kenya's case, effectively non-existent. In other countries, such as Jamaica and Trinidad and Tobago, the programmes have had a long genesis before any decisive action has been taken. In Malaysia, the privatization programme has to some extent been overestimated traditionally by ignoring the extent to which "public" share sales (i.e. intended for private agents) have SOEs as major purchasers.

Another common thread running through the experience is the concentration of privatization in certain types of enterprises. The majority of enterprises that have been privatized have been commerce, manufacturing and service enterprises - 51 out of 80 - with the next largest number being from the agricultural sector (though most of these were small estates in Malawi)(Table 5). However, proceeds from commerce, manufacturing and service enterprise sales were less than 30 percent of total proceeds, and less than half of proceeds from sales of transport and communications enterprises (Table 6). Furthermore, average sale value of privatization in this type of enterprise is only US$ 3.1 million. The great majority of privatizations to date have, as noted earlier, been concentrated in the smallest of government enterprises, which are generally located in the industrial sector. The only large enterprises that have been dealt with have tended to be either banks, or telecommunications firms, with a small number of sales in the latter category dominating the figures for total proceeds. (The transport and communications sector accounts for US$ 315 million out of total proceeds of US$ 503 million, with an average sale value of US$ 35.0 million).

The story is similar when it comes to looking at privatizations by method of sale. Somewhat surprisingly, the largest number of sales are accounted for by direct sales to domestic enterprises, after which direct sales to foreign enterprises and public sales through capital markets are roughly equal in number. However, the value of private sales to domestic enterprises is very low; an average sale value of US$ 1.3 million per enterprise, versus an average value of US$ 15.4 million for public sales, and an average US$ 12.3 million for sales to foreign enterprises. Importantly, direct foreign involvement (excluding foreign participation in joint ventures) in the privatization programmes of the eight countries accounts for almost 40 percent of total sales value.

Links between the methods of privatization and the type and size of enterprise being privatized are summarized in Tables 7 - 9. Direct domestic private sector participation has been concentrated exclusively in the smaller end of the commercial manufacturing and service, and agricultural sectors, accounting for 50 percent of all sales in these sectors. Larger sales, and in particular those in the finance and banking, and transport and communication sectors depend exclusively on direct foreign involvement and public share issues. Notable also is the higher average size of joint venture sales as a method of sale in the commercial, manufacturing and services sector, and their presence in the transport and communications sector.

4. Emerging Issues

The country studies highlight a number of major themes emerging from the privatization experience of the eight countries concerned. These tend to recur across all the countries studied, suggesting they are central to an understanding of past privatization performance, and the constraints to future programmes.

4.1 Conflicts in the Objectives of Privatization

As noted earlier in Section 2, most countries have a variety of different objectives for their privatization programmes. However, in a number of important respects, these objectives are often in conflict. Consequently, the outcome of privatizations may be different from those anticipated at the beginning of the programme.

The first, and most basic conflict, occurs because privatization in LDCs often take place in the midst of a fiscal crisis. Thus, an overriding goal of programmes tends to be the reduction of fiscal deficits by the quick sale of enterprises. This, however, clashes in a number of ways with the rationale most often put forward for privatization, namely the enhancement of efficiency. Firstly, often only the most profitable enterprises are sold, since they are the easiest to divest quickly.[16] Secondly, no *ex post* analysis is carried out on the efficiency impact of divestiture. And thirdly, it results in the issue of the post-privatization regulation of private monopolies being ignored until after divestiture has occurred.[17]

A second conflict arises with the issue of asset pricing, where the separate goals of revenue maximization, wider share ownership, and capital market development may be compromised. This point is developed further in Section 4.4.

A third conflict arises from the tension caused by the government straddling two separate roles in the sale process: (a) that of political actor attempting to make a success of the programme in the face of political opposition; and (b) that of social welfare maximizer concerned with achieving optimal benefit for the country. In public share sales this problem manifests itself in the government being simultaneously manager of the sale and provider of information on the uncertain nature of capital markets to the small investor, and needing public oversubscription as a measure of success. The fact that government is often not a neutral actor in the privatization process is clear from the number of ways in which the welfare maximizing position is departed from through such measures as underpriced sales (public and private), excessive pre-privatization "sweeteners", post-privatization preferential concessions to purchasers, a lack of concern with efficiency issues, and an unwillingness to transfer risk. These departures work to vitiate the goals of improved efficiency in the firms concerned, and of raising revenue for the government.

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[16] This phenomenon is observed in all the countries under study.

[17] So far the only utilities sold or being considered for sale are in the telecommunications sector e.g. in Jamaica, Malaysia, Sri Lanka and Trinidad and Tobago.

4.2 Public Finance and Efficiency Effects

A clear conclusion is emerging from these country studies - and, indeed, from work on other countries. Although improvements in public finance and gains in efficiency are espoused as the two most important objectives of privatization, these objectives have at best only been partially fulfilled. Very little attention has been paid to them after privatization has occurred.

The debate about public finance effects is however clouded by a frequent misunderstanding of what these effects actually are. The proceeds from asset sales are frequently treated by governments as net revenue, whereas in strict accounting terms they are simply asset swaps (cash for equity) that leave the net revenue position of government untouched, assuming the cash is invested.[18] In the long-term, the net impact on government revenues depends on the extent to which privatization raises the efficiency of the enterprise, and hence increases tax revenues, against the cost of privatization and the profits (or losses) foregone. In no countries of our study have such (admittedly difficult) calculations been attempted, suggesting that the efficiency gains are strongly expected but never measured.

However, one common facet of the privatization experience in all eight countries suggests that efficiency gains and revenue improvements have not been, or may not be, substantial. This is because the majority of firms that have been privatized are ones which have already been running relatively efficiently, either over a long period of time, or due to pre-privatization clean-ups.[19] This is especially true of share sales to the public, where it is generally assumed that the offer for sale of loss-making SOEs would

[18] For a more detailed discussion of the central issue of the net effect of privatization on the government budget balance, see Appendix II.

[19] This observation arises from the "paradox of privatization", namely that governments wish to sell loss-making enterprises, for which there are no buyers, and hence are forced to sell profitable enterprises only.

not attract private investors,[20] and hence the sale would be a political failure. In these cases, it may well be that the net long-run impact on public finance will be negative. On the other hand, clear examples of post-privatization efficiency gains are more common in other types of privatization (i.e. direct sales to the domestic and/or foreign private sector, and management leasing) such as the textile mills in Sri Lanka, ISCOTT in Trinidad and Tobago and hotel leasing/sales, bus route tenders, and agricultural marketing board sales in Jamaica. In these cases, the net impact on long-run public finance will be positive.

However, looking only at "short-term" public finance effects, namely the <u>immediate</u> revenues from sales and leases, the impact of privatization sales to date has still been small in all countries other than Jamaica. Indeed, in those countries where serious attempts have been made to address the problem of chronic public sector deficits, the immediate public finance position has been improved to a much greater extent by SOE reform measures. For example, in Trinidad and Tobago the set of reform measures introduced in the mid- and late-1980s reduced government transfers to the SOE sector by 10.5 percent of GDP between 1982 and 1988 versus privatization receipts of 2.3 percent of GDP. In Sri Lanka, the reduction of government transfers equalled 6.4 percent of GDP between 1982 and 1988, as against privatization receipts of 0.2 percent of GDP. In Papua New Guinea, the net cash flow from government to SOEs was reduced as a proportion of GDP by 1.0 percent between 1982 and 1987 as against privatization receipts of 0.04 percent to date. These aggregate figures are supported by data from individual companies undergoing pre-privatization "clean-ups" or rapid SOE reform measures, which often show dramatic improvements in their financial positions vis-a-vis government.

[20] In a number of cases - especially Malaysia - companies are required to demonstrate a dividend record before listing is achieved.

Hence, the country studies suggest that: (a) the link between privatization and efficiency is somewhat weaker than generally anticipated, and (b) that privatization has not as yet been a major part of the solution to the budgetary crises that many of them face. In other words, it seems that the two key objectives of privatization have not as yet been achieved.

4.3 Private Sector Absorptive Capacity

In this and the next section we consider how the structure of the domestic private sector determines the form and impact of privatization. Two fundamental issues need to be examined: first, the extent to which the domestic private sector can provide a competitive environment through which the economic efficiency gains expected to flow from privatization, can be realised; second, the extent to which domestic savings can be mobilised to absorb the sale of SOEs.

The domestic private sector in the developing countries studied are characterised by a number of factors. These are: enterprise size, risk aversion, concentrated asset ownership, wealth and income, and domination by a very small number of family or tribal groups. In general, firms are small (in terms of employment and turnover), are owner-managed, with limited access to finance, and have a restricted risk spreading capacity. To a large extent, these characteristics were responsible for stimulating the growth of the SOE sector in the first place: state intervention was justified on the grounds of exploitation of scale economies, absorption of commercial risk and mobilization of venture capital for development. The resulting market structures, in particular of the industrial sector, reflect these factors and have far-reaching implications for the development of an effectively competitive environment.

SOEs frequently dominate industrial sectors. Particularly in the lesser developed economies of Africa, SOEs are on average larger than their private sector competitors, and consequently are well placed to extract or maintain monopoly profit through strategic behaviour.[21] [22] In many cases the capacity to exploit this advantage is further enhanced by the pre-sale "readying" process which endows the enterprise with a favourable capital or asset structure yielding competitive advantage at the taxpayers expense.[23]

Evidence from our country studies indicates that, though not universal, SOE sectoral domination is widespread. Whilst this may be expected for example in the traditionally oligopolistic transport, energy, communications, and possibly finance sectors, it also emerges in traditionally more competitive sectors, such as manufacturing, agriculture, and services. In Sri Lanka for example, most private sector firms are very small, with over 85 percent of all firms in the manufacturing sector employing less than 5 people. Less than 1 percent of firms employ more than 100 people, and within this group are found virtually all SOEs and all foreign owned companies.[24] A comparable picture emerges in Trinidad and Tobago and in Jamaica where research suggests that market dominance is significant in a wide range of sectors, and further that dominant firms in these sectors are frequently state-owned.[25] In Kenya the manufacturing sector is

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[21] In another context, that of the UK, a good example of the importance of market structure over ownership, may be seen with (the recently-privatized) British Airways which, though facing strong competition from other international carriers, is able to exploit its size advantage in the domestic market, against its smaller domestic competitors, British Midland and Air UK.

[22] Common instruments of strategic advantage include predatory pricing sustained by high cash reserves, pre-emptive patenting of technologies, managerial head-hunting, as well as standard market leading strategies.

[23] As noted before, this out-turn is more likely when the mode of sale chosen is a public sale.

[24] USAID private sector study (1987).

[25] N. Crichton & T.W. Farrell, "Market Structure and Concentration in the Manufacturing Sector in Trinidad and Tobago", Social and Economic Studies, Vol. 1 No. 37 (1988) and M.A. Ayub, "Made in Jamaica - The Development of the Manufacturing Sector", World Bank Staff Occasional Paper No. 31 (1981).

similarly concentrated with 50 percent of all firms employing less than five people, and only 10 percent employing over 50 people. Though detailed data does not exist, the same story emerges in other countries, especially the smaller ones such as Malawi and Papua New Guinea. Only in the largest country in the sample, namely Malaysia, is the private sector deep enough to provide a sufficient degree of competition in the industrial sectors.

An important consideration is that whilst the domestic private sector may not provide the competition necessary to these SOEs, it may come from the foreign sector, either through foreign-owned companies operating directly in the domestic economy, or through import penetration. Again, evidence from our country studies reveal a standard picture of relativvely tight control on foreign direct investment in the economy, and high effective protection in most sectors. Policy towards foreign participation has been liberalised recently in a number of countries (for example Jamaica, Kenya, Malaysia, Sri Lanka, and Zimbabwe), but in general foreign participation is welcomed only in the export-oriented sectors, and direct competition with domestic producers is not widespread.[26] Similarly, our evidence points to the use of quantity restrictions and levels of effective protection which suggests a similar conclusion in terms of the impact of foreign import competition. Though most countries have instituted trade and tariff reform policies aimed at the abolition of quantitive restrictions and the reduction of nominal rates, average effective protection rates remain strikingly large.[27]

Consequently, the extent to which the foreign sector can provide an effective spur to competition is questionable. Those SOEs operating in international markets are already

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[26] Although factor market competition, especially in the skilled labour market, is.

[27] World Bank studies variously reports Effective Protection Coefficients (EPCs) for the manufacturing sector in Jamaica of 1.75 [1986], (where 1.00 represents neutral protection), and 1.33 for Zimbabwe [1987]. These figures do, however, mask an extremely wide range of protection. Comparable studies for Sri Lanka and Kenya report EPCs of 2.07 [1987] and 2.12 [1987] respectively.

exposed to competitive forces, whilst the continued protection of domestic sectors limits the impact of foreign competition on all enterprises regardless of ownership structures. Taken together these observations suggest that, in general, the degree of competition afforded by the domestic private sector in a number of developing countries is limited. In terms of the privatization debate this emphasises the central argument that a change in ownership structures without reform of the market into which the privatization occurs will not necessarily generate economic efficiency through competition.[28] As Yarrow notes:

> "...competition and regulation are more important determinants of economic performance than ownership... indeed, preoccupation with the ownership issue is likely to be damaging if it distracts attention from the more fundamental issues"[29]

4.4 Domestic Mobilization and Capital Market Development

We turn next to the issue of the mobilization of domestic resources for the acquisition of SOEs. There are, in principle, two ways in which the domestic private sector can acquire ownership of SOEs, either directly through a privately negotiated sale from Government to a company (or group of companies), or indirectly through equity participation in the form of public share issues.[30] This section will examine the former, while the following section will address the broader issues of equity participation.

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[28] The case of British Telecom is illustrative, where little improvement in efficiency after privatization has been registered except in those sectors where BT is facing direct competition from Mercury Communications Ltd.

[29] G.K. Yarrow, "Privatization in Theory and Practice", Economic Policy, Vol. 1 p364, (1986).

[30] There are a number of hybrid options, in particular management and employee buy-outs which have not featured widely in developing countries. These issues will be discussed in section 5.

To an extent the capacity of the private sector to absorb divested SOEs is determined by the same factors as shape the degree of competition in the market, namely relative firm size, and concentration. It was noted earlier that across our sample, median firm size was low, with markets tending to be highly concentrated, and frequently dominated by state-owned companies. This suggests, ex ante, a limited direct absorptive capacity by the domestic private sector. Such a view seems to be borne out by the evidence from Tables 7 - 9 which show that the average size of direct sales of SOEs to the domestic private sector barely exceed US$ 1 million. Sales of SOEs have been concentrated in the manufacturing, commercial, and services sectors, although a few smaller land sales in the agricultural sector have been carried out. Whilst this may well indicate a choice on the part of governments to commence the privatization programme by selling only the smaller enterprises in these sectors, it seems reasonable to accept that these figures also indicate a limited domestic private sector direct absorption capacity. The existence of a developed capital market provides governments with an alternative method of selling large state assets to the domestic private sector, and this method has been favoured in a number of the countries studied.[31] Moreover, as noted, privatization through public share issues is often viewed as a means of deepening and strengthening the domestic capital market by increasing the supply of tradeable stock.

