Chapter-3

Economic Reforms
and its Impact on
Capital Market
Capital markets have truly become the barometer of a country's economic performance. In India, the financial sectors as a whole and the capital markets in particular, have seen a comprehensive set of reforms in nineties and consequently have acquired great depth needed for sustained growth of Indian economy. Its most opportune time for examining and assessing the impact, challenges and opportunities arising from global and domestic developments as well as from changing market practices and regulations relating to Indian capital markets.

This chapter focuses on the basis of Liberalisation, Globalisation, reforms measures introduced in recent years for development of India capital markets, examines the current states of the capital markets and deliberates briefly on some of challenges facing the capital markets in India.

Shri Rajiv Gandhi introduced economic reforms soon after taking over as prime minister in 1985. He underlined the need for opening several areas hitherto reserved for the public sector to the private sector. But the government did not take a categorical position on issues relating to Privatization and globalisation. A sharp departure from the Industrial policy of 1956 took place with the announcement of Industrial policy 1991. Three major strategies of new economic policy are (i) liberalisation (ii) globalisation and (iii) privatization.

The main aim of liberalisation was to dismantle excessive regulatory framework and bureaucratic controls, which acted as shackles on freedom of enterprises. The ceiling on assets fixed under MRTP Act was abolished in order to permit large houses to undertake investments in the core sectors-heavy industry.
infrastructure, petro-chemicals, electronics, etc. The number of items requiring licensing was reduced to a short list of bare 15 industries. This freed the private sector to set up industrial units quickly.

Globalisation intends to integrate the Indian economy with the world economy. Four parameters to globalisation are: Unhindered (i) trade flows, (ii) Capital flows (iii) technology flows, and (iv) labour flows. The developed countries restrict the definitions to only three and omit labour flows, globalisation will remain incomplete.

**Measures promoting globalisations in India include:**

(i) Reduction of import duties.

(ii) Encouragement of foreign investment through

   (a) Grant of automatic approval for direct foreign investment up to 51 per cent equity participation and joint ventures up to 74 percent.

   (b) Majority foreign equity holding up to 51 percent allowed in trading companies.

(iii) Encouragement of foreign technology agreements within prescribed limited of payments in foreign exchange.

Privatization is the process involving the private sector in the ownership or operation of a state owned undertaking.

The reform process has helped to accelerate growth; the benefits of growth have not percolated to the poor and weaker sectors of the society.
TG No. III: 1

Growth Rate of Gross Domestic Product
(at 1980-81 prices)

<table>
<thead>
<tr>
<th>Year</th>
<th>Growth Rate</th>
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<tbody>
<tr>
<td>1991-92</td>
<td>0.9%</td>
</tr>
<tr>
<td>1992-93</td>
<td>5.0%</td>
</tr>
<tr>
<td>1993-94</td>
<td>4.5%</td>
</tr>
<tr>
<td>1994-95</td>
<td>6.7%</td>
</tr>
<tr>
<td>1995-96</td>
<td>6.3%</td>
</tr>
<tr>
<td>1996-97</td>
<td>6.8%</td>
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Since the reform process was initiated the growth rate of the economy started picking up. GDP slumped down to 0.9% in 1991-92 but started picking up thereafter. The average growth rate during last decade over 6 percent is an achievement of the reform process. This is an achievement, which has not been witnessed earlier during last 45 year of planning.

The reform process, especially its emphasis on globalization, was intended to help the acceleration of growth process by attracting a large dose of foreign capital. The experience of successful developing countries indicates that rapid growth requires a sustained effort at mobilising saving and resources and deploying them in ways, which encourage efficient production. It also aimed at widening the net of resources mobilisation.
Chapter-3: Economic Reforms & its Impact on Capital Market

Capital Market Reforms:

SEBI has been issuing guidelines from time to time for establishing a fair and transparent market. Some of the major measures announced by SEBI are briefly enumerated below:

- Regulations for underwriters of capital issues and capital adequacy norms for stock brokers, sub-brokers, merchant bankers, portfolio managers, investment advisers, other such intermediaries and depositories, participants, custodian of securities. FIIs, credit rating agencies and other such intermediaries associated with stock exchanges were announced starting from October 1993.

- RBI has liberalised the investment norms evolved for NRI's by allowing companies to accept capital contributions and issue shares and debentures to NRIs or overseas corporate bodies without prior permission.

