Globalization of Indian Capital Market

Shitin Desai
Vice Chairman
DSP Merrill Lynch Ltd.

The Indian capital markets have since the beginning of the process of liberalization in the country in the early nineties have become increasingly integrated with the global markets. This has resulted in significant gains for the economy by superior allocation of resources and better specialization of labour.

Indian capital markets have off late shown signs of maturing with the gradual adoption of globally accepted procedures and practices. Several companies have adopted the US Generally Accepted Accounting Practices ("GAAP") which ensures greater transparency in financial statements. Corporate Governance is being given impetus by limited companies as part of their efforts in greater disclosures as well as protecting shareholder value. The Securities and Exchange Board of India ("SEBI") has played an extremely important role in the development of a vibrant and well regulated capital markets. It has introduced stringent disclosure and entry norms for corporate issuers by making it mandatory for issuers to place at least 60% of the issue to Qualified Institutional Investors ("QIBs") thereby ensuring that only quality issues are listed. Further, regular disclosure standards have been given a greater impetus with quarterly reporting and half yearly results with limited audit review.

Today international financial trends have a much greater impact on the domestic stock exchanges. Accordingly, for example, market participants in India keenly watch the steps being taken by the Federal Reserve Chairman Mr. Alan Greenspan to soft land the US economy through a series of interest rate hikes or the periodic numbers indicating the movement of unemployment and inflation in the US markets, as these would have an impact on the domestic stock movements. This in turn indicates that the Indian economy and the capital markets can no longer isolate itself and escape the impact of the changes affecting the US and other leading markets.

Integration of World Economies

Today we are witnessing a gradual process of integration of the world economies, particularly through trade and financial flows across seamless boundaries. It may be defined as the process by which a national economy moves towards a single borderless world economy with open markets, that is markets without restrictions or barriers. In simple terms, globalization is the expansion of markets for goods, services, capital and labour beyond national boundaries.

The distinctiveness of a global economy are that intervention by the respective Governments is replaced to a large extent by market forces giving considerable flexibility to the market participants to take decisions from a purely commercial perspective disregarding nationality and place of origin.

The rapid progress in communication systems and in information technology has played a critical role in the globalization process. Developments in communication systems especially telecommunication, improved the flow of market reformation and speeded up the transfer of funds across the world. Similarly, advances in information technology, for example computerization, reduced the cost of transfer of funds and widened the margins. Consequently, global financial markets have become electronically connected 24-hour markets starting with the Japanese markets and circling the globe across Asia, Europe and eventually ending at the US markets in the 24 hour cycle.

Indian Capital Markets

The Indian capital markets, as was the Indian economy at large, was cocooned in a protectionist environment with myriad controls and restrictions. There were controls on foreign investments in different sectors, flow of foreign currency, access to domestic and international markets, commodity prices; in effect controls on conducting business in a commercial manner. The controls have, over the past decade since the process of liberalization was ushered in, been considerably eased and markets have become more liberalized. When the market, regulated by independent institutions, is the deciding factor and is able to define the flow of the economy, it results in a fluid economic environment that facilitates a balanced relationship with the global economy.

On a separate note, though liberalization is one aspect of achieving the balance, a cautious and studied approach is imperative. When the Asian crises broke out in July 1997 leading to a virtual free fall in the currency as well as falling market capitalization of companies in the stock markets of these countries, India remained an island of stability amidst the currency turmoil in the region. This relative stability was possibly due to a flexible exchange rate arrangement; gradual approach to liberalization and deregulation as well as a relatively cautious approach to capital account convertibility.

A robust economy will result only by the adoption of a prudent approach along with gradual moderation of the Indian capital markets

Increasing Role of the Foreign Institutional Investors

A major indication of our increasing integration with the global markets is the major role that FIIs play in the domestic capital markets. The scenario over the last fiscal reflects a greater participation by FIIs in the financial economy and today FIIs have become a very significant category of investors on the domestic bourses.

FIIs after a slow entry into the markets due to fears of bad delivery and other ills of the physical system have moved aggressively into the markets with the introduction of electronic trading and paperless settlement. The total investments by FIIs is estimated at over Rs. 51,000 crores which makes them as a category just behind UTI with a corpus of over Rs. 72,000 crores. With growing influence of the FIIs on the domestic bourses also brings with it the volatility that these investors bring to the stock exchanges. There was a sharp fall in the domestic markets in the first week of April 2000 due to the notices sent by the Income Tax department to select FIIs on alleged violation of the Indo Mauritius avoidance of double taxation treaty. The subsequent recovery of the markets upon withdrawal of these notices indicates the strong role of FIIs on the domestic markets.

The presence of the FIIs in the domestic markets has also led to a greater amount of disclosures and transparency from the domestic companies as they are very particular about their investments and those companies who were not willing to adopt the new paradigm shift in governance have seen their stocks beaten down in valuations.