Functioning capital markets fulfil a number of roles in any economy. Markets facilitate the mobilization of domestic savings; they provide a mechanism for asset valuation and for shareholder control and discipline of management; they allow for risk spreading and mobilization of non-debt capital; and they enhance allocative efficiency by promoting trade in risk and investment instruments. Privatization creates another important role for the capital market as a mechanism for creating a wide share ownership structure through the economy. In addition to generating direct economic gains (e.g. productivity enhancements induced through greater profit-orientation of employees), a broad ownership structure serves to defuse political opposition to privatization and also limits

[31] Jamaica, Malaysia, Sri Lanka, and Trinidad and Tobago.

the opportunity for future nationalization by increasing the political costs of such a move.

The absence of a capital market represent a limiting factor in terms of the scope and, crucially, the scale of asset sales to the domestic economy, which frequently means that foreign participation becomes the only means of raising finance for divestiture. The corollary however, in terms of the role of capital markets (where they exist) in the privatization programme is less clear. Whilst market depth and turnover clearly enhance absorptive capacity (note from Table 10 that Jamaica and Malaysia are the only countries in which sizeable public share issues have occurred), the success or otherwise of public issues in meeting the goals of privatization depend crucially on a host of other factors. Perhaps the most important issues is that of asset pricing. In privatization underpricing of assets is endemic, and only in a very few cases are public share issues sold at market clearing prices.[32] As a rough guide to the extent of this phenomenon it is commonplace to measure underpricing by the immediate premium in secondary trading in the new share issue. For example, the Institute for Strategic and International Studies in Malaysia calculates that the total underpricing of Malaysia's five public issues was 30 percent of the offer price (or approximately US$ 40 million), whilst the National Commercial Bank of Jamaica sale enjoyed a first day premium of 67 percent on the offer price.[33]

The incentives for underpricing are clear. First, it encourages widespread ownership (a point to which we shall return presently). Second, the support of selected groups (those who may otherwise be opposed to the programme, for example employees and management) can be "bought" with the promise of immediate capital gains. And finally, underpricing represents a means to reduce the risk of the issue being under-subscribed,

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[32] Note that at any point the market clearing price reflects not only long run asset valuation, but also current market sentiment and expectations.

[33] See R. Leeds, "Privatization in Jamaica: Two Case Studies", Harvard (1987). See also J. Vickers and G. Yarrow, "Privatization, An Economic Analysis" MIT (1988) on underpricing in UK public share issues.

especially when the perceived political cost of failure is high (for example the cost of a loss of reputation or investor confidence in a government's managerial capacity).[34] In this narrow sense, some of the revenue foregone through underpricing, which represent a public finance loss, can be viewed as the cost of eliminating the risk of failure in the market and maintaining a reputation in the eyes of investors.

A second important area is the impact of the public issue on the question of ownership distribution. With a number of significant exceptions, especially Malaysia where broad-based unit trusts are key players on the market, the concentration of share ownership is very high (see Table 10). A common feature, is that whilst underpricing (especially if it is anticipated) attracts a large number of small shareholders into the primary issue (which is subsequently broad-based), these shareholders quickly leave the market as soon as secondary trade commences where the larger institutions, whose participation in the primary issue is restricted, begin to buy up shares. For example, at the time of the public issue of the Malaysian International Shipping Corporation, there were approximately 60,000 shareholders. Following initial trading this fell rapidly to less than 5,000 shareholders - the bulk of whom were institutions. Similar outcomes were witnessed for all the other large Malaysian public share issues, as well as in Jamaica and Trinidad and Tobago.

Finally, turning to the objective of "kick-starting" the capital market, there is little evidence, possibly with the exception of Jamaica, that privatization plays a central role, not least because governments' risk aversion in terms of underpricing, ensures that the safe placement of assets becomes the primary objective. More importantly, whilst an ample supply of tradeable stock may be a necessary condition for deep and broad capital markets, it is far from being a sufficient one. Other factors seem to play a much greater

[34] This point is clearly seen in Sri Lanka, where the perceived the failure of the United Motors public issue (where almost 65% of the shares remained with the underwriters) has severely undermined investor confidence in public issues.

role in determining the development of capital markets, in particular, the macroeconomic trade and fiscal environment, monetary policy and liquidity constraints, market regulation and enforcement, and obviously prevailing risk profiles within the economy. This, of course, does not deny that privatization processes can induce growth in the supply of good quality stock, and re-intermediation of investment through the equity markets. It suggests instead that the development of capital market involves significantly broader array of reform than merely an increase in equity supply, and that privatization cannot be relied upon in isolation as a solution to weak capital markets.

4.5 Programme Management and Post-Privatization Regulation

Issues of importance in all privatization programmes are the design, sequencing and attention to technical detail of the privatizations undertaken; these issues apply with equal validity to the eight countries under study. It is crucially important for governments to consider seriously the overall framework in which privatization is to occur. Programmes have failed where governments have not ensured that the agency (or agencies) responsible for implementation of the programme has been given sufficient powers in relation to other agencies in the bureaucracy around them. Nor have implementing agencies been adequately staffed to carry out the often time-intensive process of privatization. Privatization has often been attempted without garnering the necessary support from key politicians, and has sometimes been implemented in an insufficiently transparent manner.[35]

As examples, privatization agency structures have not been adequately unified and/or supported in countries such as Kenya and Papua New Guinea, meaning that clear decisions are not taken or, if taken, are unable to be implemented. There has also been

[35] There is a need for transparency in privatization programmes in order to demonstrate that they are being carried out according to legal and fair procedures. This is often important in countries where political opposition to programmes is strong, or where there are fears of privatization being used to promote "crony capitalism".

a tendency to underestimate the resource cost of managing the privatization effort management. The lack of availability of experienced domestic technical expertise has resulted in many countries having to import expensive foreign consultants to help structure, and implement the details of each transaction. Finally, programmes have been undermined by uncertain and vacillating commitment by decision-makers: evidence from Jamaica and Malaysia suggests that strong commitment from those at the top is necessary for programme success.

Governments also have to give consideration to the sequencing of privatization transactions, where the standard approach is to start by privatizing smaller commercial/manufacturing enterprises before moving on to larger monopolists or quasi-monopolists where more complicated transactions are involved. The next year or so will be critical in deciding the sequencing issue as a number of countries are on the verge of major expansions of their programmes.[36] Also, in sequencing privatization, governments must heed the difficulties in attempting to sell state assets during periods of adjustment. Stabilization policies which squeeze access to credit, and which put upward pressure on domestic interest rates, can create an environment which is sub-optimal in terms of undertaking asset sales - particularly asset sales to the domestic private sector.

Finally, governments have underestimated the extent to which the finer details of individual privatization transactions have to be dealt with <u>before</u> asset sales can go ahead. For instance, it is often the case that major changes need to be made to the legal standing of SOEs before privatization can occur, involving delays as complicated

[36] Note that in Malaysia the private sector has expressed concern about its ability to absorb the impending privatization of the electricity and telecommunications utilities, worth roughly US$ 5.7 billion.

legislation is drafted and promulgated.[37] Recapitalization of enterprises is another issue where handling the details of such transactions is found to take much longer than expected. Privatizations require a great number of smaller issues to be addressed, especially relating to the contractual terms and conditions of the post-privatization labour force. In some countries, underestimation of these requirements has led to two specific problems. First countries are frequently involved in adjustment programmes which have time-specific privatization components. Delays in the completion of privatization transactions sometimes result in countries breaking loan conditions.[38] Second important aspects of the programme are decided either during or after the privatization itself. For example, in Sri Lanka the legal framework for transferring pension liabilities from public to private was not promulgated prior to the sale of the first enterprise.

Another more important example relates to post-privatization regulation of monopolies. The need to regulate monopolies and quasi-monopolies in order to protect consumer welfare is well established in economic theory. In practice, however, regulation has up to now been used only in the some of the countries studied.[39] When major utilities have been privatized - namely in telecommunications, which are almost always monopolists in the domestic markets of LDCs - then considerations of allocative efficiency demand that governments put in place arrangements to regulate the firms concerned. In general, though, these crucial aspects have not been dealt with adequately

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[37] In Jamaica, SOEs were given a new legal standing under the Public Enterprises Act, while in Sri Lanka the process of SOE corporatization took five years from the first suggestion of the move to its legislative completion.

[38] On account of this problem, concern has been expressed that World Bank SALs are not appropriate mechanisms for encouraging privatization. See S. Kikeri, "Bank Lending for Divestiture: A Review of Experience", World Bank Working Paper Series No. 338, (1990)

[39] Perhaps reflecting the influence of the U.S., Jamaica and Trinidad and Tobago have both regulated public and private utilities since the 1960s. However, in the other countries, regulatory bodies have been confined mostly to the agricultural sector.

prior to privatization. For example, in Malaysia, the regulation of telecommunications and electricity has lagged behind the commercialization process. Insufficient time has been spent proposing an appropriate regulatory framework, with the most likely result being the wholesale importation of the British model of regulation (e.g. RPI-X). In Trinidad and Tobago, the sale of TELCO to a foreign firm was undertaken before a new, revised regulatory authority was established.

It is worth noting that even when governments do pay attention to the issue of regulation, they still have to be careful to avoid some of the problems that have emerged from the Caribbean experience of regulation. In brief, these are: the problem of regulatory capture, whereby a powerful and well-organised monopoly biases the decisions of a weaker authority in its own favour; the difficulty of obtaining the required information from the regulated firm; the problem of (optimal) regulatory lag; the problem of "after-the fact" regulation; and the adequate specification of pricing rules.[40] It is clear that more ambitious privatization programmes will have to deal with these issues in a far more systematic way than has been the case up to now if post-privatization efficiency gains are to be ensured.

4.6 The Political Constraints to Privatization

Among the key determinants of the design and outcome of privatization programmes in developing countries are the delicate political, ethnic, and national considerations which either explicitly or implicitly tend to underlie government actions. These affect privatization programmes and outcomes in at least four ways.

[40] These points warrant particular attention in the case of a multinational, multi-product monopolist, where the regulator's punishment strategy may only marginally affect the monopolist's actions, and where the acquisition of accurate cost data is made more problematic by the possibility of transfer pricing.

First, in most countries there are domestic ethnic considerations which make income and wealth distribution issues extremely sensitive. Privatization is thus heavily influenced by the objective of promoting the economic welfare of underprivileged ethnic groups. As a result privatization programmes are often significantly hampered[41] or the entire design of the privatization programme has to be built around the issue.[42] When this constraint predominates, there is an attraction to selling enterprises through public share issues, since quotas can be imposed on various groups' purchases, as opposed to domestic sales to the private sector, where the less well-off are unlikely to benefit directly.

Second, in most developing countries, there is an unwillingness to sell major national assets to non-nationals. This sensitivity is frequently the result of a colonial/imperial experience. Indeed localization was frequently one of the main reasons for the original nationalization programmes, especially in Africa and the Caribbean. Given the sizes of the foreign and domestic private sectors relative to the size of the larger SOEs (see Tables 2 - 4), it is clear that this will act as a major brake on privatization in the countries concerned.[43] In part, this is due to the perception that privatization without foreign participation will simply allow the reconcentration of asset ownership in the hands of a small wealthy domestic elite. Again, nationalization was often justified by governments as a method of improving highly-skewed wealth distributions.

Third, there is often opposition to asset sale programmes from domestic labour, especially in enterprises slated for privatization. The result of these pressures is that

[41] Examples here are Kenya, Sri Lanka, and Zimbabwe.

[42] Exemplifying this is Malaysia, where concern over the issue of Bumiputera vs. Chinese income and wealth distribution has influenced the design of the entire privatization programme.

[43] A classic example of this is the commitment by the government of Trinidad and Tobago to retain the large oil and gas-based industries in public ownership. Given the size and technical nature of these firms, sale could only be to the foreign private sector.

measures to gain employee support have become an important feature of developing country privatization programmes. They range from extremely restrictive post-privatization employment guarantees negotiated between governments and buyers, to the use of preferential and generous Employee Share Ownership Programmes in public sales.

Finally, there are frequently problems caused by anti-privatization coalitions in the political and technocratic elites which either have developed entrenched interests in parastatal enterprises or have an ideological anti-privatization bias. In extreme cases, this can result in the sabotaging of privatization programmes to engineer failure.[44] In most countries, the pressure to assuage such groups can be a cause of privatization "sweeteners" being granted. The most common example of this occurs when the need to ensure the support of the management of an enterprise being privatized for the sale results in the granting of post-privatization concessions (for example, protected markets, preferential import tariffs and foreign exchange allocations), or the abandonment of intended liberalization measures.[45]

Thus, a consideration of these issues suggests that the incorporation of non-economic objectives is an important part of the privatization experience. Because of this the particular design of privatization programmes in each individual country is likely to be of some significance in explaining success or failure.

5. The Implications for Privatization in Developing Countries

The predominant thrust of the foregoing review of emerging issues is that privatization in developing countries has progressed relatively slowly. It has involved a surprisingly slight shift of ownership from public to private and has not yet, in itself, yielded

[44] Critics of the Malaysian and Sri Lankan privatization programmes have identified this as a feature of the programmes to date and a potential problem for the future.

[45] Note that this point, and the deleterious impact of such measures on potential efficiency gains, is a theme in the literature on U.K. privatizations.

significant efficiency improvements - despite an undoubted commitment to the policies in the countries involved. We argue that this disparity reflects fundamental structural constraints limiting the scope and impact of privatization in developing countries, but also believe that this has been exacerbated by specific design weaknesses in privatization programmes. However, we argue strongly that there are a number of ways in which, with appropriate design, privatization can play a beneficial, if somewhat limited, role in the adjustment process.

5.1 Structural Constraints

As noted in Section 4, developing countries are characterised by narrowly-based private sectors and a concomitantly narrow savings/investment base. Protection is high, SOEs dominate many sectors, and the extent of effective competition is questionable. This combination of factors severely militates against fulfilment of a number of the objectives of privatization. Revenue enhancement and expenditure-reduction goals have been shown to be more successful when tackled directly through SOE reform; the development of capital markets has been seen to require policy measures much broader and more gradual than simply increasing equity supply; and efficiency gains are frequently retarded without direct reform of the macroeconomic and industrial climate. Without exchange rate and domestic price liberalization, and without diversified industrial promotion, privatization per se will be largely cosmetic.

Finally, private sector development (as well as privatization), can only thrive in a conducive monetary and fiscal environment. Erratic monetary control and short-term interest rate crowding-out, non-neutral taxation, parallel markets' distortions, all represent major policy environment constraints. Against this background, many of the objectives of privatization will be compromised. It is incorrect to infer from this however that privatization cannot be an effective policy instrument in such an environment, but rather that it highlights the crucial importance of designing a policy which is consistent with these structural constraints, and which is implemented in tandem with broader adjustment measures (including direct SOE restructuring).

