Significance of Securities Market in the Growth of an Economy: An Indian Context

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I thank the organizers of this programme for affording me an opportunity to reiterate the significance of a very vital segment of the economy, i.e. the securities market.

It is needless to say that the financial markets (banks and the securities markets) finance economic growth. They channelise savings to investments and thereby decouple these two activities. As a result, savers and investors are not constrained by their individual abilities, but by the economy's ability to invest and save respectively, which inevitably enhances savings and investment in the economy. To the extent the growth of an economy depends on the rate of savings and investment, financial markets promote economic growth.

The banks and securities markets are two competing mechanisms to channel savings to investment. The securities markets score over banks in the allocational efficiency, as it allocates savings to those investments which have potential to yield higher returns. This inevitably leads to higher returns to savers on their savings and higher productivity on investments to enterprises. Hence to the extent economic growth depends on the rate of return on investments, securities market promotes economic growth.

With this brief background, I propose to talk first about functions of the securities market, then its role and importance in the growth of an economy, then how a liberalized securities market promotes economic growth, then talk about its significance in the Indian economy and finally, significance of the market in the growth of Indian economy.

Functions of Securities Market

The securities market allows people to do more with their savings than they would otherwise. It also allows people to do more with their ideas and talents than would otherwise be possible. The people's savings are matched with the best ideas and talents in the economy. Stated formally, the securities market provides a linkage between the savings and the preferred investment across the entities, time and space. It mobilizes savings and channelises them through securities into preferred enterprises.

The securities market enables all individuals, irrespective of their means, to share the increased wealth provided by competitive enterprises. The securities market allows individuals who can not carry an activity in its entirety within their resources to invest whatever is individually possible and preferred in that activity carried on by an enterprise. Conversely, individuals who can not begin an enterprise they like can attract enough investment form others to make a start and continue to progress and prosper. In either case, individuals who contribute to the investment share the fruits.

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The securities market also provides a market place for purchase and sale of securities and thereby ensures transferability of securities, which is the basis for the joint stock enterprise system. The liquidity available to investors does not inconvenience the enterprises that originally issued the securities to raise funds. The existence of the securities market makes it possible to satisfy simultaneously the needs of the enterprises for capital and of investors for liquidity.

The liquidity the market confers and the yield promised or anticipated on security encourages people to make additional savings out of current income. In the absence of the securities market, the additional savings would have been consumed otherwise. Thus the provision of securities market results in net savings.

The securities market enables a person to allocate his savings among a number of investments. This helps him to diversify risks among many enterprises, which increases the likelihood of long term overall gains.

Securities Market and Economic Growth

I strongly believe that a well functioning securities market is conducive to sustained economic growth. There have a number of studies, starting from World Bank and IMF to various scholars, which have established robust relationship not only one way, but also the both ways, between the development in the securities market and the economic growth. An important study by Ross Levine and Sara Zervos (1996) finds that the stock market development is highly significant statistically in forecasting future growth of per capita GDP. Their regressions forecast that if Mexico or Brazil were to obtain stock markets as advanced as Malaysia, then they might obtain an additional per capita GDP growth per year of 1.6%. This happens, as market gets disciplined / developed/ efficient, it avoids the allocation of scarce savings to low yielding enterprises and forces the enterprises to focus on their performance which is being continuously evaluated through share prices in the market and which faces the threat of takeover. Thus securities market converts a given stock of investible resources to a larger flow of goods and services.

The securities market fosters economic growth to the extent that it-(a) augments the quantities of real savings and capital formation from any given level of national income, (b) increases net capital inflow from abroad, (c) raises the productivity of investment by improving allocation of investible funds, and (d) reduces the cost of capital.