Issuance of ADRs / GDRs by Indian Corporates

The easing in the capital raising norms has had a positive fall out for the Indian corporate as well. The step towards raising capital from the overseas markets began with Indian corporates raising resources through the issuances of Global Depository Receipts (“GDRs”) in the early nineties. Subsequently, the markets for overseas resource raising opened up with the issuance of American Depository Receipts (“ADRs”) in the vibrant and deep US markets by Infosys Limited and the consequent listing of the scrip on the tech heavy NASDAQ exchange. The compliance with the strict accounting and disclosure norms and the strong track growth demonstrated by the Infosys and Indian IT stocks in general based on the success of the offshore development model gave the scrip good response in the US markets. Thereby leading to a strong re-rating of the stock in the domestic markets leading to the “INFY” and the NASDAQ becoming household names in India.

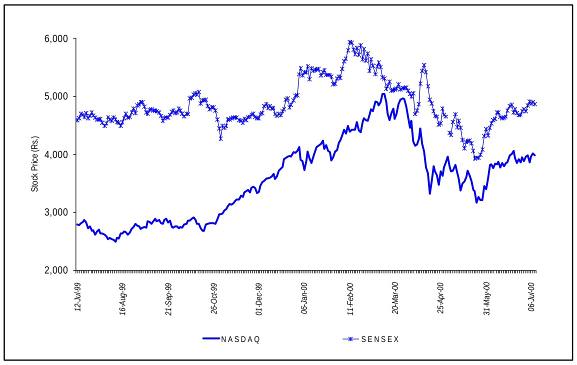
The strong response generated by the issue was also due to the lack of any Indian paper in the portfolio of US centric funds. Infosys offered them an opportunity to diversify into the high growth Indian IT sector which had built for itself a strong brand equity in the US markets with a reputation for high quality and adherence to strict delivery schedules. This issue opened up the sophisticated and deep US markets to strong Indian corporates complying with stringent accounting and disclosure norms. Subsequent issuances by Satyam Infoway, ICICI, ICICI Bank and more recently by Rediff and Silverline have further reinforced this trend.

An interesting fact on the integration is presented by the fact that the total amount raised in the international markets by Indian corporates in 1999-00 at over US $ 1040 million was marginally higher than the total amount raised by all corporates from the domestic markets through public and rights issues at US $ 1020 million. This illustrates the complimentary role played by the international markets to the domestic savings in the overall growth of the economy. The current year is likely to be a continuation of this trend from companies in the IT and the pharma sector.

Integration of Indian Markets with the Global Exchanges

Financial markets over the last fiscal showed strong signs of recovery. This recovery has been brought about on the back of improved economic conditions that marked the end of the 3-year cyclical slowdown. Additionally, strong domestic corporate performance (particularly from the technology sector) as well as the return of an optimistic economic outlook the world over, as the Asian economies recovered more rapidly than expected and the US continued its growth acceleration. The stock markets showed steady northward trend despite the Kargil conflict and the fall in the Union Government in early part of the fiscal year. The markets rebounded with renewed vigour post elections after the new government was sworn in. The rally was predominantly led by the TMT (“Technology, Media & Telecom”) stocks, which was reflective of the valuations commanded by the stocks in these sectors in the NASDAQ.

The listing of the Indian corporates on the US exchanges and the increasing influence has led to a piquant situation of the Indian stock markets getting strongly coupled to them, particularly the NASDAQ. It is now common for the market participants to watch the movements of the NASDAQ and based on the direction of movement of the NASDAQ composite index on the previous night, make a prediction on the likely movement of the BSE sensex and turn out right more often than not. The following graph illustrates the strong correlation between the BSE sensex and the NASDAQ over the past one year.



This might seem to be over reaction and might correct itself going forward as the NASDAQ is predominantly a tech heavy exchange whereas the BSE sensex is more broad based, though the so called "new economy" stocks of TMT sector have been playing an increasingly important role in the movements of the sensex after the inclusion of greater number of stocks from these sectors in the sensex. It is however clear that the Indian markets have become more integrated and cannot isolate themselves from the gyrations and the volatility of the global markets. Hence, events like the anti trust case on Microsoft or the increase in interest rates by the Federal Reserve would have its rumblings on the domestic bourses.

Some Concerns

It must be borne that substantial inflows of capital into economies pose problems for the exchange rates, money supply and interest rates. The flow of capital into a country's foreign exchange market increases the demand for the domestic currency which, as a result, appreciates. This worsens the trade balance by making export non competitive and imports cheaper. Further, capital inflows cause an expansion in money supply and impact interest rates at a time when the monitoring authorities would prefer a credit squeeze. The inflows accordingly would call for a management of the exchange rate and monetary policy.

Such capital inflows also aggravate the negative consequences of a globalization of the financial system. As large proportion of the foreign inflows are in the form of portfolio investment and short-term funds, they are by their nature extremely volatile. Any sudden and quick reverse capital flows upset the national economic policies being pursued.

Indian capital markets have to live up to this reality and the Government has to take steps to minimize the impact of these sudden outflows of capital. The phased time table drawn by the Tarapore Committee on the introduction of capital account convertibility linking it to the achievement of certain key milestones is a step in the right direction. It also throws up the issue of creating a global financial mechanism to protect the markets from the sudden movements of capital and debilitating influence it could have on economies.

Globalization of the Indian capital markets have given it the much needed depth and the consequent liquidity. It has helped strong Indian corporates to access resources from the international markets and has led India to be part and parcel of the movements in the financial markets globally. However, the markets have to realize that there is an upside as well as a downside to any trend and only those who are well prepared will emerge stronger.