- The stock exchange were directed to broad-base their governing boards and change the composition of their arbitration, default and disciplinary committees.

- RBI has liberalised the investment norms evolved for NIR's contributions and issue shares and debentures to NRIs or overseas corporate bodies without prior permission.

- The Government has allowed foreign Institutional Investors (FIIs) such as pension funds, mutual funds, investment trusts, asset or portfolio management companies etc. to invest in the Indian capital market provided they register with SEBI.
SEBI has made it compulsory for credit rating of debentures and bonds of more than 18 months maturity.

One of the major achievements of the new economic reforms was that it provided a big boost to the inflow of foreign investment.

An analysis of foreign investment flows for the period 1991-92 and 1995-96 (Upto November, 95) reveals that the total investment flows of the order of US $ 11.744 billion were made, out of which direct investment accounted for US$ 3.694 billion i.e. 31.5 percent of total. As against it, portfolio investment accounted for US$ 8.05 billion i.e. 68.5 percent of total. Direct foreign investment is less than one-third of total foreign investment and even of this, 10.4 percent is contributed by NRI's. This implies that only 21.1 percent (nearly one fifth of the total) is contributed by foreigners.

TG No. III: 2

<table>
<thead>
<tr>
<th>Foreign Investment flows by category (US$ million)</th>
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</thead>
<tbody>
<tr>
<td><strong>A) Direct Investment</strong></td>
</tr>
<tr>
<td>(a) RBI automatic route</td>
</tr>
<tr>
<td>(b) FIPB route</td>
</tr>
<tr>
<td>(c) NRI (40% and 100%)</td>
</tr>
<tr>
<td><strong>B) Portfolio Investment</strong></td>
</tr>
<tr>
<td>(a) FII's</td>
</tr>
<tr>
<td>(b) Euro-equities</td>
</tr>
<tr>
<td>(c) Offshore funds and others</td>
</tr>
<tr>
<td><strong>Total A+B</strong></td>
</tr>
</tbody>
</table>

*For April-Nov.


Portfolio investment of the order of $8.05 billion is of a speculative nature and is not money, which can take to fight in a
period of political and economic uncertainty. It was not wise on the part of the government to permit portfolio investment because this has only strengthened the foreign business firm’s control of the share market; such a course is not beneficial to the country.

**TG No. III: 3**

**Direct Foreign Investment: Inflows vs. Approvals**

<table>
<thead>
<tr>
<th>(US$ million)</th>
<th>Approvals</th>
<th>Actual Inflows</th>
<th>Actual inflows as % approvals</th>
</tr>
</thead>
<tbody>
<tr>
<td>1991</td>
<td>325</td>
<td>155</td>
<td>47.5</td>
</tr>
<tr>
<td>1992</td>
<td>1781</td>
<td>233</td>
<td>12.8</td>
</tr>
<tr>
<td>1993</td>
<td>3558</td>
<td>574</td>
<td>16.0</td>
</tr>
<tr>
<td>1994</td>
<td>4332</td>
<td>958</td>
<td>21.9</td>
</tr>
<tr>
<td>1995*</td>
<td>4999</td>
<td>1517</td>
<td>29.9</td>
</tr>
<tr>
<td>Total (1991-95)</td>
<td>14995</td>
<td>3437</td>
<td>22.6</td>
</tr>
</tbody>
</table>

*Source: Government of India, Economic survey (1995-96)*

*upto Sept 1995.

Note: Approval and inflows includes NRI Investment as well.

The above data about foreign direct investment (FDI) approvals and actual inflows reveals that although during 1991-95 (upto Sept. 1995) approvals of FDI of the order of US$ 14.995 billion were given, actual inflows accounted for barely US $3.437 billion i.e. 26 percent of total approvals. Obviously, the realised FDI is less than one fourth of the total approvals. Unless the tag between the actual inflows and approval is reduced the role of FDI in giving a boost to our economy would remain a myth. (See table...
TG No. III: 4 Foreign Investment approvals in India Vis-à-vis actual inflows).

The government's intentions to attract FDI are earnest but inflows are falling. One step forward, two steps backward. That's what India's FDI policy has been ever since after liberalization. The government will have to do a lot more than only open up the economy in letters and announce policies for foreign inflows. It will have to ensure that the staff, including officers at every level, will have to change their mindset and work for the creation of congenial environment where paper work is minimal and norms are clear. Making the working environment more investor friendly, liberalising policies and decentralizing the approval process. Establishing a single point interface between foreign investors, their by achieving single window clearance.