It is reasonable to expect savings and capital accumulation and formation to respond favourably to developments in securities market. The provision of even simple securities decouples individual acts of saving from those of investment over both time and space and thus allows savings to occur without the need for a concomitant act of investment. If economic units rely entirely on self-finance, investment is constrained in two ways: by the ability and willingness of any unit to save, and by its ability and willingness to invest. The unequal distribution of entrepreneurial talents and risk taking proclivities in any economy means that at one extreme there are some whose investment plans may be frustrated for want of enough savings, while at the other end, there are those who do not need to consume all their incomes but who are too inert to save or too cautious to invest the surplus productively. For the economy as a whole, productive investment may thus fall short of its

potential level. In these circumstances, the securities market provides a bridge between ultimate savers and ultimate investors and creates the opportunity to put the savings of the cautious at the disposal of the enterprising, thus promising to raise the total level of investment and hence of growth. The indivisibility or lumpiness of many potentially profitable but large investments reinforces this argument. These are commonly beyond the financing capacity of any single economic unit but may be supported if the investor can gather and combine the savings of many. Moreover, the availability of yield bearing securities makes present consumption more expensive relative to future consumption and, therefore, people might be induced to consume less today. The composition of savings may also change with fewer saving being held in the form of idle money or unproductive durable assets, simply because more divisible and liquid assets are available.

The securities market facilitates the internationalisation of an economy by linking it with the rest of the world. This linkage assists through the inflow of capital in the form of portfolio investment. Moreover, a strong domestic stock market performance forms the basis for well performing domestic corporate to raise capital in the international market. This implies that the domestic economy is opened up to international competitive pressures, which help to raise efficiency. It is also very likely that existence of a domestic securities market will deter capital outflow by providing attractive investment opportunities within domestic economy.
Any financial development that causes investment alternatives to be compared with one another produces allocational improvement over a system of segregated investment opportunities. The benefits of improved investment allocation is such that Mc Kinnon defines economic development as reduction of the great dispersion in social rate of return to existing and new investments under domestic entrepreneurial control. Instead of emphasising scarcity of capital, he focuses on the extra-ordinary distortions commonly found in the domestic securities markets of the developing countries. The distortions in the real sectors such as monopoly power, tariff protection, import quotas, credit rationing and so forth add salt to injury. In the face of great discrepancies in rate of return, the accumulation of capital does not contribute much to development. A developed securities market successfully monitors the efficiency with which the existing capital stock is deployed and thereby significantly increases the average return.

In as much as the securities market enlarges the financial sector, promoting additional and more sophisticated financing, it increases opportunities for specialisation, division of labour and reductions in costs in financial activities. The securities market and its institutions help the user in many ways to reduce the cost of capital. They provide a convenient market place to which investors and issuers of securities go and thereby avoid the need to search a suitable counterpart. The market provides standaridised products and thereby cuts the information costs associated with individual instruments. The market institutions specialise and operate on large scale which cuts costs through the use of tested procedures and routines.

There are also other developmental benefits associated with the existence of a securities market. First, the securities market provides a fast-rate breeding ground for the skills and judgement needed for entrepreneurship, risk bearing, portfolio selection and management. Second, an active securities market serves as an ‘engine’ of general financial development and may, in particular, accelerate the integration of informal financial systems with the institutional financial sector. Securities directly displace traditional assets such as gold and

stocks of produce or, indirectly, may provide portfolio assets for unit trusts, pension funds and similar FIs that raise savings from the traditional sector. Third, the existence of securities market enhances the scope, and provides institutional mechanisms, for the operation of monetary and financial policy.
While the above indicate that the securities market promotes economic growth, it is not one way relation. The economic growth also promotes securities market, which I am not discussing now.

Liberalised Securities Market and Economic Growth

Now let me explain how a liberalized securities market helps promote economic growth. The more liberalized a securities market is, the better is its impact on economic growth. Interventions in the securities market were originally designed to help governments expropriate much of the seigniorage and control and direct the flow of funds for favoured uses. These helped governments to tap savings on a low or even no-cost basis. In some economies governments used to allocate funds from the securities market to competing enterprises and decide the terms of allocation. The result was channelisation of resources to favoured uses rather than sound projects. In such circumstances accumulation of capital *per se* meant little, where rate of return on some investments were negative while extremely remunerative investment opportunities were foregone. This kept the average rate of return from investment lower than it would otherwise have been and, given the cost of savings, the resulting investment was less than optimum. This led mainstream development economists to argue that liberalization of securities market is the road to higher levels of domestic savings/investment and more efficient allocation of capital.