It is important to note that the lifting of these constraints represents a goal of the development process in general, rather than merely an impediment to the privatization process in particular. In the worldwide experience, it is no accident that countries which have run successful privatization programmes (e.g. Chile, Mexico) have been those where the structural constraints highlighted above were less binding. In our sample, countries which have had at least moderately successful programmes viz Jamaica and Malaysia, are on most measures far more "developed" than those which have not run programmes at all viz Kenya and Zimbabwe. While mindful of the points we make below concerning the importance of programme design, this suggests that privatization as a widespread programme may be appropriate only with the attainment of a certain level of development.

5.2 Programme Design Weaknesses

Programme design must clearly be consistent with the structures and constraints faced by the economy: the direct import of approaches and methods developed in industrialised countries with different economic structures must be approached with caution. There are a number of issues that arise from our country studies.

First, our evidence suggests that the lead time required - both in terms of preparation of enterprises for sale and, importantly, in terms of the legal and institutional framework for privatization -is much longer than initially anticipated. The country studies covered by this research reveal a series of programmes which are only now beginning to come to fruition, some eight to ten years after the programme had been launched. Furthermore, attempts to cut corners and accelerate programmes too rapidly can create serious implementation problems and compromises. This strongly suggests that privatization cannot be regarded as a short run policy palliative. It is especially not a solution to short– or even medium-term public finance imbalances.

Secondly, clarity, transparency, and dissemination of policy are of paramount importance in programme design. Objectives must be clearly defined and prioritized; methods of sale considered; preferred and proscribed sectors and purchasers must be enumerated; sequencing must be decided; and the programme as a whole linked into the broader adjustment programme. Failure to do so leads to implementation problems, delays, and frequently the programme is compromised by confusion and uncertainty. A clear example of this is the eventual publication of the "Privatization Guidelines" in Malaysia, which followed a period during which the objectives and methods of the policy were unclear, and the charge of "cronyism" was levelled against the government. The "Guidelines", which are available to the private sector, represent a clear and concise statement of the policy, its scope and proposed method of implementation, and its objectives.

Third, regardless of initial ambition, the scope of privatization initiatives must be realistically tailored to the capacity of the economy to provide a competitive environment and /or the government to effectively regulate private sector monopoly power. This must be concluded in tandem with policy on foreign participation in the economy. It is perhaps worth stressing that though market structures in many countries preclude effective divestiture of all but the smallest competitive enterprises, governments direct considerable resources to the policy, and often at the expense of other methods of SOE reform. Preliminary evidence in this respect points to divestiture yielding greatest returns in the more competitive sectors of the domestic economy (i.e. smaller-scale manufacturing and services), and also in those sectors exposed to international competition (for example, international telecommunications and airways). Though often identified as possible targets for divestiture (principally in view of their weak financial performance), there has been virtually no progress in areas such as heavy industry, capital-intensive agriculture, or domestic natural monopolies.

Fourth, and in spite of the previous point, there is the question of interference. It was noted above that one of the perceived objectives of privatization is that it creates a barrier to public sector interference in firm-level decision making. Thus, even if market structures are not competitive (or indeed, even if regulatory capacity is expected to be weak), privatization may still be justified on the grounds that it limits the scope of public sector interference.[46]

Finally there is the key issue of adapting the methods of enterprise sale to the structural constraints in the economy - not least the relative absorptive capacity of the foreign and domestic private sectors. Attention seems to have been relatively narrowly focused on public share issues (where capital markets exist) and on direct sales. Even for public share issues, greater use of methods other than fixed-price single tranche offers can be employed to minimize underpricing and improve sequencing without jeopardising the success of the sale. In particular attention should be given to the use of multiple tranching of equity sales, and the use of public tendering of some tranches.[47] This is particularly important in the pricing of equity where no market currently exists, where small initial tranches can be used to create a market into which future equity can be sold.

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[46] It may be worth mentioning however that the degree of interference varies across countries, and, more importantly, across policy regimes in the same country without ownership changes. In Papua New Guinea, for example, SOE financial performance has been radically altered following a 1983 Cabinet directive creating a hands-off relationship between Government and the SOEs, based only on clear financial criteria (e.g. dividend targets, rates of return etc). This directive has contributed to the performance turn-around referred to in Section 4.2 above.

[47] These methods have been employed in Trinidad and Tobago in the sale of Trinidad Cement Limited, and the on-going sale of Government equity in the National Commercial Bank. See also J. Vickers and G. Yarrow "Privatization: An Economic Analysis" MIT (1988) on methods of public share issue in the UK.

As noted, larger direct sales have tended to be focused on the foreign sector and consequently encountered problems of ownership and distribution. In planning for divestiture thought may be given to other methods of privatization such as joint ventures and, importantly, management and employee buy-outs. This method has been used with some degree of success in the U.K..[48] Though employee participation has generally been afforded a role in public share issues, few attempts have been made to develop this method amongst the countries studied.

Similarly, greater attention may be given to other types of SOE reform - in particular private provision of public services. Though this area of reform is prey to similar problems in terms of market structures and regulatory weaknesses, there is a mounting body of evidence[49] which suggests that contracting-out is a financially viable and resource-efficient way of limiting the size of the SOE sector.

Consideration of the above points, and especially the design of a programme with reference to the structural features of an economy, can make an important difference to a privatization effort. This is borne out by the example of Jamaica. The Jamaican economy is characterised by: only a medium-size domestic private sector; a relatively small capital market; and a hostile macro-economic environment. Yet the government has been able to carry out a programme substantially larger than any other country in our sample. After an initial five-year lag during which the focus was on reforming the largest SOEs and changing the legal status of the SOE sector, the programme has been characterised by well-thought out and mostly successful public sales (especially in terms of attracting smaller investors), a substantial number of smaller direct sales to the domestic private sector, and selected use of management contracts with and direct sales

[48] In 1982, National Freight road hauliers was sold to a consortium of current and former managers and employees for roughly US$ 70 million.

[49] See G. Roth, "The Private Provision of Public Services", Oxford: Oxford University Press (1987).

to the foreign sector. Attention was paid to the mechanics of the programme, and strong support was given by political leaders. We suggest that the Jamaican experience may provide a useful template for other countries in their design of privatization programmes.

6. Conclusions

From these preliminary findings three main conclusions emerge. First, in view of the binding nature of the structural constraints facing privatization efforts in many developing countries, the primacy of privatization as a policy in itself ought to be reassessed and the high expectations associated with it reduced, both on the part of governments and the donor community. This does not reflect a view that privatization cannot generate gains in efficiency, flexibility and resource allocation, but rather that currently-prevailing structural weaknesses in the economy militate against these gains being realised at present.

Second, and consequently, efforts should be directed in the short run towards more direct SOE reform, and in particular the adoption of commercial methods of operation, performance monitoring and accountability within the public sector. In the long run attention needs to be paid directly to the alleviation of the structural constraints in the economy which act not only to limit the effectiveness of privatization efforts but which, more importantly, act as a brake on the process of development as a whole.

However, in the context of this reduced role for privatization, attention needs to be paid to the careful design of programmes, and in particular the development of the necessary competitive and regulatory frameworks required for a greater shift to market-based economic management. Thus while privatization can proceed at present, we feel that as a widespread panacea for developing economies the policy is somewhat premature. Without the appropriate economic environment, the danger is that privatization may not achieve its objectives and may be condemned to failure without being given a fair trial.

Appendix I: Defining Privatization

I.i Privatization as a Goal

Privatization is commonly used as a general label for (i) any expansion of the scope of private sector activity in an economy , and (ii) the adoption by the public sector of efficiency enhancing techniques commonly employed by the private sector.

I.ii Privatization as an Instrument

We define privatization rather narrowly as the transfer of asset ownership and control[50] from the public sector to the private sector. Privatization, as we define it, relates directly to the concepts of state shrinkage and SOE reform.

State shrinkage may be defined as any activity which reduces the involvement of the state in economic activity (hence its synonymity with privatization as a goal). Whilst state shrinkage embraces privatization as a subset, its scope is wider, including in addition such activities as asset/service closure, contracting-out of government services (both services provided by the government to the private sector, for example waste disposal, and also services provided by government to itself, for example printing services), and build-operate-transfer (BOT) methods of asset accumulation.

SOE reform also intersects with privatization (all privatizations involve reform of SOE ownership and management structures), and with state shrinkage. Some SOE reform involves state shrinkage, for example BOT projects or contracting out, but there is also a large class of SOE reforms, mainly the adoption of best private sector practices, which entail neither privatization nor state shrinkage. Examples of this are adoption of "private sector-style" management information systems (which have a neutral impact on privatization or state shrinkage)[51], balance sheet restructuring, and debt equity

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[50] Or as Vickers and Yarrow put it, the entitlements to the residual profits from operating an enterprise. See J. Vickers and G. Yarrow, "Privatization: An Economic Analysis", The MIT Press, (1988).

[51] Although if the introduction of such techniques improve the financial performance of the SOE sector and reduce its net drain on the central government budget, then this is in a sense state shrinkage. If this argument is taken, then all SOE reforms in pursuit of financial and economic efficiency are cases of state shrinking. This is a case of state shrinking in the sense of scale rather than scope.

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SYMPOSIUM ON CAPITAL MARKET DEVELOPMENT
AND PRIVATISATION

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Can Privatisation Succeed? Economic Structure and Programme Design in Eight Commonwealth Countries

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conversions (whose direct impact may in fact lead to an expansion of state activity as narrowly defined).

I.iii An Alternative Definition of Privatization

In the U.S., where the issue of asset sales is of limited applicability, privatization is generally taken to mean a change in the provision of a service from public sector supply to private sector supply irrespective of the nature of the funding of the service.

There are a number of issues specific to the developing country case which complicate this broader definition, in particular, the role of BOTs and, perhaps, more importantly, the role of external agents in the supply process. A common theme in adjustment at present is the greater involvement of external donors in the supply of technical assistance - principally in terms of management - in the overall supply of public goods. A standard example is in the road construction sector where direct construction by a public works department is replaced by a donor-funded, and partially donor-managed, programme involving private sector (often foreign) contractors. Whilst this would clearly be considered a privatization by the second definition in the sense that the source of supply has changed, it is unclear whether this would normally be regarded as such elsewhere. Similarly, the use of religious, charitable, foreign or domestic NGOs in the provision of, for example, health services again is covered by the second definition, but is not encompassed by the common usage of privatization in the developing country context.

Finally there is the complex issue of the BOTs, which represent a contracting out of the provision of a service (in particular the process of fixed capital formation) with the intention of the asset reverting to the public sector following a pay-back period during which the private sector operator earns the revenue from the asset. In a sense this is a variant of the contracting out of public works in which the remuneration system for the contractor is altered from a risk-free lump sum payment to a risk bearing payment scheme spread out over time.

Appendix II: The Public Finance Effects of Privatization

The confusion surrounding the short- and long-run effects of privatization emanates from a tendency to view the public finance impact of privatization on a cash-flow rather than a net-worth basis. Whilst the immediate effect of an asset sale (which we presume for the moment is of a profitable enterprise) is indeed a reduction in the overall budget deficit, this must be offset against higher deficits in the future caused by the loss of the future earnings stream from the asset sold. However if government were to invest the proceeds in income-earning assets, and if it is further assumed that asset markets are efficient, then the net proceeds earned from investing the proceeds from the asset sale in, say, bonds will generate a profit stream of equal net present value. The private sector thus reduces its holdings of money (or other financial assets) and acquires equity in privatized enterprises, whilst the government reduces its equity and increases its holding of money. To emphasise the point consider the case where the private sector sells bonds to purchase privatization equity, whilst the government use the sale proceeds to retire outstanding bond liabilities. Since in either case the transaction involves a change only in the composition of the sectors' net wealth, and not its level, the fiscal impact must be neutral. Note also that all the arguments follow when a loss-making public enterprise is sold, except here government pays a price to the private sector equal to the present discounted sum of future losses.[52]

Whilst this neutrality result underlines the importance of considering the public finance impact of privatization in a long term perspective, it also serves to isolate the ways in which positive public finance effects emerge from privatization. The most important non-neutrality, and the one which in effect drives the whole privatization debate, is the efficiency gains brought about by the transfer of ownership from public to private sector. Increased profitablitiy yields a higher future revenue flow to the Government, which combined with the indirect effects of increasing the marginal efficiency of investment in the economy (thereby leading to further second-round effects), have a positive effect on public finance.

There are other ways in which the sale of assets can be non-neutral: differing tax regimes between public and private sectors; liquidity and capital market constraints, such that assets are not easily substitutable and yield differentials between assets may persist; differing risk profiles of public and private sector investment portfolios. Though these market inefficiencies will generate deviations from the basic neutrality result which may be significant and persist over time, they do not fundamentally alter the basic result that the principal determinant of the public finance effect of privatization is the impact that the shift from public to private ownership will have on increasing the efficiency, and therefore the tax yield of the firm.

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52. The initial cash payment can be thought of in terms of "sweeteners" - subsidies, debt write offs etc, rather than a cash payment.

TABLE 1 - World Bank Lending For SOE Reform and Privatization

Number of loans by type of loan and by region

	SALs	SECALs	TALs	PELs	PETALs	TOTAL	Privatization Component.	Value[4] (US$m)
Africa	30	17	21	9	2	79	45 [1][2]	1,687
Latin America	14	4	10	5	-	33	18 [3]	1,965
Asia & Pacific	5	3	-	1	-	9	7	870
Middle East & N.Africa	6	11	3	2	-	22	4	830
TOTAL	55	35	34	17	2	143	74	5,352

Source: A.Galal: "Public Enterprise Reform. A Challenge for the World Bank." World Bank WPS 407(1990)

Notes:
1. Includes $85m (2 SALs) to Malawi
2. Includes 26 SALs.
3. Includes $191.4m (3 SALs, 1 PEL, 1 TAL) to Jamaica
4. Total value of lending with privatization component

Abbreviations:
SAL Structural Adjustment Loan
SECAL Sector Adjustment Loan
TAL Technical Assistance Loan
PEL Public Enterprise Loan
PETAL Public Enterprise Technical Assistance Loan

TABLE 2 - [illegible] Privatizations by Country and by Method of Sale

	[illegible]	Public Sale	Private Sale			MS & Lease		Closure
			Domestic	Foreign	Joint	Domestic	Foreign	
Jamaica [1]	30	3	15	4	4	3	1	4
Kenya [2]	0	0	0	0	0	0	0	1
Malawi [3]	17	0	10	7	0	0	0	1
Malaysia [4]	21	5	10	0	2	4	0	5
Papua New Guinea	1	0	0	1	0	0	0	0
Sri Lanka [5]	6	4	0	2	0	0	0	0
Trinidad and Tobago	5	2	0	2	0	0	1	7
Zimbabwe	0	0	0	0	0	0	0	0
TOTAL	80	14	35	16	6	7	2	18

Notes:

1. Details on some smaller privatizations sales are missing. Sales of hotels have been treated individually - the earlier leasing of those same hotels is not included. Land sales are noted both as private sales and leases to the domestic sector.
2. One privatization in the agricultural processing sector was later repurchased by government.
3. Not including the MDC/ADMARC/Press Holdings share swap of 1984.
4. Not including build-operate-transfer projects or divestiture of trust companies to PNB or other trust agencies.
5. The sale of United Motors Ltd. was part-public and part-private to the foreign sector. It has been treated as two sales to show this.

