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Relationship between capital Market, Capital Flows and Policy issues in the Indian context- A survey of the existing Literature.

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Abstract

In India, after the structural adjustment programme capital flows have increased drastically. It has been more than the current account deficit which did not record any such steep rises. This mismatch has created new challenges stabilization and exchange rate management in the economy. This paper elaborates on various aspects of the capital flows to India and their policy implications by reviewing the existing literature in this area.

Keywords: Capital Market, Capital Flows, Policy, Exchange rate

Introduction

Since the mid-1990s there has been a surge in capital flows to the Indian economy. Capital flows to India gained momentum from the 1990s after the initiation of economic reforms. We can see that not only there is change in the size of capital inflows to India but also there is a compositional shift in these flows. Predominantly official and private debt flows are giving way to non-debt creating flows. If the absorption capacity of the economy is less huge inflows over a short span of time can cause upward pressures on the exchange rate, overheating of the economy, and possible asset price bubbles. So what do the studies tell us about the implications of these flows, policy issues and their solutions? Let us review the existing literature on the same

Studies on capital market, capital flows and policy issues in the Indian context

S.S Tarapore (1999)[1] covers various vital aspects of financial policy including monetary and credit policy, development of the money market, regulation and supervision in the financial section, fiscal issues, exchange rate policy and the debate on capital account convertibility. He attempts to contribute meaningfully to the ongoing debate on financial sector reform of 90's. He argues that full account convertibility would invite the danger of financial crises in India.

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Gopinath (1997)[2] makes a revision of the policy issues on foreign investment. He also analyses the flow of foreign investment by dividing it into different phases. The methodology used consist of secondary data, the study is mainly descriptive in nature without much statistical and empirical analysis to support the arguments. Still it helps in providing a critical overview of major policy issues

Chakraborty(1999)[3] attempts to explain the effects of inflows of private foreign capital on some major macro economic variables in India using quarterly data for the period 1993-99.Using VAR and co integration models she points out that co-integration exists between foreign currency assets and money supply and between nominal effective exchange rates and exports. An important drawback of the study is that she fails to detect the causal factors behind this co integration

Avadhani (1997)[4] gives a comprehensive treatise on capital markets in India. It is a manual of entire spectrum of law procedures and practices relating to issue management, capital markets, listing, stock exchanges analysis and portfolio management and SEBI guidelines (issued up to 30the Jan 1997). He is able to provide the basic understanding on capital markets from a literary perspective only.

Vyuptakesh Sharan & Indra Nath Mukherji(2001)[5] argues that before the onset of the reforms in India, the foreign trade, investment and debt scenario was in a state of serious distress with retrogressive consequences for the pace of development. This initiated the process of economic reforms and liberalization in the country. Of the gamut of reforms introduced in the early1990's they focuses exclusively on those in the external sector and examines the reform measures in this area and evaluates their adequacy and effectiveness. They provide an analysis of improvements, in the size and structure of foreign trade with the ultimate goal of reducing the current account deficit. They give the following suggestions

- Increase in direct portfolio foreign investment to meet the deficit.
- Alleviation of the external debt burden.
- Strengthening of the BOP position through Indian Ventures abroad.

The picture that emerges does much to demystify the subject and unravel interrelated issues with clarity.

Kvalijit Singh (1997)[6] critically investigates and analyses the main reasons and motives of German investments in India during the post liberalization period (1991-96). According to him there are three major Reasons for German corporations to invest in India (I) Availability of cheap labor and toothless labor laws (II) India's huge domestic market for goods and services (III) Least environmental and public health regulations with their ineffective implementation by state machinery. He argues that it is becoming economically unviable for the German corporations to continue their manufacturing in Germany and they are shifting their manufacturing plants to India. He documents cases of illegal and unethical practices committed by German corporations in India. It calls for immediate action by the Indian authorities to take steps to enforce regulatory mechanism and legislations.

Vathsala Mani (1978)[7] identifies the causes for the inadequacy of the traditional theory of capital movements. She tries to improve upon the predictability of these theories by introducing new assumptions of Economies of Scale and Transfer Costs and by focusing on the features of the economy which have a close bearing in its capacity to absorb the inflow of foreign capital.

Shah and Thomas (1997)[8] strongly advocate stock market reforms in India. They studied the capital markets using VAR, Efficiency indexes and other econometric techniques on the various stock market indicators like market capitalization, volatility etc from 1991-1996 . Through a comparative analysis of banks and stock markets they find out that banks and stock markets compete in two dimensions i.e. to maximize the quality of their information processing and to minimize the transaction costs. In India stock markets are more efficient than banks in both dimensions; also stock markets have more freedom to process information. The stock market development plays a key role in assisting the banking sector reforms. Efficient stock markets contribute to the long run growth of the real economy through efficient allocation of scarce savings and improving fund utilization efficiency. Analyzing the effect of FPI on the real economy they have concluded that it has a positive impact via the asset effect and lower cost of capital. They point out that the transaction costs in the stock markets have declined considerably.