The implication of intervention is illustrated in figure 1. The vertical axis represents cost of capital and rate of return on investment and the horizontal axis represents the amount of capital raised from the securities market. With intervention, the demand for investment is represented by DdD, which indicates lower average rate of return corresponding to sub-optimal resource allocation. As the level of investment increases to OD, the maximum permitted by the authorities, the average rate of return decreases as relatively less remunerative investments are approved. SS represents the supply of capital. This results in an investment of K. If, however, intervention is withdrawn, rate of return will go up causing a shift in demand for investment schedule to D_1D_1, which will be down ward sloping through out. This would result in higher investment and consequently income which would shift supply schedule of capital to S^1S^1. The investment would further increase to K* and rate of return would improve to r*. Rate of return improves because removal of intervention rations out low yielding investments. As the cost of capital goes up, the entrepreneurs are likely to switch to less capital-intensive technologies. Such technologies may not only raise the average productivity of capital, but also represent appropriate technology provided by relative availability and cost of labour and capital in the economy. Letting rate of return be determined by the market mechanism would reduce or even eliminate the costs involved in credit rationing arrangements and thereby enhance the efficiency of the economy as a whole. High rate of return would stimulate demand for financial assets and expand financial sector.

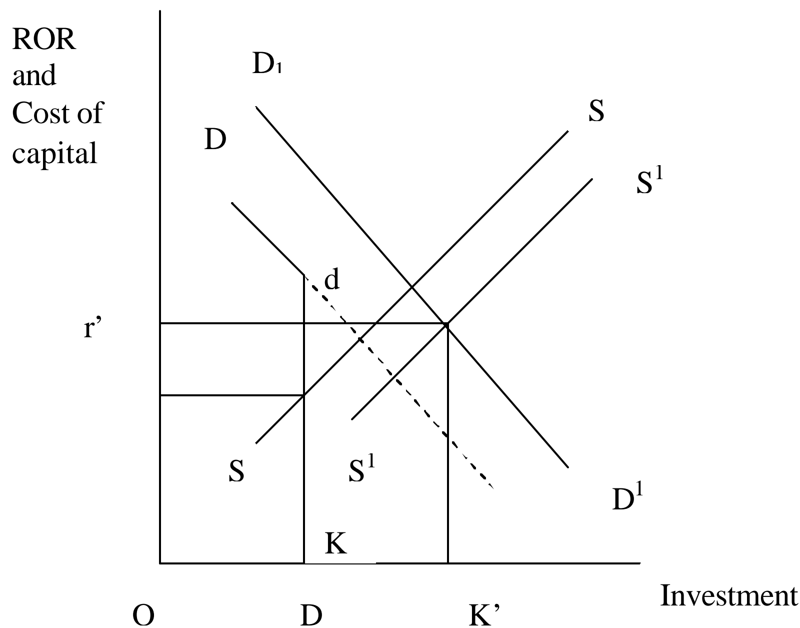

Figure 1: Effect of liberalisation of Securities Market

One of the bitter fruits of intervention has been the shrinkage of the securities market. When subject to effective expropriation through suppressed return on investment, people naturally seek a proper reward elsewhere, either through capital flight, through a retreat to underground or through the hoarding of goods. People keep their savings out of the markets. The underground sector allocates the resources, but relatively inefficiently. Another major consequence has been insulation of developing countries from international capital markets. The domestic market is shielded from competition.
Misallocation of resources can result because of distorting interventions or the presence of market failure either in the goods market or in the securities market, which are interlinked. Improvement in allocation efficiency, therefore, requires removal of distortions from both the markets.

Significance in Indian Economy

Three main sets of entities depend on securities market. While the corporates and governments raise resources from the securities market to meet their obligations, the households invest their savings in the securities. I will now dish out a few statistics, mostly taken from the Indian Securities Market Review, a publication of the National Stock Exchange, to indicate the level of significance. While corporate sector and governments together raised a total of Rs. 226,911 crore from the securities market during 2001-02, there are about 20 million investors who have invested in the securities. Tables 1 and 2 indicate the significance of the securities market in Indian economy.