TABLE 3 - Privatization Proceeds by Country and by Method of Sale [1]

(US$ Million [2])

	Total	Public Sale	Private Sale Domestic	Private Sale Foreign	Private Sale Joint
Jamaica [3]	203.5	73.3	22.9	97.6	9.8
Kenya	0.0	0.0	0.0	0.0	0.0
Malawi [4]	7.9	0.0	2.8	5.1	0.0
Malaysia [5]	188.5	133.0	21.5	0.0	33.9
Papua New Guinea [6]	1.0	0.0	0.0	1.0	0.0
Sri Lanka [7]	10.7	3.0	0.0	7.7	0.0
Trinidad and Tobago [8]	91.7	6.8	0.0	84.9	0.0
Zimbabwe	0.0	0.0	0.0	0.0	0.0
TOTAL	503.2	216.1	47.2	196.2	43.7
No. of Privatizations [1]	71	14	35	16	6
AVERAGE VALUE	7.1	15.4	1.3	12.3	7.3

Notes:
1. Not including management contracts or leases.
2. Converted at the exchange rate applicable at the date of sale.
3. The values of some of the small sales (inc. land sales) listed in Table 1 are missing.
4. See note 3 to Table 2.
5. Not including the UPSAK sale of 8 small enterprises. These had a combined capital of US$ 25.7 million and total accumulated losses of US$ 22.6 million in FY 1987/88.
6. Estimated value of sale.
7. See note 5 to Table 2.
8. Not including the proceeds from the Development Finance Co. sale (unknown).

TABLE 4 - Privatization Proceeds by Country and by Method of Sale [1]

(% of GDP [2])

	Total	Public Sale	Private Sale: Domestic	Private Sale: Foreign	Private Sale: Joint
Jamaica [3]	6.93	2.57	0.84	3.22	0.31
Kenya	0.00	0.00	0.00	0.00	0.00
Malawi [4]	0.61	0.00	0.24	0.37	0.00
Malaysia [5]	0.60	0.42	0.08	0.00	0.11
Papua New Guinea [6]	0.04	0.00	0.00	0.04	0.00
Sri Lanka [7]	0.15	0.04	0.00	0.11	0.00
Trinidad and Tobago [8]	2.27	0.17	0.00	2.10	0.00
Zimbabwe	0.00	0.00	0.00	0.00	0.00
AVERAGE [9]	1.77	0.53	0.19	0.97	0.07

Notes:
1. Not including the value of management contracts or leases.
2. The figures represent the total of privatization proceeds to date as a sum of the proportions of those proceeds to GDP in the respective years of sale.
3. The values of some of the small sales (inc. land sales) listed in Table 1 are missing.
4. See note 3 to Table 2.
5. See note 5 to Table 3.
6. Estimated value of sale.
7. See note 5 to Table 2.
8. See note 8 to Table 3.
9. Not including Kenya or Zimbabwe.

TABLE 5 - Number of Privatizations by Country and by Function of Enterprise [1]

	Total	Commerce, Manufacturing & Services	Finance & Banking	Transport & Communications	Water & Energy	Regulatory & Marketing	Agri-cultural
Jamaica [2]	30	21	1	4	0	0	4
Kenya	0	0	0	0	0	0	0
Malawi [3]	17	10	0	0	0	0	7
Malaysia [4]	21	12	1	4	0	0	4
Papua New Guinea	1	0	0	1	0	0	0
Sri Lanka [5]	6	6	0	0	0	0	0
Trinidad and Tobago	5	2	2	1	0	0	0
Zimbabwe	0	0	0	0	0	0	0
TOTAL	80	51	4	10	0	0	15

Notes:
1. Excluding closures, including management contracts and leases.
2. See note 1 to Table 2.
3. See note 3 to Table 2.
4. See note 4 to Table 2.
5. See note 5 to Table 2.

TABLE 6 - Privatization Proceeds by Country and by Function of Enterprise

(USD Million [2])

	Total	Commerce, Manufacturing & Services	Finance & Banking	Transport & Communications	Water & Energy	Regulatory & Marketing	Agri-cultural
Jamaica [3]	203.5	71.2	16.5	115.6	0.0	0.0	0.1
Kenya	0.0	0.0	0.0	0.0	0.0	0.0	0.0
Malawi [4]	7.9	4.9	0.0	0.0	0.0	0.0	3.0
Malaysia [5]	188.5	49.2	6.3	113.4	0.0	0.0	19.6
Papua New Guinea [6]	1.0	0.0	0.0	1.0	0.0	0.0	0.0
Sri Lanka	10.7	10.7	0.0	0.0	0.0	0.0	0.0
Trinidad and Tobago [7]	91.7	6.2	0.6	84.9	0.0	0.0	0.0
Zimbabwe	0.0	0.0	0.0	0.0	0.0	0.0	0.0
TOTAL	503.2	142.2	23.4	315.0	0.0	0.0	22.7
No. of Privatizations [1]	71	46	4	9	0	0	12
AVERAGE VALUE	7.1	3.1	5.8	35.0	0.0	0.0	1.9

Notes:
1. Excluding management contracts, leases and closures.
2. Converted at the exchange rate applicable at the date of sale.
3. See note 1 to Table 2 and note 3 to Table 3.
4. See note 3 to Table 2.
5. See note 4 to Table 2 and note 5 to Table 3.
6. Estimated value of sale.
7. See note 8 to Table 3.

TABLE 7 - Number of Privatizations by Method and by Function of Enterprise

	Public Sale	Private Sale			MS & Lease		TOTAL
		Domestic	Foreign	Joint	Domestic	Foreign	
Commerce, Manufacturing & Services	8	24	10	4	4	1	51
Finance & Banking	3		1				4
Transport & Communications	3		4	2	1		10
Water & Energy							0
Regulatory & Marketing							0
Agricultural		11	1		2	1	15
TOTAL	14	35	16	6	7	2	80

TABLE 8 - Value of Privatizations by Method and by Function of Enterprise

(US$ Million)

	Public Sale	Private Sale Domestic	Private Sale Foreign	Private Sale Joint	TOTAL
Commerce, Manufacturing & Services	92.9	27.5	12.0	9.8	142.2
Finance & Banking	23.4				23.4
Transport & Communications	99.8		181.3	33.9	315.0
Water & Energy					0.0
Regulatory & Marketing					0.0
Agricultural		19.8	2.9		22.7
TOTAL	216.1	47.2	196.2	43.7	503.2

Notes:
This table excludes the value of management contracts and leases, the UPSAK sales in Malaysia, some smaller privatizations in Jamaica, and Trinidad and Tobago's sale of DFC.

TABLE 9 - Average Value of Privatizations by Method and by Function of Enterprise

(US$ Million)

	Public Sale	Private Sale			TOTAL
		Domestic	Foreign	Joint	
Commerce, Manufacturing & Services	11.6	1.1	1.2	2.4	3.1
Finance & Banking	7.8				5.8
Transport & Communications	33.3		45.3	17.0	35.0
Water & Energy					
Regulatory & Marketing					
Agricultural		1.8	2.9		1.9
TOTAL	15.4	1.3	12.3	7.3	7.1

Notes:
This table excludes the value of management contracts and leases, the UPSAK sales in Malaysia, some smaller privatizations in Jamaica, and Trinidad and Tobago's sale of DFC.

Table 10 - Comparative Capital Market Performance in 1988 (US$ million)

Country	Total Capitalization	Capitalization as a % of GDP	Annual Turnover	Number of Listed Companies	Number of New Issues [1]	Value of New Issues	New Issues as a % of Capitalization	Concentration Ratio [2]
Jamaica	784.1	23.91%	24.9	40 [3]	2 [4]	26.0	0.00%	63.0%
Kenya	517.2	6.30%	22.5	56	1	8.5	1.63%	-
Malaysia	36,349.2	108.82%	2,581.5	295	NA	626.1	1.72%	-
Sri Lanka	475.1	7.98%	11.9	176	10	6.3 [5]	1.33%	80.5%
rinidad and Tobago	267.3	6.60%	29.8	33	0	0.0	0.00%	78.0%
Zimbabwe	774.1	15.03%	133.9	54	2	6.4	0.83%	-

Sources:
Jamaican Stock Exchange Yearbook; Ngenye Kariuki and Co. Stockbrokers, Nairobi;
vesting in the Stock Exchange in Malaysia (KLSE); Colombo Stock Exchange Annual Report 1988;
nidad and Tobago Stock Exchange Annual Report 1989; Zimbabwe Stock Exchange Annual Report 1989.

Notes:
1. Includes Rights Issues
2. Turnover of top 25% of firms by turnover as percentage of total turnover
3. Ordinary stock only (excludes preference share and corporate bond stock)
4. Includes Telecomms of Jamaica stock issue (US$20.3m)
5. Par value of offers. In a number of cases issues were undersubscribed.

Table 11 - Public Share Issues

Country	Company	Sector	Gross Proceeds (US$ m)
Jamaica	National Commercial Bank	Finance	16.54
	Caribbean Cement Company	Manufacturing	36.45
	Telecommunications of Jamaica	Telecommunications	20.28
Malaysia	Malaysian Airline Services	Transport	25.37
	Malaysian International Shipping Corporation	Transport	54.10
	Sports Toto	Services	44.85
	Tradewinds	Finance	6.30
	Saravak Cement	Manufacturing	2.41
Sri Lanka	Sri Lanka Rubber Corporation	Manufacturing	0.00
	Lanka Milk	Manufacturing	0.01
	United Motors	Services	2.99
Trinidad and Tobago	National Commercial Bank	Finance	0.55
	Trinidad Cement Limited	Manufacturing	6.32

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SYMPOSIUM ON CAPITAL MARKET
DEVELOPMENT AND PRIVATISATION

14-16 NOVEMBER, BOMBAY

Issues in Privatization and Capital Market Development

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1. INTRODUCTION

"The stock market is a cornerstone in [our] privatization programme, and this public share issue holds a special place in this for three reasons. First, as a flagship listing anticipated both at home and abroad. Second, the flotation should help to pump new life into the market's narrow provincial image. And third, it will give diversity and a measure of maturity to the market, since there aren't many stocks than can count among international portfolios, but this one happens to be one of them."

[Financial Times 20/9/90]

That sustainable industrialization and modernisation in "free-market" developing economies depends quite significantly on the timely evolution of broad and deep capital markets is accepted as axiomatic. Recently, it has become fashionable to assert that free-market models of economic development are demonstrably superior to the alternatives. One result of this shift has been the redrawing of the boundary between the public and private sector in developing countries, partially through privatization. This movement has been reinforced (and perhaps overly influenced in some cases) by examples of enthusiastic large-scale privatization in developed economies such as the UK, France, Japan, Australia and New Zealand. The transmission of privatization experience and the political preferences which have spurred that process in these industrial economies has occurred through the provision of bilateral and multilateral aid. While such a trend may, in several developing economies, be helpful, it is not without attendant dangers.

That these two priorities ie. capital market development on the one hand, and privatization on the other, have become fused in the minds of policy makers is understandable.[2] But such mutual dependence is not absolute; nor should it be exaggerated. There can be little argument that privatization, especially if it is to occur

[2] Indeed two important features of structural adjustment in developing countries - particularly in the way it is promulgated by the Bretton Woods institutions - involve the liberalization of financial markets (implying progressive capital market development) and a reduced role for the public sector (ie. more privatization).

on a large scale, can be facilitated or impeded by the presence of properly functioning capital markets. But, privatization can, and often does, occur both: (a) in the absence of adequate formal capital markets; and/or (b) without the intermediation of capital markets even where such markets exist and function well.[3] The sale of public assets to private parties, domestic or foreign, does not require transactions to be intermediated through a formal market. Similarly, capital markets can be (and in many countries have been) developed in quite a healthy fashion without privatization programmes. Equally, privatization can offer much-needed, if not in some instances unique, opportunities for capital market development. However, we will argue that they can, if mishandled, weaken the capacity of nascent capital markets to intermediate and manage the risks resulting from public-to-private asset transfers. Hence, careful planning and design of policy and implementation is therefore necessary if programmes of privatization and capital market development are to have mutually reinforcing effects.

Accelerating the pace of capital market evolution in developing countries has assumed particular significance in the last two decades as the gap between the rapid and continuing development of sophisticated capital markets in the industrial world, and relatively immature markets in the developing world, has widened as financial integration has proceeded in the capital markets of the industrial world. Developing countries, other than the NICs, are becoming marginalized in the global competition for scarce capital. Similar reasons apply in arguing for the urgency of capital market development in a domestic context. At present the mobilization of domestic savings in developing countries, and of financial savings in particular, is a relatively inefficient process. It is characterised by limited institutional (and technological) capability for intermediating between the risk-reward, portfolio diversification and liquidity preferences of savers and the capital needs of investing units, by weak instrumentation (for the division, valuation, exchange and transfer of current and forward risk), and by ineffective regulation.

[3] In fact our evidence would suggest that in terms of number and scale of enterprises sold, non-market sales predominate, even when capital markets exist and are quite well developed.

Fostering the emergence of competitive capital markets of sufficient breadth and depth, is therefore coming to be seen as a key step in overcoming these weaknesses in domestic as well as foreign resource mobilization and allocation. In theory, properly functioning capital markets are essential in increasing the capacity of investors and of financial intermediaries to "unbundle" and package risk in different ways and to increase the tradability and liquidity of financial claims. They are seen as more efficient than any alternative in determining, at any given time, the financial value of assets based on their intrinsic values, replacement values and discounted future streams of earnings which might be derived from them. Also, though capital markets permit the separation of asset ownership and asset management, they are also supposed to exercise appropriate discipline over asset managers and protect the interests of asset owners through responsive price signals and specialized professional analysis. Efficient capital markets are also supposed to contribute to improved information in risk evaluation for guiding the decisions of savers, by requiring more complete and transparent public disclosure requirements. In turn the latter creates confidence in financial securities and on the reputation of issuers, intermediaries, and the government concerned. Finally, efficient and sophisticated capital markets whose operations are neither restricted by fiat or overwhelmed by government intervention become a key indicator of macroeconomic policy.