.... the fall is more steep is direct investment rather than portfolio investment⁵. (See table TG No. III: 5 Decline in Foreign Investment).

**Impact of stock exchange on economic growth:**

Stock market has impact on economic growth by the creation of liquidity. Liquid equity markets render investment less risky and more attractive by allowing savers to acquire an asset and sell it quickly and cheaply if they need access to their savings or alter their Portfolios. At the same time companies can raise equity and enjoy a permanent access. Liquid markets improve the allocation of capital and enhance the prospects for long-term growth. Liquidity provided by stock markets renders investment less risky and more profitable. In the words of Levine, "investors will come if they can leave".⁶
TG No. III: 4

Foreign Investment approvals in India Vis-a-vis actual inflows

Note*: Up to June 1999. Amount includes NRI investments.

Source: Financial express ‘Think tank FDI’ April 14, 2000
TG No. III: 5

Source: Financial express 'Think tank FDI' April 14, 2000
Impact of Industrial Policy (IP) 1991:

Along with industrial delicensing, IP 1991 brought significant changes in the foreign investment policy. These changes are designed to attract enhanced capital inflows into India on a sustained basis and to encourage technology collaborations agreements between Indian and foreign firms. Today India welcome FDI in virtually every sector of economy except those of strategic concern such as defence, railway, and atomic energy. Foreign trading companies are encouraged to assist export activities. Foreign equity proposal unlike in the past, need not necessarily be accompanied by foreign technology agreements. Accordingly, the Foreign Exchange Regulation Act (FERA) 1973 has been amended. The salient features of the new policies towards foreign investment are:

1. Automatic approval for foreign equity participation up to 51 percent is granted in high priority industries.
2. Foreign trading companies can have up to 51 percent share in trading houses engaged in export activity.
3. Foreign investment in hotel and tourism related industry up to 51 percent equity is permitted and in mining sector up to 50 percent.
4. Use of foreign brand names/trade marks for sale of goods in India is permitted.
5. Foreign equity up to 100 percent is encouraged in export oriented units power sector, electronics and software technology parks.
6. Foreign equity is permitted even in small-scale enterprises up to 24 percent.

7. Recently a Foreign Investment Promotion Council (FIPC) has been formed which will formulate guidelines for policy as well as promote investment opportunities in the country.

8. A foreign investment project proposal has to get a clearance from Secretariat of Industrial Approvals (SIA) or Foreign Investment Promotion Board.

9. Foreign companies engaged abroad might open branch offices/project offices in India, with necessary permission of RBI.

10. Repatriation of capital and sales proceeds:

Foreign capitals invested in India are allowed to be repatriated with capital appreciation, if any, after payment of taxes due on them. And repatriation of sale proceeds of assets held in India is also allowed with prior RBI approvals subject to payment of applicable taxes.

**Developments in the capital Markets:**

The role of stock exchange has acquired significance in mobilisation of savings and channelisation into productive investment only in 70s and 80s though market was subject to government control and regulations. In nineties, the capital markets, however, have emerged as an important source of capital mobilisation and witnessed considerable growth, following comprehensive set of reforms introduced in these areas as a part of financial sector reforms.
The extent of growth in capital markets in India can be measured by the fact that as against an amount of about $6 billion equivalent mobilised during the 10 year period upto 1990-91 the amount mobilised during six years between 1991-92 to 1997-98 increased over eleven-fold to around $68 billion. In 1990 the pre-reform period, 75% of incremental financial saving went to banks approximately 25% to capital markets. In 1996 the banking sector received 47% of the household savings and the equity market 53%. Thus there has been a marked shift towards capital markets from the traditional banking system.

The secondary market too has grown significantly and market capitalisation on National Stock Exchange (NSE) has increased from $94 billion in November 1994 to $132 billion in April 1998. Net cumulative portfolio investments by FIIs have crossed $9 billion mark. The substantial flow of foreign portfolio investments has made the trade volume on stock exchanges increase considerably.