Table 1: Dependence on Securities Market

Year	Share (%) of Securities Market in			
	External Finance of Corporates	Fiscal Deficit of Central Government	Fiscal Deficit of State Government	Financial Savings of Households
1990-91	19.35	17.9	13.6	14.4
1991-92	19.17	20.7	17.5	22.9
1992-93	33.38	9.2	16.8	17.2
1993-94	53.23	48.0	17.6	14.0
1994-95	44.99	35.2	14.7	12.1
1995-96	21.67	54.9	18.7	7.7
1996-97	22.12	30.0	17.5	6.9
1997-98	28.16	36.5	16.5	4.5
1998-99	27.05	60.9	14.1	4.2
1999-00	33.58	67.1	13.9	7.3
2000-01	31.39	61.4	13.8	4.3
2001-02	N. A	69.4	15.2	N. A

Source: Economic Intelligence Service-Corporate Sector, CMIE & RBI (Copies from Indian Securities market Review, a publication of NSEIL).

The Indian economy witnessed a descent growth of 6% per year in 1990s against euphemistically described as Hindu Growth Rate of 3.5% over preceding four decades. This was possible by contributions mostly by the organised secondary and tertiary sectors (industry and service). The securities market helped these organized sectors, corporate and government, to raise resources to realise a growth rate of 6%. Of late the activity in the securities market has slowed down, so also the level of activity in the economy.

Table 2: Resource Mobilisation from the Primary Market

(Rs. cror

Issues	1990-91	1991-92	1992-93	1993-94	1994-95	1995-96	1996-97	1997-98	1998-99	1999-00	2000-01	200
Corporate Securities	**14,219**	**16,366**	**23,537**	**44,498**	**48,084**	**36,689**	**37,147**	**42,125**	**60,192**	**72,450**	**78,396**	**74,4**
Domestic Issues	14,219	16,366	23,286	37,044	41,974	36,193	33,872	37,738	59,044	68,963	74,199	72,0
Non-Govt. Public Companies	4,312	6,193	19,803	19,330	26,417	16,075	10,410	3,138	5,013	5,153	4,890	5,6
PSU Bonds	5,663	5,710	1,062	5,586	3,070	2,292	3,394	2,982	-	-	-	
Govt. Companies	-	-	430	819	888	1,000	650	43	-	-	-	3
Banks & FIs	-	-	356	3,843	425	3,465	4,352	1,476	4,352	2,551	1,472	1,0
Private Placement	4,244	4,463	1,635	7,466	11,174	13,361	15,066	30,099	49,679	61,259	67,836	64,9
Euro Issues	-	-	702	7,898	6,743	1,297	5,594	4,009	1,148	3,487	4,197	2,3
Government Securities	**11,558**	**12,284**	**17,690**	**54,533**	**43,231**	**46,783**	**42,688**	**67,386**	**106,067**	**113,336**	**128,483**	**152,5**
Central Government	8,989	8,919	13,885	50,388	38,108	40,509	36,152	59,637	93,953	99,630	115,183	133,8
State Governments	2,569	3,364	3,805	4,145	5,123	6,274	6,536	7,749	12,114	13,706	13,300	18,7
Total	**25,777**	**28,650**	**41,227**	**99,031**	**91,315**	**83,472**	**79,835**	**109,511**	**166,259**	**185,786**	**206,879**	**226,9**

Source: RBI. (Copied from Indian Securities Market Review, a publication of NSEIL

Corporate Sector: The 1990s witnessed emergence of the securities market as a major source of finance for trade and industry. A growing number of companies are accessing the securities market rather than depending on loans from FIs/banks. The corporate sector is increasingly depending on external sources for meeting its funding requirements. There

appears to be growing preference for direct financing (equity and debt) to indirect financing (bank loan) within the external sources. According to CMIE data, the share of capital market based instruments in resources raised externally increased to 53% in 1993-94, but declined thereafter to 31% by 2000-01.

Average annual capital mobilisation from the primary market, which used to be about Rs.70 crore in the 1960s and about Rs.90 crore in the 1970s, increased manifold during the 1980s, with the amount raised in 1990-91 being Rs. 4,312 crore. It received a further boost during the 1990s with the capital raised by non-government public companies rising sharply to Rs. 26,417 crore in 1994-95.