Unfortunately, despite sustained efforts at capital market development by various developing country governments with the assistance of various international agencies, the results to date have been mixed at best. Only a handful of developing countries currently have reasonably well developed equity markets which have a sufficient number of security listings and a reasonable volume of trading to generate investor confidence. Virtually none have mature bond markets in government or corporate long-term or medium-term debt, and even in countries with active stock exchanges there are too few brokerage and trading intermediaries to render these markets genuinely competitive. The quality of these markets in terms of absorptive and underwriting capacity, market-making capacity, research and analysis and in settlement processing is woeful by international standards as is the patchy quality of market regulation and disclosure requirement for listed companies. Few of the advanced developing country capital markets are endowed with the same business support infrastructure which in even the smaller developed country capital markets are taken for granted.

Concurrently the disposal of public assets and encouragement of indigenous private entrepreneurial capability through privatization have become an important priority. Privatization is seen as a means of reversing the many negative influences arising from poor SOE performance and of reviving growth in private savings and investment for development. It is also seen as having greater potential for better resource allocation and asset management. It is seen as an important tool in development policy and structural reform, aimed at achieving multiple objectives which include: improvements in public finance; efficiency gains in resource allocation and asset use; promotion and development of an indigenous private sector capability; development of the capital market; wealth and income redistribution; and meeting external adjustment conditionalities.[4] Experience with privatization in a selected group of countries suggests that these objectives fall far short of being met. Just as there is a yawning gap between the theoretical benefits to be derived from efficient capital markets and the meagre gains that have been captured so far by a few developing countries, so there is likely to be a gap between the intended objectives of privatization and its actual accomplishments in the intermediate term.

By drawing on some survey evidence, this paper addresses two key sets of questions. First, can public asset sales through capital markets help to enhance the management of privatization programmes? And second, can privatization help to overcome some of the endemic structural and operating weaknesses in developing country capital markets and provide opportunities for market intermediaries to improve their capabilities and services? Sections 2 and 3 briefly introduce the capital markets considered in this paper and deal with the first of these questions. However, we believe the more interesting questions concern the set of dynamic issues concerning

[4] These objectives are discussed more fully in Adam, C.S & W.P.Cavendish, "Can Privatization Succeed? Economic Structure and Programme Design in Eight Commonwealth Countries", a paper of the FIT Centre, Queen Elizabeth House, University of Oxford presented at this conference.

the impact and potential of privatization in capital market development: we exami this set of issues in more detail in section 4. Section 5 offers some overall conclusi which may apply to other countries as well.

2. CHARACTERISTICS OF CAPITAL MARKETS IN COUNTRIES STUDIE

Our study of privatization in eight Commonwealth countries included six count with existing capital markets (namely Jamaica, Kenya, Malaysia, Sri Lanka, Trini and Tobago, and Zimbabwe). With the exception of the two African countries, have used the capital market in their privatization programmes, although to vary degrees. Tables 1 to 7 describe these markets in detail.[5]

With the exception of Malaysia, where market capitalization since 1980 consistently represented over 50% of GDP, the capital markets in these countries small. Market capitalization generally has been at the same level as other coun with weak capital markets, and has been below that of other emerging markets, capitalization generally less than 20% of GNP (table 2). Turnover has been simil modest: aside from Malaysia (where turnover has been on average 8% of GNP), i generally been less than 2% of GNP (table 4). Moreover, the depth of trade on t markets (including Malaysia) is very low, especially in comparison with ma markets, and, more appropriately, with the NIC markets (table 5, where market d is measured by market turnover as a percentage of market capitalization).

The record of these markets in the 1980s is mixed. In some cases markets deepened during the 1980s, and especially in the latter half of the decade. Th Jamaica, Malaysia and Sri Lanka, capitalization has generally risen as a perce of GNP, turnover rates have mostly increased (notwithstanding the effect of the stock market crash in more developed markets), and a greater number of stock traded now compared to a decade ago (for which see table 6). The most dra example of an expanding market has been the Jamaican Stock Exchange,

[5] All data from IFC Emerging Stock Markets Factbook and our own studies.

market capitalization has risen from 2.0% of GNP in 1980 to 25.0% of GDP in 1988. However, in other cases, notably Trinidad and Tobago and Zimbabwe, the reverse has occurred: capitalization has fallen as a percentage on GNP, and the number of firms listed has been reduced. It is worth noting, though, that in real terms only the Jamaican Stock Exchange has grown: the other five have remained virtually constant or declined (see table 7 and figure 1).

Finally, in a number of markets, especially the more dynamic ones of Malaysia and Jamaica, there have been significant developments in the introduction of new instruments, players and techniques. In Malaysia for example, a Second Board was instituted in 1989, traders now deal using a real-time computer-based OTC system, and new markets have been established in corporate bonds, commodity futures, and mortgage bonds, as well as equities and Government paper. While not nearly as dramatic, there have been some similar developments in the other markets in our studies, especially concerning the drafting of new securities legislation. Also, it is generally the case that governments in the countries studied have paid more attention during the 1980s to the issue of capital market development, largely in response to the increasing role of the private sector in development.

3. CAPITAL MARKET CONSTRAINTS ON PRIVATIZATION

At the most basic level, the absence of a capital market constrains the government in its choice of privatization method to direct sales. However, the existence of only a weak capital market will also push the government in the same direction, since there will be a limit to the size of sales that can be absorbed by a small capital market both in a static and dynamic sense. Clearly, there are positive reasons why the government may choose to divest through direct sales. They are speedier, more covert, identify a buyer directly, sometimes allow a higher sale price, and allow the satisfaction of other objectives. However, "forced" divestiture through direct sales caused by the nonexistence or presence of thin capital markets imposes potentially significant costs to the government. These can be broadly classified as problems of

resource mobilization, policy transparency, and post-privatization performance monitoring.

Resource Mobilization

There are a number of separate issues involved here. First, the issue of search costs. The essence of the capital market is to provide the mechanism through which the aggregate demand of a large number of small buyers can be channelled into the supply of entitlements to a small number of large assets. In the absence of such a market, sellers (ie. the government in the case of privatization) incur extensive search costs in identifying individual buyers with sufficient resources and capacity to acquire the assets. Second, in cases where the distribution of wealth is highly skewed, sale of assets to such agents can have adverse economic welfare implications, arising from concentration of asset ownership. The adverse effects on ownership concentration can, without appropriate regulation, lead to situations where dominant agents/firms act to limit the economic effects of privatization in terms of pricing and production. A number of countries which do not have developed capital markets have frequently found that the scope of privatization is limited by the inability to mobilize domestic resources from a sufficiently wide base to avoid an increase in ownership concentration. In other words, the absence of a capital market not only creates difficulties in the sale of large assets (usually those whose sale will have the greatest economic impact), but when other types of sales occur, they can lead to the exacerbation of monopoly power in the domestic private sector.

Third, capital markets can assist in eliminating one of the major barriers to capital accumulation through equity ownership, by reducing the minimum size of investment in financial/corporate assets for any individual agent. To the extent to which privatization programmes claim the broadening of economic participation through asset ownership as one of their main objectives, the absence of a capital market constitutes a significant barrier. This feature of capital market privatization sales is of particular importance in cases where income and asset distribution assume a strong political dimension. For example, in Kenya, Malaysia, Trinidad and Tobago,

and Zimbabwe, one of the most significant barriers to the expansion of privatization programmes is concern over concentration of asset ownership in the hands of powerful ethnic groups.

Fourth, an extension of this issue is where foreign savings represents an alternative source of demand for privatized enterprises. Here again the politics of divestiture to the foreign sector are frequently difficult, and there are numerous cases where Governments have found that foreign investors have represented the only source of capital sufficiently large for privatization. Governments have mainly viewed the advantages of foreign participation in the domestic economy in terms of technical and management expertise. Foreign ownership is still perceived as a disadvantage. When capital markets do not exist, it can be difficult to acquire these management services except at the cost of the sale of the majority of assets.[6] Where they do exist, then by tapping into a broader domestic capital base and, significantly, by offering a market through which foreign investors' equity stakes can be liquidated, foreign participation in the privatization programme is possible.

Fifth, capital markets permit governments to deal with the "lumpiness" of asset sales, especially through the use of multiple tranches in the divestiture of the same enterprise. This has the benefits of reducing the demand on domestic resources by any single tranche, (thereby avoiding dramatic relative price changes and subsequent crowding-out), allowing the smoothing of government revenues, and establishes more accurate pricing of assets, thereby avoiding revenue losses through underpricing.[7]

[6] Both political and economic ie. profit and dividends foregone to the economy.

[7] When underpricing results from uncertainty rather than from political preferences.

Policy Transparency

There is a second set of important issues in which the existence and use of the capital market can affect the management of a privatization programme. In general,[8] public share issues on established markets impose the conditions of clarity, transparency, and consistency on the vendor. For example, public share issues require independent statements of valuation of the firm to be sold, full dissemination of information, a declaration of actual and contingent liabilities, clear statements of corporate policy, and future disclosure obligations. The government is also impelled to specify clearly its intended future policy towards the firm. Such conditions are not characteristic of direct sales.[9] This is not to argue that there is no role for private market sales, but to suggest that the establishment of a reputation as an "honest broker" by government in privatization can be enhanced through public share sales. A privatization programme based solely on private direct sales can be consistent with being an "honest broker": however, it is less easy for the Government to specifically create a reputation using this approach.

Performance Monitoring

A third role of the capital market relates to the way in which it can facilitate capturing and retaining the intended efficiency gains of privatization, or indeed even ensure that these gains are in fact achieved. Capital markets not only assist the achievement of appropriate levels of balance sheet gearing, by providing the

[8] Although this is not necessarily the case, since it is possible to sell assets in poorly regulated markets. Repeated use of such markets is, however, less easy, especially if foreign participation is required.

[9] Across developed and developing country cases there are numerous cases where the apparent reporting and disclosure conditions are significantly weaker for non-market sales. In Kenya none of the sales have been through the capital market, and all have been shrouded in mystery; in Malaysia the initial first-come-first-serve contracts and Build-Operate-Transfer Schemes have been attacked for their tendency to "cronyism"; in Sri Lanka, there are the cases of the sales of the government-owned tile factories and textile mills; while in the UK, the British Aerospace acquisition of Rover, and the attempt to sell Powergen to the Hanson Corporation, illustrate this point.

enterprise with access to future equity capital.[10] They also provide a market-based mechanism whereby the initial efficiency gains expected from privatization can be locked in. Share-trading in a company provides a direct valuation of the net worth of the enterprise, and facilitates the monitoring of management and the elimination of operational inefficiency; especially where management reward is linked directly to enterprise performance as reflected by share values. Hence, capital markets can provide appropriate incentive and monitoring environments for continued efficiency improvements after sale.

In the absence of capital markets or, more commonly, in the presence of capital markets which do not actively carry out these functions (especially markets where the threat of take-over is weak and where the share price can be manipulated by large players), the costs of performance monitoring and the creation of appropriate incentive structures will be higher and more are likely to be borne by government. Furthermore, the enterprise itself may well find the cost of capital borrowing/restructuring is increased due to constrained access to credit.

4. THE IMPACT OF PRIVATIZATION ON CAPITAL MARKET DEVELOPMENT

The principal function of a capital market in any economy is to intermediate and allocate commercial risk. This capacity will develop over time depending upon the nature of asset flows through the market. However a privatization programme which is based significantly on a programme of asset sales through the capital market will in general affect the nature of the risk intermediated by the market, and also the capacity with which the market manages this intermediation.

It is clear that most of the effects of privatization on the development of nascent capital markets are not unique to privatization per se. However, the nature of

[10] There is also the argument that access to non-debt capital, by limiting the leverage of the enterprise, improves the terms on which the enterprise can contract debt. In most cases listing on a capital market acts as a signalling mechanism to the banking sector and thereby enhances the company's access to credit.

privatization programmes inevitably add a particular dimension to the discussion.[11] **First, in general privatization issues are relatively large in relation to other equity issues and to the market. Second, the assets sold through privatization may have** characteristics different from those prevailing in the market. For example, they may be concentrated in certain sectors (eg. transport and communications), be of a similar capital vintage, and/or be of larger than average size. Third, privatization issues have a higher profile than non-privatization issues and tend to involve a greater number of players, many of whom are new to equity trading. Fourth, privatization programmes are often used as a way of stimulating other market developments, such as the launch of new instruments, and the development of industry regulation. And fifth, privatization programmes are viewed by vendor and purchasers as dynamic processes, and consequently the success or failure of the programme has important reputation and policy credibility implications for the government. These features suggest that the impact of privatization on capital markets is likely to be mixed, and that the dynamic impact of privatization on capital market development needs close attention.

It is widely believed that an increase in equity supply through the sale of privatization shares will "kick start" a capital market. We wish to suggest that this paradigm is unduly narrow and ignores some of the more important dynamic linkages. Privatization, we suggest, will impact on the capital market in four main ways:

i) it will increase the volume of equity listed on the market;
ii) it will alter the number and type of players on the market;
iii) it will impose significant demands on the technological, regulatory, and operational capacity of the market;
iv) it will constitute a significant (if short- or medium-term) intervention by the government in the capital market.

[11] It is also the case that when privatization is accomplished through direct sales, such divestiture creates pressures for the future tradability and liquidity of private claims.

4.1. Privatization and the supply of equity on the market.

Capital market privatizations clearly increase the volume of equity listed, and as such may be expected to have positive effects on the functioning of the market. First a greater supply of equity may means improved opportunities for portfolio composition and risk-spreading opportunities, a higher volume of trade (since there are now more relative prices in the market), more accurate asset pricing and valuation, a broader sectoral spread of assets, and generally improved information flows within the market and elsewhere through the economy.

Second, an increase in the supply of equity will enhance the liquidity of the equity market relative to other markets, and may lead to improved asset composition across the financial system as a whole. Specifically, greater equity market liquidity can provide an avenue for both public and private sector contractual savings institutions to reduce their exposure to long term government paper (for which there is frequently no secondary market).[12]

Third, increased equity market depth and liquidity may be expected to induce a switch from real and informal asset holdings into financial assets. In the absence of developed equity markets and generally low real interest rates, a large proportion of private sector savings are often held in non-financial forms. The financialization of savings can lead to greater efficiency in resource mobilization and allocation.[13] For example, perceived equity market weaknesses in Sri Lanka and also in Africa have contributed to a relatively high level of informal sector savings.

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[12] Discussions on capital market development in Malaysia, Kenya, and Papua New Guinea, have focused on this specific point.

[13] See "Domestic Resource Mobilization for Diversification in Africa" ed M.Nissanke, FIT Centre, Queen Elizabeth House, University of Oxford (forthcoming).