**Capital market in the post liberalisation era:**

Thanks to series of comprehensive reforms measures introduced by the government of India since 1991-92, that the capital markets have reached these levels. Among the various measures introduced the abolition of office of controller of capital issue together with free pricing of issues by corporate constitute perhaps the most important developments in the capital market in the post reform era. Another landmark was the establishment of securities and exchange broad of India (SEBI) with statutory functions and powers to bring about a healthy and orderly growth of the capital market. SEBI has truly transformed the capital market through a series of well designed and well-sequenced reforms measures.
introduced over the last few years covering both the primary and secondary markets.

To protect interests of investing community and also to provide greater flexibility to the issuers the SEBI issued a new set of guidelines on Capital Issues in 1992. Companies in India can now enter the market directly with a variety of instruments and determine issue prices in accordance with their market perceptions and in conformity with certain guidelines relating to disclosure and investor protection. Also, no longer offer documents need to be vetted by the SEBI; merchant bankers/issuers would remain responsible for ensuring compliance with the norms on disclosure and investment protection prescribed by SEBI.

In addition several new market intermediaries including mutual funds and FIIS have been permitted to operate, making the capital markets much more diversified. Several reform measures have been introduced to attract investments from FIIs both in the primary and secondary markets.

The emphasis on the secondary market reforms has been towards upgradation of post trade infrastructure to international levels. Secondary market policy improvements assumed the form of greater transparency in trading system, reduced settlement cycles, extension of screen based trading and introduction of forward trading with adequate safeguards.

In India, as the reform process gains momentum, capital markets have to play an important role as provider of capital resources. The resource requirements to sustain a higher growth and especially the investment needs of the infrastructure sector are indeed very large. Much of the needed investment is expected to
come from increased private sector participation in industrial development. In this context an efficient capital market institution becomes a pre-requisite for providing a conducive framework for investors, issues and various financial intermediaries.

With a sharp increase in the number of companies accessing capital markets and the burgeoning investor population in the initial phase of reforms considerable strain had been placed on systems and procedures in stock exchanges combined with the extremely cumbersome and time consuming procedure for taking and giving deliveries of scrip’s, the existing mechanism was found to be quite inadequate to operate efficiently. Therefore, a need was felt for an alternative mechanism. Screen based trading systems and automated settlement systems were considered to be essential.

Thus, was born the National Stock Exchange of India (NSE) in 1994 which introduced for the first time in India nation-wide fully automated screen based trading facilities to investors in the line with international markets. NSE has now carved a niche for itself with its commitment to efficient operations, discipline and transparency of systems and procedures and in less than 5 years has emerged as the country’s largest stock exchange.

Another important development has been the setting up of National Securities Depository Ltd. (NSDL) which has ushered in an era of dematerialised trading. NSDL was set up jointly by IDBI, UTI and NSE is moving fast towards a cost effective national clearance and depository system. This will help in cutting transactions costs, significantly reducing delays in transfer of ownership of securities, creating liquidity for holdings and ensuring better investor protection. The first on and half years of NSDL saw several developments on depository front. The
depository infrastructure grew with more companies, depository participants (DPs) and stock exchanges joining NSDL. As on date 203 companies constituting 60 percent of total market capitalisation, have entered into agreements with NSDL. Amongst these, a dematerialised facility is available for shares of around 184 companies. At present NSDL has around 55 depository participants, who are catering to the investors from 219 locations across country. Further, the two largest stock exchanges viz NSE and BSE have joined NSDL to facilitate settlement of trades executed in their dematerialised segments. It is very encouraging to note that many global custodians have recommended the use of NSDL to their clients in the US and other countries. SEBI has made it mandatory for FIIs, MFs, Banks and FIIs to sell only in the dematerialised segment with respect to select list of securities. SEBI has also allowed delivery of dematerialised shares in physical segment of NSE and BSE thereby alleviating all concerns relating to the liquidity of dematerialised holdings.

**Challenges facing the capital market:**

Some of the challenges faced by the capital markets in India, which needs to be adequately addressed to realise the vision of an efficient market system. It is a fairly known fact that the capital markets in India are going through a very subdued phase. The total number of public Issues that hit the market in the year 1998-99 was 32, garnering about Rs. 7000 crore against 1343 issues aggregating over Rs. 13000 in the year 1994-95. Out of Rs. 7000 core raised during 1998-99, nearly an amount of Rs. 6500 crore was accounted for debt issues by developmental financial Institutions; equity assurances aggregated a mere Rs. 500 crore. Its evident that equity offerings are no longer a favourite with.
Indian investors. Over the years there has been a paradigm shift towards fixed income securities and now, after the recent decision to make incomes from mutual funds tax free, most mutual fund schemes are also drawing overwhelming response.