The market appears to have dried up in the late 1990s due to inter play of various factors. The corporates have shifted focus to other avenues for raising resources like private placement where compliance is much less. Available data, although scanty, indicate that private placement has become a preferred means of raising resources by the corporate sector. Private placement contributed about Rs. 65,000 crore during 2001-02. The corporate sector raised a total Rs. 74,403 crore during 2001-02 from the securities market.
The market is getting institutionalised as people prefer mutual funds as their investment vehicle, thanks to evolution of a regulatory framework for mutual funds. The net collections by mutual funds picked up during 1990s and increased to Rs. 19,953 crore during 1999-2000. Starting with an asset base of Rs. 25 crore in 1964, the total assets under management at the end of January 2003 was Rs. 121,806 crore.

Governments: Along with increase in fiscal deficits of the governments, the dependence on market borrowings to finance fiscal deficits has increased over the years. During the year 1990-91, the state governments and the central government financed nearly 14% and 18% respectively of their fiscal deficit by market borrowing. In percentage terms, dependence of the state governments on market borrowing did not increase much during the decade 1991-2001. In case of central government, it increased to 69.4% by 2001-02. The central government and the state governments together borrowed Rs. 110,510 crore from market during 2001-02 against Rs. 10,557 crore in 1990-91.
The primary issues of the Central Government have increased many-fold during the decade of 1990s from Rs. 8,989 crore in 1990-91 to Rs. 133,801 crore in 2001-02. The issues by state governments increased by about five times from Rs. 2,569 crore to Rs. 18,707 crore during the same period.

Households: According to RBI data, household sector accounted for 89% of gross domestic savings during 2000-01. They invested only 4% of their savings in securities, including government securities and units of mutual funds during 2000-2001. The share of financial savings of the household sector in securities (shares, debentures, public sector bonds and units of UTI and other mutual funds and government securities) is estimated to have gone down from 22.9% in 1991-92 to 4.3% in 2000-01.

Investor Population: The Society for Capital Market Research and Development carries out periodical surveys of household investors to estimate the number of investors. Their first survey carried out in 1990 placed the total number of share owners at 90-100 lakh. Their second survey estimated the number of share owners at around 140-150 lakh as of mid-1993. Their third survey estimates the number of shareowners at around 2 crore at 1997 end. According to the SEBI- NCAER survey of Indian investors conducted in early 1999, an estimated 12.8 million, or 7.6%, of all Indian households representing 19 million individuals had directly invested in equity shares and or debentures as at the end of financial year 1998-99. An estimated 15 million, or nearly 9%, of all households representing at least 23 million unit holders had invested in units of mutual funds.

Disinvestment Programme

The disinvestment programme in India would not have been successful if it did not have a well developed securities market. So far, Government of India has been able to disinvest to the tune of over Rs. 31, 000 crore, including about Rs. 5,000 during the current fiscal.

Reforms in Securities Market

With the objectives of improving market efficiency, enhancing transparency, preventing unfair trade practices and bringing the Indian market up to international standards, a package of reforms consisting of measures to liberalise, regulate and develop the securities market was introduced. The practice of allocation of resources among different competing entities as well as its terms by a central authority was discontinued. The issuers complying with the eligibility criteria were allowed freedom to issue the securities at market determined rates. The secondary market overcame the geographical barriers by moving to screen based trading. All kinds of securities – debt and equity, government and corporate – are traded on exchange side by side. Trades enjoyed counter-party guarantee. The trading cycle shortened to a day and trades are settled within 3 working days, while all deferral products were banned. Physical security certificates almost disappeared. A variety of derivatives were permitted. Corporate governance has improved significantly. As a result of these reforms, the market design has changed drastically for better as may be seen from Table 3. This has boosted the confidence of international investors in Indian securities market. Indian market is getting integrated with the global market though in a limited way through euro issues. Since 1992, when they were permitted access, Indian companies have raised about Rs. 37,000 crore through ADRs/GDRs. More than 500 FIIs are currently registered with SEBI. They have made net cumulative investments of about US $ 16 billion by the end of February 2003. One can gauge the extent of reforms in the securities market from the change in transactions costs. The market impact cost of transactions in equity on stock exchanges has reduced from 0.75% in mid-1993 to 0.10% in January 2003. The brokerage has reduced from 3% to 0.15%. Lower transaction cost means higher attraction for investors in securities and issuers of securities to participate in the market on a larger scale.