These three arguments have featured strongly in the privatization debate in a number of countries in our study,[14] and though it is too premature to draw definite conclusions, some evidence does exist to suggest that these phenomena will occur. In our study the most dramatic developments have been witnessed in Jamaica where over the five years from 1985, when the capitalization of privatized firms rose from 4% to 26% of total market capitalization, indicators of market competition - in particular capitalization and turnover concentration ratios - suggest that the new privatization issues have significantly influenced the market structure.[15]

Notwithstanding the above points, a number of problems arise, the most important of which concerns the risk profile of the market. In a first-best situation, an increase in the supply of equity through privatization may be expected to improve the risk profile of the market, and at worst would leave it unchanged. In reality however, most small markets are likely to be skewed in terms of their risk profile,[16] and given the tendency for privatization issues to be large in relation to the average size of the listed companies, in many cases privatization will have significant effects on the risk profile as well as the structure of the market. Table 7 shows the scale of privatization issues in relation to various measures of market absorptive capacity. Even in the deepest of the markets covered in our study, new privatization issues account for a significant proportion of new equity investment. Again in Jamaica, for example, such was the size of privatization programme, that by 1988 privatization stocks accounted for 37% percent of market capitalization, and 26% of value of turnover, while 4 of the 10 largest listed companies were privatized.[17] A similar, if less dramatic, picture is beginning to emerge in Malaysia as the government proceeds to list three of the

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[14] These view have been expressed, inter alia, by the Capital Markets Development Authority in Kenya, the Sri Lankan Securities Council, and by representatives of the central banks of Malaysia, Papua New Guinea, and Malawi.

[15] In particular, from 1985 to 1989, the four-firm concentration ratio by capitalization fell from 55% to 43%, while the corresponding concentration ratio by volume fell from 60% to 43%.

[16] For example in Sri Lanka, of the top five companies, which accounted for 53% of total turnover in 1988, three were in the financial sector, and the other two were in the services sector.

[17] Including the largest company on the Jamaica Stock Exchange in 1988, Telecommunications of Jamaica.

largest utilities in the country, while in other countries are similarly susceptible to this form of market dominance.

It is not inevitable that this type of equity injection should be distortionary, but there are certain characteristics which give grounds for concern. The first and most important is the sectoral concentration of privatization issues. If privatization issues are concentrated in the same sector this can enhance the degree of risk covariance within the market. The case of Malaysia is illustrative. To date 92% of the value of privatization share issues through the Kuala Lumpur Stock Exchange (KLSE) have been in the transport and communications sector. Since the value of these issues so far has been so small in relation to the size of the market, there is no particular problem of risk distortion. However, the forthcoming sales of the telecommunications and electricity companies would mean that privatized enterprises in the transport and communications sector could account for up to 15% of total market capitalization. It is plausible to assume that these enterprises follow a similar path over the business cycle; this event alone will have a non-trivial effect on the risk structure of the KLSE. To a degree, in view of the size of the KLSE, the Malaysian experience is likely to be mild in comparison to many thinner markets, where single privatization issues could account for much higher percentages of market capitalization.

The second way in which increased equity supply has wider implications is through the potential crowding-out of other forms of saving. While there may be unambiguous wealth effects from privatization, (in which the realizable value of an asset in the private sector is greater than when it is in the public sector), an increase in the supply of equity will also induce portfolio adjustment within the equity market itself and across other markets. This may have crowding-out implications for both the equity market and the bond and money markets. Concern about equity market crowding-out is present in Malaysia, where prior to the listing of the first tranche of equity in the state telecommunications company (which was anticipated to raise the equivalent of almost 100% of the previous year's total new issues on the KLSE), the central bank imposed a moratorium on rights issues by existing listed companies.

Anecdotal evidence also abounds from other markets of investors and issuers holding off on new issues in anticipation of privatization issues.

Crowding-out of other markets can also occur. In theory, privatization is essentially an asset swap between the government and the private sector: consequently full crowding-out in other asset markets may be anticipated. This outcome assumes an efficient capital market, and in reality the effects of increased equity supply are likely to be less direct, and may even have benign effects on other markets. In particular, as noted above, greater activity in the equity market will draw funds away from the market for government securities, the effect of which will be to induce greater competition in the market for government paper, with attendant benefits in encouraging greater market determination of interest rates. However, less welcome may be the extent to which short-term speculation in privatization stocks crowds-out money and financial markets.[18]

The implications of the above are twofold. The first is that though privatization can be a quick way of increasing the volume of stock in the market, there are clear indications that the risk profile of privatization issues may not be optimal for a fragile developing market. It is therefore important that, if privatization programmes are to foster capital market development, then the volume and sequencing of equity issues must be examined to ensure that the overall risk profile of the market remains balanced and not overly exposed to trade or other exogenous shocks. Second, it is likely that there will be some degree of crowding-out of savings elsewhere in the financial sector. In particular attention must be given to the extent to which the privatization programme constrains the raising of funds through the equity market by the private sector, and also the extent to which the programme may impinge on the other financing requirements of government.

[18] A noted case of this phenomenon occurred with the share issues by the three largest commercial banks in Kenya, all of whom issues new equity on the Nairobi Stock Exchange from 1986 to 1989. In each case shares were generously priced and the issues over-subscribed. Monetary statistics show clear drops in balances held on deposit with the banking sector in the months that these issues were made.

concept of wider share ownership is at the core of virtually every privatization gramme. While this probably has more to do with the politics than the economics rivatization, there are a number of important economic channels through which roader base of players will influence the development of the capital market. In eral, whilst there is evidence concerning the acquisition of shares in privatization es by new shareholders, the more relevant issues in terms of general equity rket development are the extent to which privatization alters the behaviour of sting players; what type (rather than how many) new players attracted by the ie; and the way in which the privatization issues shape new investor perceptions ut future privatization and other share issues.

e positive effects of more players in the market are relatively straightforward. As th the effect of an increase in the supply of equity on the market, an increase in the mber of players may be expected to reduce the degree of concentration and rease the degree of competition within the market. In addition there exists the w that broader equity participation in the economy will foster a market-oriented ic in the economy at large which will have positive macroeconomic benefits in eas as diverse as wage bargaining, investment policy, and internal economic ficiency.[19]

ese ideas are impossible to quantify, and, as we shall suggest below, it is far from ear that privatization is the most efficient way to foster this ethic. More germane the issue of capital market development, is the extent to which privatization may e expected to influence the performance of the important existing players on the arket.

[19] In Jamaica, for example, there is anecdotal evidence of much greater interest on the part of chief nancial officers and accountants in the relative performance of their companies' share performance nd its performance relative to competitors.

In most capital markets the key players tend to be the long term savings and pension institutions. In a number of programmes (Malaysia, Papua New Guinea, Kenya, and Sri Lanka) a key element in the privatization and capital market debate has concerned the need to promote greater equity participation by these institutions. The commonly-held view is that faced with very thin secondary markets in government paper, and negligible markets in corporate bonds, these players have tended to adopt extremely risk averse investment policies focused on long term government paper, the bulk of which is held to maturity. The deepening of the capital market through privatization stocks, combined (often) with revision of policy objectives and investment guidelines of these institutions to take greater equity participation is seen as one of the most important externalities of the privatization and capital market debate. The extreme risk aversion of the long term contractual saving institutions (and their propensity to hoard stock) has long been identified as one of the major constrains to the development of the capital market in many, especially African, developing countries. Consequently, the stimulus that privatization issues seem to be giving to these institutions may have far reaching effects for the financial system as a whole.

Another key group of new players, and the one which has attracted much attention amongst the donor community, are foreign investors. The attraction of foreign participation in privatization programmes has been alluded to earlier, but there are other discernable externalities arising from the inflow of foreign investors into the equity market. First is the belief that foreign investors are more dynamic than domestic investors and will induce closer monitoring and control than may otherwise occur. Second, is that greater orientation towards foreign participation results in attention being directed towards revision of securities legislation, and in particular foreign investment conditions, both of which could be expected to induce greater direct foreign inflows into non-privatization assets.

Foreign entry into the domestic equity market does however have costs, the most immediate of which in the privatization case concerns underpricing (addressed in greater detail in Section 4.4). Underpricing of public assets to the domestic private sector essentially represents a transfer from taxpayers to holders of privatization shares without affecting overall social welfare. In an open economy context however it involves an absolute welfare loss to the economy as a whole, as part of the benefit of the underpricing is captured by foreign parties. This problem, (which, incidentally, is an oft-raised criticism of the management of the UK privatization programme, especially following the large acquisition of BP by the Kuwait Investment Office) is not inevitable, and it is interesting to note that the Malaysian Government have attempted to address this issue through a two-tier pricing scheme for shares in the state telecommunications company, in which foreign investors wishing to partake in the primary issue must pay approximately twice the price for shares as Malaysians.

A final group of players who are frequently targeted in privatization issues are the employees of the enterprise being sold. In a general sense the arguments for specific targeting of employees for equity participation are based on ideas of increased productivity and other profit related incentives. Experience suggests, however, that such incentive schemes are relatively inefficient, and it seems more plausible that employee participation in privatization issues is driven by other factors.

Many Employee Share Ownership Programmes (ESOPs) exist outside the equity market, although frequently there are intra-firm markets. Wider tradability of equity by employee-shareholders clearly makes the equity more attractive, and, it may be the case that if equity market sales are the chosen method of sale, then some form of ESOP is required. The main function of an ESOP in privatizations seems to be to transfer wealth to employees, principally to reward loyalty or to avert their opposition, especially in cases where retrenchment is expected. If underpricing is endemic, then ESOPs, which give employees secure access in the allocation system, will guarantee against employees "missing out" on any windfall profits made as a result of undervaluing the net worth of their past and future labours. In some cases this process can become very sophisticated.[20] Whether such schemes have a sustained impact depends on the nature of employees qua shareholders rather than as employees. Consequently the issues to which we now turn concerning the behaviour of individual shareholders as a whole, apply equally to players brought into the market through ESOPs.

The most obvious, and possibly least important set of drawbacks from a large increase in equity in the market, is the impact on players who, for whatever reason, find themselves in captive underwriting positions. For example, a number of Jamaican private sector underwriters were obliged by Government to subscribe for 50% of privatization issues in order to destroy the incentive for these underwriters, as investors to see the issue fail. More generally, in a number of countries, major public sector institutions are expected to fulfil investment as well as underwriting functions for new, large, privatization issues. The undoubted conflict of interests generated affects not only the role of these players in the market, but also feeds back on the design of the privatization programme itself in cases where such players are major public enterprises (as in the case of PNB, a major state-owned investment company, in Malaysia).[21]

As noted, privatization has frequently included as one of its objectives, the promotion of wider individual share ownership through public issues. One of the main instruments used by any issuer of shares, particularly in privatization sales, is the allocation/pricing process through which government can directly influence the

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[20] In the case Seprod, a Jamaican company privatized in 1985 of the sale 33% of the total share issue was reserved for employees at a price of J$1.50 against a market issue price of J$2.50. The option to purchase these shares at any time was exercisable for five years and financed through a payroll deduction plan.

[21] The Malaysian case is however somewhat special in that one of the main functions of the PNB has traditionally been to act as a buffer against commercial risk being passed on to individual shareholders. Until late 1989, PNB operated a unit trust scheme, known as the Amanah Saham Nasional (ASN), through which individual subscribers to units were effectively shielded from all downside commercial risk by PNB. Latterly, especially as the likelihood of continued buoyancy in the KLSE is reduced, concerns have been raised that with the expansion of the privatization programme, the PNB will be unable to continue to underwrite this risk, which ordinarily should be passed on to individual investors.

composition of players in the primary market. Evidence suggests however that, in some markets - most noticeably the KLSE - this allocation distribution is not sustained, particularly when the issue price diverges significantly from the market price. What occurs is that the share distribution rapidly contracts as successful individual applicants realize capital gains through sales (usually) to institutions who seek to hold assets long-term and who were rationed in the primary allocation. This phenomenon does little to the structure of market players, but represents a cumbersome method of effecting a lump-sum cash transfer from the issuer (government) to lucky share applicants, instrumented through the equity market.

The prevalence of this behaviour on the part of new players raises an important second-order effect, operating principally in terms of moral hazard and adverse selection effects. Consistent share underpricing on the part of the Government represents an imperfect form of risk insurance for investors. The presence of such insurance induces market participants to act in otherwise excessively risk assuming ways, ie. the moral hazard effect. In addition it will attract players into the market who would not otherwise participate in an "un-insured" equity market, ie. the adverse selection problem. It seems clear that however desirable this form of insurance may be from a political point of view, it is doubtful that it serves to develop the equity market. More sharply, the issue is raised of whether a influx of investors who see equity participation as a low-risk, speculative activity is consistent with stable capital market development.

This phenomenon is, however, not universal. One particularly noticeable feature about new players attracted by privatization issues in many countries is the relative lack of sophistication of their portfolios. Even in the UK, a large majority of the new shareholders, attracted by the underpriced privatization issues generally hold very narrow portfolios consisting of only the shares of privatized companies, where their portfolio composition is determined principally by the vagaries of the allocation process rather than by any other portfolio choice criteria. To a large extent this phenomenon is not an inevitable consequence of privatization per se, but it is likely

to be prevalent in markets where sophistication in share dealing is relatively low. A striking example of this has occurred in Jamaica, where share underpricing has not been accompanied by a rash of profit-taking by successful applicants in the primary issue. On the contrary, the new entrants, though numerous are relatively unsophisticated and tend not to trade in the secondary market.[22]

This lack of sophistication of new players can constitute a problem. Not only may the absence of secondary market trading neutralize the positive effect of an increase in equity supply, but it also raises problems concerning the control and discipline of management by shareholders. This is a variant of the general free-rider problem of widespread share ownership. Since the benefits of monitoring become a free good amongst all shareholders, there will be incentives for small shareholders to free-ride on the monitoring effort of larger shareholders. In the case where there is a large number of small passive shareholders, this free rider problem can become sufficiently strong such that a sub-optimal level of monitoring of management ensues. The most worrying scenario is in the case of large, powerful enterprises in which the widely spread, passive, domestic small shareholders exercise no effective control over either dominant overseas shareholders and/or the enterprise management. This problem has already emerged in Jamaica (as discussed in section 4.4).

Though attracting a large number of new players through privatization may be seen as having independent political benefits, the key to capital market development is clearly the quality of new investors. Pricing policies which introduce only risk averse new players attracted by the prospect of certain capital gains, clearly do not augur well for long term, sustainable development of the market. New players attracted to

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[22] As the table shows, there is a marked difference in the movement in the share distribution of the two largest capital market shares in Jamaica (where new players seem to be passive) and Malaysia (where there is a strong tradition of stagging new issues).

Company	Number of Shareholders Issue	End 1989
NCB (Jamaica)	30,606	30,309
TOJ (Jamaica)	17,168	17,426
MAS (Malaysia)	25,000	11,500
MISC(Malaysia)	60,000	5,000

ity markets on the promise of virtual zero downside risk will not only continue xpect significant underpricing in future privatization issues, but may also prove be volatile players when the market assumes a less distorted risk profile. isequently information and education about equity participation is essential not y for this reason, but is also necessary to ensure that the market is not hindered equity hoarding on the part of passive shareholders.