Ajith Singh (1998)[9] believes in just the opposite ideology of Shah and Thomas. He argues that the real economy did not benefit from the stock market boom. Stock market boom did not lead to an increase in the domestic savings of households in India .Households merely shifted from bank deposits to corporate securities as an investment avenue. He pointed out that variations in corporate investments cannot be attributed to variations in resources raised from the stock markets. Increased productive use of investment resources was also absent.

Nagraj (1996)[10] examines empirically the long term trends in India's capital markets. He then links these trends to the structural changes that have taken place in the economy's saving pattern. The variables used are the amount of capital raised, share of financial saving in GDS, Gross fixed capital formation, corporate GFCF as percentage of GDCF, corporate profitability etc for 1960-1995 .He finds out that the growth of Indian capital market was in fact financial disintermediation (household portfolio substitution effect). No correlation was found to exist between growth rate of capital mobilization and aggregate saving rate as well as between corporate physical investment and value added. In the 1980's statistically significant correlation did not exist between annual growth rate of external capital and corporate fixed capital formation (it was present earlier). Though the ratio of corporate tax to gross profit showed a decline, the contribution of internal finance to corporate fixed investment did not show a long term increasing trend (declining trend). In the 1980's the growth of the real value added in the corporate manufacturing sector was found to be less than that of the registered manufacturing sector as a whole, suggesting that in the case of small corporate firms with no access to stock market funds growth rate exceeded than that of the large corporate firms.

Nagraj's finding regarding the corporate GFCF is questionable because the corporate GFCF as percentage of GFCF and GDP doubled in1990's when compared to 60's and 70's. Similarly the idea of financial disintermediation is unrealistic because if it was so there would have been huge decline in bank deposits, which did not happen according to the RBI statistics.

Prantab Basu and Mathew R Morey(1998)[11] analyzed the impact of economic policy reforms on stock market prices in India (1957-1996).They tested the random walk hypothesis using Famas efficient market hypothesis . Their study points out how the reforms since 1984 affected the market structure and efficiency of major stock markets in India (BSE and NSE). They found that from mid 1980's equity prices in India behaved like a random walk suggesting that the market obeyed Fama's efficient market hypothesis till the scam of 1992. After 1992 the equity prices were influenced by external factors and whether the market still obeyed the hypothesis (if yes why? if no why?) the questions remain unanswered in their study.

Shah and Thomas (2001)[12] offer some conceptual insights into the problem of obtaining liquid securities markets in small countries. They used cross country data sets and case studies of India, Mauritius and Middle East financial Network .The analysis of the turnover ratio with the log models and the market capitalization leads to the following conclusions .Small countries do appear to have limitations in supporting the modern securities industry since they trade in small securities which has less liquidity . Shah and Thomas suggest that these countries can think of two innovative policy options. First is the unification of all organized financial trading into a single securities market and the second is exploiting the international linkages through outsourcing of IT functions of core exchange institutions or listing on markets outside the country.

Lalitha (1995) [13] examined the problems and prospects of new issue markets in India .She has focused on the new issues by the private corporate sector in 1998. Public issues were analyzed based on (a) type of industry (b) size of firm (c) age of firm and (d) size of issue. Much of the work focuses on the policy incentives of the government and how it influenced the public issues E.g. Introduction of new securities increasing interest rate on debentures had increased the activity in the new issue market. Lalitha emphasizes the need for spreading equity cult throughout the country. However the study lacks any theoretical or mathematical conclusion with regard to the impact of reforms on the new issue market.

Parthapratim Pal (2006)[14] examines the impact of FPI on India's economy (1991-2005) and industry. Using the market capitalization ratio, resource mobilization from the primary market, composition of household saving in financial assets etc he finds that the perceived benefits of FPI have not been realized in India. The supposed linkage effects between the secondary market boom and the real economy have not worked in the way the main stream model predicted. Instead it has lead to increased uncertainty, skepticism and serious problems of macroeconomic management for policy makers.

Shah and Thomas (2001)[15] presents the results of their descriptive study on policy issues in the Indian securities market .They make a critical analysis of the policies adopted by RBI and SEBI and what are the implications of these policies for the securities market . They find that the reforms have transformed the capital market in India and had a positive impact on the market. Still a more detailed analysis shows that we have to again make adjustments in our policies so that we have better enforcement, compatible institutional mechanisms and more internationally integrated market.

Conclusion

These reviews present a very interesting picture. Most of the reviews acknowledge the linkages between capital flows and internal and external factors. In the Indian context one could say that compared to the studies on capital markets their institutional structure and reforms, very few studies have been made on the capital flows to India. Also among those studies which concentrate on the capital flows major focus has been on the factors which influence these flows rather than on their impact. This gives rise to a research gap i.e. how these capital inflows affect the capital markets and the real economy once they flow without any barriers in a globalized environment? Or to be precise what are the impact of these flows? The exact nature of these research questions can be explained only if more studies come in this context.

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