Table 3: Elements of Market Design in Indian Securities Market, 1992 and 2003

Features	1992	2003
Regulator	No Specific Regulator, but Central Government oversight	A specialized regulator for securities market (SEBI) vested with powers to protect investors' interest and to develop and regulate securities market. SROs strengthened.

Intermediaries	Some of the intermediaries (stock brokers, authorized clerks and remisiers) regulated by the SROs.	A variety of specialized intermediaries emerged. They are registered and regulated by SEBI (also by SROs). They as well as their employees are required to follow a code of conduct and are subject to a number of compliances.
Access to Market	Granted by Central Government	Eligible issuers access the market after complying with the issue requirements.
Pricing of Securities	Determined by Central Government	Determined by market, either by the issuer through fixed price or by the investors through book building
Access to International market	No access	Corporates allowed to issue ADRs/ GDRs and raise ECBs. ADRs/GDRs have two way fungibilty. FIIs allowed trade in Indian market. MFs also allowed to invest overseas
Corporate Compliance	Very little emphasis	Emphasis on disclosures, accounting standards and corporate governance
Mutual Funds	Restricted to public sector	Open to private sector and emergence of a variety of funds and schemes
Trading Mechanism	Open outcry, Available at the trading rings of the exchanges, Opaque, Auction/negotiated deals	Screen based trading system, Orders are matched on price-time priority, Transparent, Trading platform accessible from all over country
Aggregation order flow	Fragmented market through geographical distance. Order flow unobserved.	Order flow observed. The exchanges have open electronic consolidated limit order book (OECLOB).
Anonymity in Trading	Absent	Complete
Settlement System	Bilateral	Clearing House of the Exchange or the Clearing Corporation is the central counter-party
Settlement Cycle	14 day account period settlement, but not adhered to always	Rolling settlement on T+3 basis
Counterparty risk	Present	Absent
Form of Settlement	Physical	Mostly Electronic
Basis of settlement	Bilateral Netting	Multilateral Netting
Transfer of securities	Cumbersome. Transfer by endorsement on security and registration by issuer	Securities are freely transferable. Transfers are recorded electronically in book entry form by depositories.
Risk Management	No focus on risk management	Comprehensive risk management system encompassing capital adequacy, limits on exposure and turnover, VaR based margining, client level gross margining, on-line position monitoring etc.
Derivatives	Absent	Exchange traded futures and Options available on

Trading		two indices and select securities

Market is efficient means the enterprises that do well in the real sectors are rewarded with funds for growth and expansion. All these inevitably lead to higher economic growth.

Road Ahead for Securities Market

The securities market promotes economic growth. More efficient is the securities market, the greater is the promotion effect on economic growth. It is, therefore, necessary to ensure that our securities market is efficient, transparent and safe. In this direction, SEBI has been working since its inception and would continue to work to continuously improve market design to bring in further efficiency and transparency to market and make available newer and newer products to meet the varying needs of market participants, while protecting investors in securities. The aim is to make Indian securities market a model for other jurisdictions to follow and make SEBI the most dynamic and respected regulator globally.

Some of the initiatives on which SEBI is working are:

a. Introducing exchange traded interest rate derivatives
b. Promoting an index to comprehensively reflect the level of corporate governance
c. Setting up a central listing authority to dynamise listing requirements
d. Facilitating demutualization of stock exchanges
e. Building a cadre of securities market professionals through training and certification
f. Constructing a central registry of securities market participants and professionals
g. Rationalising margin trading, securities lending and short selling
h. Promoting secondary market for corporate debt securities
i. Implementing market wide straight through processing from trade initiation to settlement
j. Operationalising T+1 rolling settlement
k. Reviewing all regulations of SEBI and code of conduct for intermediaries
l. Providing a legal framework for central counter party
m. Consolidation of exchanges and other market participants
n. Benchmarking Indian securities market with best in the World

I am sure, these measures would definitely improve efficiency of the market leading to higher economic growth.