Privatization and Equity Market Management Capacity

s clear that equity market management capacity will evolve gradually with any 1-privatization increase in equity. However, the large scale, and the bunching cts of privatization sales will have a catalytic effect on the market institutions and ir capacity to maintain and improve the functioning of the market. Similarly vatization has proved to be a stimulus to the revision of financial sector regulation. h effects influence the performance of the financial services sector as a whole. In countries we have studied market capacity has improved in four main areas.

st is the revision (or in some cases the introduction) of capital market regulatory ictures. In Malaysia the securities legislation was overhauled with the 1983 urities Industry Act; in Sri Lanka a Securities Council was established in 1987 to vide for orderly market trading and investor protection; in Kenya the Capital rket Development Authority was created in 1989 in an attempt create a market ironment in which the (as yet dormant) privatization programme could progress; l in Papua New Guinea the Government have been involved in establishing a ulatory framework for a capital market through which privatizations can be ated. The story in Jamaica is characteristic of many similar markets. The Jamaican ck Exchange (JSE) has since its inception operated without any form of securities islation, to the extent that concern has been repeatedly expressed about insider ding and the manipulation of the market. The influx of new players, including the spect of greater international participation in the Jamaican equity market, has dermined the integrity of the self-regulating structure, and has resulted in a build- of pressure on the market authorities to jettison this image and overhaul their

legal and regulatory framework. It is widely believed within the market that the introduction of an effective regulatory framework is imperative, if the privatization process and the integration of the JSE into the broader Caribbean stock exchange initiative is to be achieved.

Second, a related development has been the stimulus that the introduction of foreign players to the privatization process has had on tax policy and policy towards foreign equity participation. For example, in Sri Lanka's first stock market listing (of United Motors) 5% of the equity was sold to the Mitsubishi Motor Company. To effect this sale, however, Government was obliged to issue a waiver on the 100% tax on non-resident share transactions, originally enacted in 1963. As the privatization programme has unfolded, however, statements have been made by Government to indicate that this 100% tax would be repealed wholesale, first for privatization share issues, and then more widely. Similarly, in the Trinidad Cement Limited sales the Ministry of Finance relaxed the otherwise heavily regulated licensing system for foreign participation. And in Malaysia where, as the privatization programme has expanded, and particularly as increasingly larger issues are being considered, formerly strict conditions on direct equity participation by foreign investors have weakened. The Privatization Act, which is due to be promulgated in early 1991, is expected to announce that foreign participation up to 100% will be permitted for privatization equity in cases where suitable local buyers are absent.[23]

Third, the anticipation (and realization) of heavier trading volumes associated with the privatization programmes has resulted in technological development in trading and settlement systems, and the promotion of expertise in support services. For example both Sri Lanka and Malaysia have seen the introduction of new trading and settlement systems in the last three years, while in most countries undertaking privatization there has been a discernable decrease in reliance on external technical assistance in areas such as underwriting, valuation and management of privatization issues.

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[23] Malaysian Business Times 6/10/89.

Fourth, the push for privatization has seen the development of new financial instruments, aimed at bundling privatization stocks in such ways that markets can be made. The most common instrument being considered at present is a unit trust composed specifically of shares in privatized companies.[24] To date no such trusts have been launched in the study countries, but proposals are in progress in Sri Lanka, Malawi, and Kenya.

Generally, the impact of privatization on this aspect of capital market development has been, and is likely to be positive. However there remains a risk that the pressures on the market and its supporting infrastructure to process the large volumes of trade associated with a rapid programme of privatization, may undermine the credibility and integrity of the market.[25] Since the loss of credibility in the capital market will not only jeopardize the privatization programme itself, but will clearly set back the overall process of capital market development, it is important that the push for privatization through the capital market does not exceed the technical capacity of the market to manage the sales.

4.4 Government Policy and Interventions in the Capital Market.

So far we have focused on the direct link between privatization and capital market development. However for most governments the privatization programme is also directed towards meeting other objectives. First is the important role of privatization in signalling to the domestic economy and, increasingly more importantly, to the external donor and creditor community, a commitment to structural adjustment. Privatization has consequently become a key instrument for the creation of political and policy reputation. Second, in many countries, though privatization has emerged as a response to the failure of public enterprise, it can be argued that privatization

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[24] In particular, these unit trusts have been conceived of as a vehicle for the partial divestiture of the asset portfolios of government-owned development finance institutions.

[25] For example, though not associated with the privatization programme per se, the KLSE suffered from a serious credibility problem associated with the loss of a significant amount of scrip in early 1990 on the change over to their computerised reporting and settlement system.

is in effect an alternative instrument for meeting the same set of non-economic objectives of special interest groups that were pursued through public enterprise. In many cases such interest groups have been wary about this the shift in policy direction.

Consequently, the cost of failure of privatization issues becomes extremely high, especially in the early stages of the programme, both in terms of reputation effects and in terms of alienating the government's political support base. As such most government's adopt an extremely risk averse stance with regard to privatization issues, the effects of which may be detrimental to capital market development. This risk aversion is reflected in two main ways. These can be classed as issues of underpricing and of sequencing.

Underpricing and Wider Share Ownership

We suggested earlier in section 4.2 that underpricing may lessen the expected benefits of privatizations on capital market development. It may even result in such privatizations being detrimental, due to adverse selection and moral hazard problems. However, it is clear from the general record of privatization that underpricing is not a random event, but is systemic to such sales. For example, the an analysis of capital market divestments from our country studies is shown in Tables 8 and 9. In terms of first day pricing, of the eight sales for which we have detailed enough data, six were underpriced and five substantially so.[26] For the two issues which were overpriced, the timing of the Sri Lankan sale was widely criticised, while the overpricing of the Jamaican CCC issue was a direct result of the overenthusiasm generated by the response to the previous (underpriced) NCB offer.[27] The story is generally unchanged when three month prices are examined.[28] Furthermore, other

[26] We define underpricing to be a situation where the offer price is less than the post-sale revealed market price.

[27] In fact this Jamaican experience offers evidence of the potential dynamic costs of underpricing.

[28] Note that these are a less reliable guide to under- or overpricing to due the effect of intervening noise on the share price.

countries (eg. France, Japan and the UK) show a similar history of underpricing in stock market sales.[29]

It is clear that the persistence of underpricing reflects the attempt by governments to satisfy certain objectives through the sale of shares. The key goal here is that of wider share ownership. Underpricing encourages more share applications from small agents in two ways. The first is through lowering the cost of a given asset bundle in the presence of wealth and credit constraints. The second occurs when underpricing is well signalled in advance. In this event, the riskiness of investment is intentionally reduced and this will induce more risk-averse agents to apply for shares. The wider share ownership objective is then made instrumental through the government's choice of share allocation scheme.[30] However, we would argue that underpricing is a costly and inefficient method of achieving the objective of wider share ownership. If this is the government's true objective, then the "give-away" option should be explored more fully.

It may be the case, though, that the government has the secondary aim of creating a class of buyers antagonistic to the renationalization of the enterprise. This clearly involves some mix of sunk investment in asset acquisition combined with a capital gain, so that the repurchase of the firm is not only costly, but also unpopular. Thus, one would expect to find motives for underpricing to be particularity strong where privatization is politically controversial. For example, the Jamaican Prime Minister's comment on the NCB privatization (which was at the time strongly opposed by the opposition) was:

> "...[in achieving its objective] to democratise the ownership by as wide a cross-section as possible ... [this] will make it virtually impossible for any government to renationalise ... [this act] is irreversible ... no power on earth can change it."

[29] See chapter 7 of J.Vickers and G.Yarrow, "Privatization: An Economic Analysis", (1988).

[30] In the event of oversubscription, almost all sales have involved a weighting of the allocation scheme towards the smaller investor.

Given the strongly political nature of divestment, it is quite probable that underpricing will remain embedded in capital market sales, with the attendant negative externalities for capital market development.

Allied to underpricing has been the stipulation of restrictions on the extent of individual share ownership, principally to head off concerns about the re-concentration of ownership in the hands of private sector elites. Such restrictions, which are present in virtually all public share issues in the countries studied here, generally limit any individual shareholding to a maximum of 10% of the total equity. Though such measures may have political validity, they do so only at the cost of further institutionalization of the free-rider problems associated with wider share ownership.

Sequencing and Reputation

The choice of enterprises for sale, their sequence of sale, and the price at which they are sold, are important instruments through which a government can reduce the political risk of failure, create policy reputation and address the concerns of interest groups. Underpricing, aside from reducing the risk of low take-up of shares, represents a direct means of creating a reputation, by increasing the likelihood that a strong demand will continue to exist for future sales. Moreover it has been argued[31] that the actual sequencing of sales may also help Government to signal its good faith to investors. For example, if a Government has a weak reputation for consistency, then potential investors may fail to take up shares for fear of future re-nationalization, or other forms of default (for example changing regulatory, pricing, protection, taxation or other revenue raising controls on the enterprise). Whilst underpricing and the promotion of a wide share base are strong forms of precommitment against renationalization, this can be reinforced by the type of enterprise sold. For example government may attempt to bolster their reputation for credibility by concentrating on selling assets in sector where the scope for default is

[31] See Adam, C.S. and Cavendish, W.P. "What Price Privatization? Government reputation and assets sales" (1990, unpublished).

more limited, for example in those sectors open to greater foreign participation. We have already alluded to the problems that may arise from both the sectoral composition of enterprise sales and to the problems of adverse selection, moral hazard and free-rider effects of underpricing. What this discussion on sequencing and reputation effects suggests is that even when governments may well be aware of these issues, considerations of political risk aversion and reputation may be overriding.

5. CONCLUSIONS

The main purpose of this paper has been to suggest that the links between privatization and capital market development are both strong and can be mutually reinforcing. Privatization can make a major contribution to the deepening of equity markets, but the "kick starting" paradigm in itself is too simplistic. In doing so we have attempted to identify a number of key issues which need to be addressed if progress in privatization and capital market development are to remain congruent over the medium term. First, there is the need to ensure that sudden increases of equity on the market do not adversely warp the risk profile of the market in a way that compromises its capacity to absorb and spread risk. Second, it is important to consider the extent and direction of crowding-out effects of large equity floatation. Third, in attempting to increase the number of players in the market, consideration must be given to the quality and sophistication of new players attracted, and the impact that pricing and allocation policies will have on their market behaviour. Fourth, greater attention than has hitherto been the case must be paid to education and information about equity participation. And fifth, the pace of privatization needs to be matched to the technical capacity of the market.

Notwithstanding these points, we have also argued that the relationship between privatization and the capital market is not simply about "getting the prices right". Privatization is adopted as a policy by governments to achieve other, possibly non-economic, goals. The pursuit of some of these may jeopardise rather than enhance the smooth development of the capital market.

COMPARATIVE STOCK MARKET PERFORMANCE 1980 TO 1989

1. Market Capitalization

(US$ million)

	1980	1981	1982	1983	1984	1985	1986	1987	1988	1989
STUDY COUNTRIES										
Jamaica	54	127	177	113	142	266	536	631	796	957
Kenya	-	-	-	-	-	-	-	-	474	-
Malaysia	12,395	15,300	13,903	22,798	19,401	16,229	15,065	18,531	23,318	39,842
Sri Lanka	-	-	-	-	-	365	421	608	471	-
Trinidad	-	1,175	1,357	1,011	843	463	374	388	266	411
Zimbabwe	1,456	-	355	265	176	360	410	718	774	1,067
OTHER COUNTRIES										
India (Bombay)	7,565	11,302	11,497	8,510	8,313	14,364	13,588	14,480	23,845	27,316
Nigeria	3,118	3,010	1,458	2,970	3,191	2,743	1,112	974	960	1,005
London	205,200	180,600	196,200	225,800	242,700	328,300	439,530	680,721	771,206	826,598
NYSE	1,448,120	1,333,385	1,520,267	1,898,063	1,862,945	2,324,646	2,636,598	2,588,890	2,793,816	3,505,686
Singapore	24,418	34,308	31,235	15,525	12,247	11,069	16,620	17,931	24,049	35,925
All Emerging Markets	86,125	87,991	71,399	84,554	93,775	115,224	145,164	201,164	366,491	611,130

Source: IFC Emerging Stock Markets Factbook (1990), and own sources.

2. Market Capitalization as a Percentage of GNP

	1980	1981	1982	1983	1984	1985	1986	1987	1988
STUDY COUNTRIES									
Jamaica	2.0%	4.3%	5.4%	5.3%	7.5%	13.1%	22.1%	22.1%	25.0%
Kenya	-	-	-	-	-	-	-	-	5.6%
Malaysia	50.6%	61.2%	51.9%	76.1%	57.2%	52.0%	54.7%	57.9%	67.2%
Sri Lanka	-	-	-	-	-	6.2%	6.7%	9.5%	-
Trinidad	-	17.2%	17.0%	12.7%	10.6%	8.8%	7.5%	8.7%	-
Zimbabwe	27.2%	-	5.2%	4.3%	3.4%	7.6%	7.7%	12.3%	-
OTHER COUNTRIES									
India (Bombay)	4.4%	6.4%	6.1%	4.1%	4.0%	6.3%	5.9%	5.7%	-
Nigeria	3.0%	3.2%	1.6%	3.3%	3.4%	3.0%	1.8%	3.4%	3.1%
All Emerging Markets									
Memorandum Items:									
GNP in US$ million									
Jamaica	2,666	2,970	3,293	2,133	1,898	2,035	2,429	2,868	3,183
Kenya	6,949	5,882	5,446	5,545	5,564	6,037	7,268	8,011	8,443
Malaysia	24,488	25,005	26,796	29,369	33,944	31,201	27,560	31,993	34,686
Sri Lanka	3,696	4,136	4,655	4,364	5,350	5,924	6,293	6,395	-
Trinidad	6,236	6,849	7,990	7,966	7,952	5,251	5,303	4,462	-
Zimbabwe	5,355	6,423	6,813	6,144	5,108	4,715	5,333	5,255	-
India	172,725	184,120	187,822	205,242	202,015	211,609	232.163	254,948	-
Nigeria	103,310	95,229	93,130	89,769	93,023	90,223	60.652	28,755	30,503

3. Market Turnover (US$ million)

	1980	1981	1982	1983	1984	1985	1986	1987	1988	1989
STUDY COUNTRIES										
Jamaica	3	2	6	5	7	21	68	73	25	90
Kenya	-	-	-	-	-	-	-	-	-	-
Malaysia	2,572	3,498	1,392	3,398	2,226	2,335	1,180	3,329	2,623	6,888
Sri Lanka	-	-	-	-	-	3	5	11	12	-
Trinidad	-	19	232	151	76	61	52	25	22	69
Zimbabwe	154	136	75	38	6	9	12	23	39	36
OTHER COUNTRIES										
India (Bombay)	2,760	7,386	5,030	2,377	3,915	4,359	10,781	6,743	12,241	17,362
Nigeria	14	10	12	16	16	15	16	-	5	4
London	35,791	32,524	32,676	42,544	48,857	68,417	[illegible]	369,329	579,171	320,268
NYSE	409,316	415,760	508,144	797,123	786,204	997,189	1,795,998	2,423,066	1,719,721	2,015,544
Singapore	3,654	6,377	2,419	5,588	3,849	1,333	2,679	6,354	4,470	13,711
All Emerging Markets	23,672	32,745	21,049	25,215	31,912	42,697	79,334	155,226	406,272	1,159,312