1992-93 to 1994-95

- Liberalization was introduced in the economy and import restrictions were gradually reduced. SEBI was set up. The concept of pricing as per a pre-determined formula prescribed by controller of capital issues (CCI) was done away with and free pricing regime came into being.

- Industrialists and other financial intermediates perhaps, failed in their vision to comprehend the effect of liberalisation and continued the unabated expansion/diversification spree without realising that excess capacities were being built up in the economy. Several fly-by night operators joined the bandwagon and capitalised on the bullish market sentiments.

- Investors too continued to flock in, without realising that the excess capacities on account of fresh capacity build-up and imports may adversely affect the performance of such companies.

- On account of the then prevailing buoyant market, almost all issues received overwhelming responses. Investors also made handsome gains in the initial period of one to two years. However, as the performance of most of these companies could not meet the expectations of the investors subsequently, the secondary market prices of such companies took a beating.
1995-96 onwards:

- Most issuers were not able to keep up their financial performance in the latter years.

- Investors had lost heavily on their investments and were keen to offload their holding even at a loss, leading to huge floating stocks in the market.

- Investors shied away from equity investments and moved over to fixed income securities.

- The change in the investor psyche has, thus, been a result of the factors outlined above. In the primary equity market a major challenge currently is the revival of the depressed conditions of the market. The sluggishness of the primary equity market which is continuing for over two years is attributed to various factors including investors apathy which is mainly due to poor performance of large number of scrip's floated with a high premia during 1993-95 following freeing of the pricing. The matter was compounded by irregularities noticed in the pricing of some of the issue, which imparted a considerable negative influence in the minds of investors. Further, there was a liquidity constraint in the financial system during 1995-96 and large part of 1996-97, which led to spurt in interest rates diverting investor's preference from equity to debt issues in the primary market.

The continued subdued nature of the primary equity market has become an area of major concern, as it hampering implementation of many industrial projects causing time and cost overruns and thereby affecting the industrial growth of the country.
The secondary equity market has also remained subdued over the past few years, although it has shown some revival trends, confined to few select scrips. In a way revival of primary equity market depends crucially on the health of the secondary market. Policy reforms in the secondary market have been quite comprehensive so far as the creation of efficient and transparent infrastructure is concerned. India today had NSE and BSE, which provides screen-based automated and transparent trading. Post trading facilities have improved considerably with the setting up of National Securities Depository Ltd. Other exchanges have also now computerised their operations, settlement cycles are being rigidly followed. There is also a gradual shift towards demat form of trading. However, secondary markets have come to be dominated by the FIIs. The recent events in South-East Asia have to some extent affected their sentiments. What is required is to make the Indian financial Institute participate to a much larger extent than they are doing today. UTI and other mutual funds as well as LIC have to be much more active on the secondary markets.

**Derivative Products:**

Another important challenge before the Indian capital market is the development of market for derivative products. Developed capital markets have all introduced derivative products in financial markets. In India this is a new evolving concept.

Prior to globalisation of Indian economy the stock markets were somewhat insulated from international influence. This is not the case any more. The recent S.E. Asian crisis has shown that due to high degree of integration or linkage among financial markets; the crisis can be quickly transmitted to other financial markets. In an
integrated global economy, it is imperative to take steps to regulate the markets effectively so as to retain investor confidence in a country’s economy and particularly the stock market.

In short liberalisation in capital market has resulted in many improvement in the functioning of the stock market, there are several aspect, which still needs merit attention so that capital market can play a meaningful role in industrial and economic development. The sluggish trend in primary equity market needs to be reversed by restoring investor’s confidence in the market. Secondary market trading needs to be broad based and various intermediaries, both in primary and secondary market should be strengthened to confirm to international standards. Regulatory and other aspects need to be looked into. Also Indian capital market should mature to introduce derivative products for risk management in capital market.

The recent South East Asian crisis needs to be carefully studied. A market-oriented system with appropriate regulation lead to growth with stability, otherwise there may be shocks both external and internal which might destabilise the economy.
References:

2. Ibid.
3. Ibid.
5. Ibid.
8. Ibid.