4. Market Turnover as a Percentage of GNP

	1980	1981	1982	1983	1984	1985	1986	1987	1988
STUDY COUNTRIES									
Jamaica	0.1%	0.1%	0.2%	0.2%	0.4%	1.0%	2.8%	2.6%	0.8%
Kenya	-	-	-	-	-	-	-	-	-
Malaysia	10.5%	14.0%	5.2%	11.3%	6.6%	7.5%	4.3%	12.0%	7.6%
Sri Lanka	-	-	-	-	-	0.1%	0.1%	0.2%	-
Trinidad	0.0%	0.3%	2.9%	1.9%	1.0%	1.2%	1.0%	0.6%	-
Zimbabwe	2.9%	2.1%	1.1%	0.6%	0.1%	0.2%	0.2%	0.4%	-
OTHER COUNTRIES									
India (Bombay)	1.6%	4.0%	2.7%	1.2%	1.9%	2.3%	4.6%	2.6%	-
Nigeria	0.0%	0.0%	0.0%	0.0%	0.0%	0.0%	0.0%	0.0%	0.0%

5. Market Turnover as a Percentage of Market Capitalization

	1980	1981	1982	1983	1984	1985	1986	1987	1988	1989
STUDY COUNTRIES										
Jamaica	5.56%	1.57%	3.39%	4.42%	4.93%	7.89%	12.69%	11.57%	3.14%	9.40%
Kenya	-	-	-	-	-	-	-	-	0.00%	-
Malaysia	20.75%	22.86%	10.01%	14.90%	11.47%	14.39%	7.83%	20.66%	11.25%	17.29%
Sri Lanka	-	-	-	-	-	0.82%	1.19%	1.81%	2.55%	-
Trinidad	-	1.62%	17.10%	14.94%	9.02%	13.17%	13.90%	6.44%	8.21%	16.79%
Zimbabwe	10.58%	-	21.13%	14.34%	3.41%	2.50%	2.93%	3.20%	5.04%	3.37%
OTHER COUNTRIES										
India (Bombay)	36.29%	62.58%	43.75%	27.93%	48.34%	34.52%	79.34%	46.57%	51.34%	63.56%
Nigeria	0.45%	0.33%	0.82%	0.61%	0.50%	0.55%	1.44%	0.72%	0.52%	0.40%
London	17.44%	18.01%	16.65%	18.34%	20.13%	20.36%	30.24%	57.27%	75.07%	38.75%
NYSE	28.30%	31.18%	33.43%	42.00%	42.20%	42.90%	68.12%	93.59%	61.55%	57.49%
Singapore	14.96%	18.32%	7.74%	35.39%	31.43%	12.49%	16.12%	38.22%	18.59%	38.17%
All Emerging Markets	27.49%	37.21%	29.48%	29.32%	34.03%	37.06%	54.69%	78.66%	110.25%	189.78%

6. Number of Listed Companies

	1980	1981	1982	1983	1984	1985	1986	1987	1988	1989
STUDY COUNTRIES										
Jamaica	38	36	35	36	36	38	40	43	44	45
Kenya	54	55	54	54	54	54	53	53	55	57
Malaysia	182	187	194	204	217	222	223	232	238	251
Sri Lanka	-	-	-	-	-	171	171	168	176	-
Trinidad	-	29	34	34	36	36	33	33	33	31
Zimbabwe	62	62	62	60	56	55	53	53	53	54
OTHER COUNTRIES										
India (Bombay)	992	1,031	1,106	1,151	1,295	1,529	1,912	2,095	2,240	2,390
Nigeria	90	93	93	93	93	96	99	100	102	111

7. Equity Market Indices

		1980	1981	1982	1983	1984	1985	1986	1987	1988	1989
STUDY COUNTRIES											
Jamaica	Nominal	70	152	211	240	461	942	1,500	1,515	1,439	2,076
	CPI	100	113	120	134	171	215	248	264	286	338
	Real Index	70	135	176	179	270	438	605	574	503	614
	1980 = 100	100	193	252	257	386	627	866	822	721	880
Kenya	Nominal	378	350	350	383	386	421	506	735	859	816
	CPI	100	112	135	150	165	187	194	205	221	236
	Real Index	378	313	259	255	234	225	261	359	389	346
	1980 = 100	100	83	68	67	62	60	69	95	103	91
Malaysia	Nominal	367	380	291	402	304	234	252	261	357	565
	CPI	100	110	116	120	125	126	126	128	131	145
	Real Index	367	346	251	335	243	185	200	204	273	390
	1980 = 100	100	94	69	91	66	51	55	56	74	106
Sri Lanka	Nominal	-	-	-	-	-	122	131	218	172	-
	CPI	100	118	131	149	174	176	190	205	234	
	Real Index	-	-	-	-	-	69	69	106	74	
	1980 = 100	-	-	-	-	-	100	100	153	106	
Trinidad	Nominal	-	-	-	72	60	49	38	40	32	49
	CPI	100	114	127	147	166	179	193	214	230	264
	Real Index	-	-	-	49	36	27	20	19	14	18
	1980 = 100	-	-	-	100	74	56	41	38	29	38
Zimbabwe	Nominal	477	228	136	124	123	252	286	450	553	869
	CPI	100	113	125	154	185	201	230	258	278	320
	Real Index	477	202	109	80	66	125	124	174	199	272
	1980 = 100	100	42	23	17	14	26	26	37	42	57
OTHER COUNTRIES											
India (Bombay)	Nominal	124	175	167	183	200	396	425	390	635	840
	CPI	100	113	122	136	148	156	170	184	202	230
	Real Index	124	155	137	134	135	254	250	212	314	365
	1980 = 100	100	125	111	109	109	206	202	171	254	295

8. Capital Market Privatization and the Increased Supply of Equity

	1984	1985	1986	1987	1988	1989	1990
JAMAICA							
Privatization Share Value as % of Market Capitalization	0.00%	0.67%	2.87%	4.51%	2.52%	0.00%	
Privatization Share Value as % of Prior-Year Turnover	37.67%	76.01%	43.90%	27.13%	0.00%	n.a	
Privatization Share Value as % of Prior-Year New Issues							
TRINIDAD AND TOBAGO							
Privatization Share Value as % of Market Capitalization	0.00%	0.00%	0.00%	0.00%	0.00%	0.65%	
Privatization Share Value as % of Prior-Year Turnover		0.00%	0.00%	0.00%	0.00%	13.35%	
Privatization Share Value as % of Prior-Year New Issues		0.00%	0.00%	0.00%	0.00%	ERR	
MALAYSIA							
Privatization Share Value as % of Market Captitalization	0.00%	0.11%	0.00%	0.18%	0.01%	0.00%	1.51%
Privatization Share Value as % of Prior-Year Turnover	0.00%	1.11%	0.00%	4.01%	0.11%	0.09%	13.03%
Privatization Share Value as % of Prior-Year New Issues	0.00%	2.70%	0.00%	32.45%	0.73%	0.39%	97.57%
SRI LANKA							
Privatization Share Value as % of Market Capitalization						0.59%	1.10%
Privatization Share Value as % of Prior-Year Turnover						56.18%	188.03%
Privatization Share Value as % of Prior-Year New Issues						49.63%	146.67%

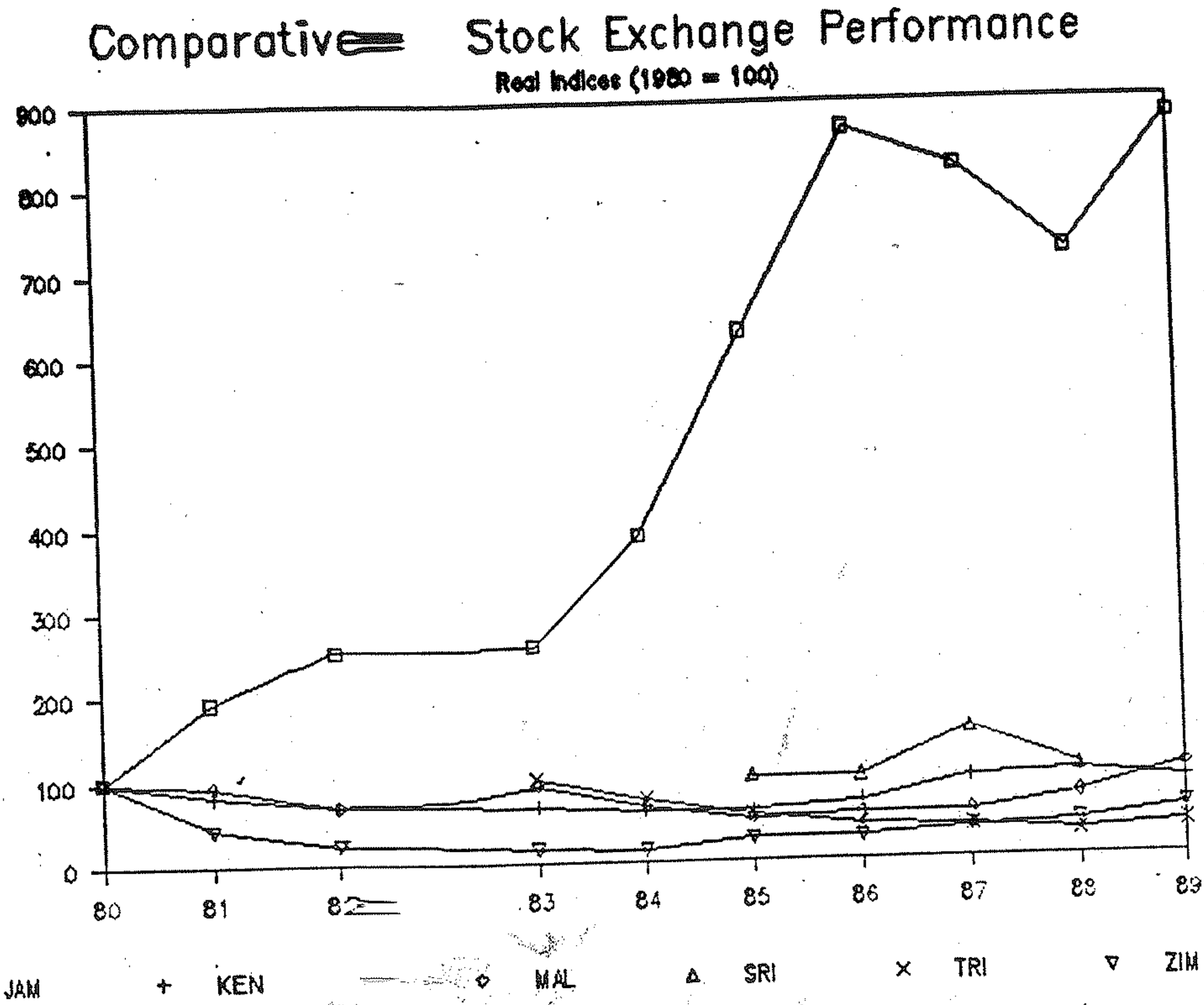
Public Share Issue Share Price Movement

9. First Day Excess Demand/Excess Supply Data

Company	Country	Currency	Issue Price	Opening Price	Shares Offered	Shares Sold	Excess Demand(+)/Supply(-) Local Currency	Percent
CCC	Jamaica	J$	2.00	1.90	111,945,488	78,690,000	(67,728,878)	-30.25%
NCB	Jamaica	J$	2.95	4.94	30,600,000	30,600,000	60,894,000	67.46%
Seprod	Jamaica	J$	2.50	-	3,000,000	3,000,000	-	-
TOJ	Jamaica	J$	0.88	0.90	126,500,000	126,500,000	2,530,000	2.[illegible]%
MAS	Malaysia	M$	1.80	3.50	70,000,000	70,000,000	119,000,000	94.44%
MISC	Malaysia	M$	2.40	5.00	84,985,000	84,985,000	220,961,000	108.33%
TW	Malaysia	M$	1.10	2.30	15,000,000	15,000,000	18,000,000	109.09%
CMS	Malaysia	M$	1.30	2.48	5,000,000	5,000,000	5,900,000	9[illegible]%
UMSL	Sri Lanka	SL Rupees	10.00	10.00	10,000,000	3,300,000	(67,000,000)	-67.00%
NCB	Trinidad	TT$	0.69	-	3,410,000	3,410,000	-	-
TCL I	Trinidad	TT$	0.75	-	12,000,000	12,000,000	-	-
TCL II	Trinidad	TT$	0.85	-	21,000,000	21,000,000	-	-
							Mean	46.59%
							Std Dev	64.39%

10. Three Month Excess Demand/Excess Supply Data

Company	Country	Currency	Issue Price	Adjusted Issue Price	3 Month Price	Shares Offered	Shares Sold	Excess Demand/Supply: Local Currency	Excess Demand/Supply: Percent	Notes
CCC	Jamaica	J$	2.00	1.85	1.51	111,945,488	78,690,000	(65,750,850)	-29.37%	
NCB	Jamaica	J$	2.95	3.47	4.60	30,600,000	30,600,000	34,593,881	38.32%	
Seprod	Jamaica	J$	2.50	3.98	6.65	3,000,000	3,000,000	8,002,018	106.69%	[1]
TOJ	Jamaica	J$	0.88	0.93	0.90	126,500,000	126,500,000	(3,641,437)	-3.27%	
MAS	Malaysia	M$	1.80	1.70	2.63	70,000,000	70,000,000	65,130,043	51.69%	
MISC	Malaysia	M$	2.40	3.81	7.20	84,985,000	84,985,000	238,139,619	141.27%	
TW	Malaysia	M$	1.10	1.40	1.93	15,000,000	15,000,000	8,024,713	48.63%	
CMS	Malaysia	M$	1.30	1.41	2.05	5,000,000	5,000,000	3,189,956	49.08%	
UMSL	Sri Lanka	SL Rupees	10.00	9.43	11.00	10,000,000	3,300,000	(79,054,023)	-79.05%	
KCB	Trinidad	TT$	0.69	-	-	3,410,000	3,410,000	-	-	
TCL I	Trinidad	TT$	0.75	-	-	12,000,000	12,000,000	-	-	
TCL II	Trinidad	TT$	0.85	-	-	21,000,000	21,000,000	-	-	
								Mean	36.00%	
								Std Dev	62.99%	


Comparative Stock Exchange Performance
Real Indices (1980 = 100)
900
800
700
600
500
400
300
200
100
0
80
81
82
83
84
85
86
87
88
89
JAM
KEN
MAL
SRI
TRI
ZIM