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Capital Markets are an Instrument for Capital Formation

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Employment is needed for the good of the public at large. Employment generation cannot happen without economic development, which in turn, requires investment. Investment is possible either through FDI or domestic saving and capital formation.

Our overdependence on FDI will not lead us anywhere. When the whole world, including countries like the US, Australia are running after FDI, it is naturally a scarce commodity. Clearly, it is highly unlikely for us to beat this global competition. We have therefore to look for domestic avenues for capital formation.

The objective of capital markets is to channelize savings to entrepreneurs in the form of debt and equity. With Indian stock markets hitting records levels every day, some uncomfortable truths have been lost sight of. Firstly, it must be accepted that stock exchange indexes (the Sensex, Nifty, etc.) are not the barometer of the capital market, but at best a reflection of sentiments and future expectations. The health of the capital market depends on liquidity and retail participation, both of which are missing in the current stock market. Only when the capital markets are healthy, can they perform their role in capital formation.

The Indian public does hold assets for very long periods of time. They start buying jewelry when a girl child is born; invest in government bonds like Kisan Vikas Patra, and of course in land. The long-term nature of their savings is perfectly suited to the needs of the economy, which requires investment projects with long gestation periods. Therefore, these savings need to be tapped into by introducing newer products. It is time instruments like Silver ETFs and delivery-based trading on the currency exchange are introduced. New products will bring in new investors. A case in point is the Gold ETF, which had Rs. 7,188 crores asset as on 31st December 2014. The total asset under management under Gold and other ETFs and Fund of Funds that invest overseas was Rs. 16,558 crores as per SEBI's latest data. While this pales in comparison to the total AUM of the mutual fund industry, which stands at over Rs. 10 lakh crores, it must be accepted that these newer instruments have brought in new investors to the market.

Financial literacy is of utmost importance to familiarize people with the working of the financial markets and its various aspects and must be promoted vigorously. Under no circumstances should it lead to an impression that we are moving towards a 'caveat emptor'. One of the biggest reasons for people to not invest their hard-earned money in the stock market has to do with its image, where fortunes are made or lost depending on luck. For every story in their circles, where someone has made money in the stock market, there are others where people have lost all their money.

More often than not, the loss would be the consequence of bad stock selection, faulty trading strategies or simple greed.

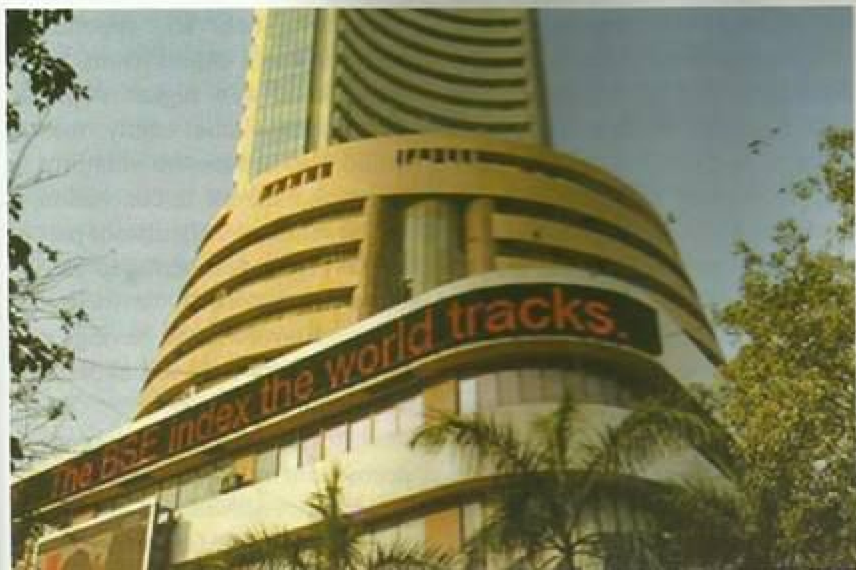
The government must gradually list all public Sector enterprises; else, all the money would be chasing only a few stocks leading to unsustainable valuation and the consequent disappointment. The government should not look at the listing of companies from the narrow prism of raising resources to overcome fiscal constraints or to invest in other sectors. It has been seen that the governments taps the primary/secondary market only when it faces the resource constraints. A welcome approach would be to look at disinvestment as a method to supply good quality stocks for people to invest in.

Some Important Highlights

1) Our overdependence on FDI will not lead us anywhere. When the whole world, including countries like the US, Australia are running after FDI, it is naturally a scarce commodity.
2) Stock exchange indexes (the Sensex, Nifty, etc.) are not the barometer of the capital market, but at best a reflection of sentiments and future expectations.
3) Financial literacy is of utmost importance to familiarize people with the working of the financial markets and its various aspects and must be promoted vigorously.
4) Though the savings ratio of the households (as a percentage of GDP) is high, a large part of it is parked in non-productive sectors like land/real estate, gold, etc., whereas the productive sectors of the economy are either starved of capital or face a prohibitive cost of borrowing.
5) Foreign inflows do not come to support government's development agenda and will disappear at the slightest hint of economic problem or to earn a marginally higher risk adjusted return if such an opportunity presents itself.

The Jan Dhan Yojana for financial inclusion has been a stupendous success and has been making news across the globe. We must try to find ways to bring/ encourage these people to save through financial investments, rather than in physical assets. This one scheme if properly capitalized upon could be the most significant step in puling people out of poverty.

Regulators should realize that the whole financial system with all its stakeholders needs to be protected to protect retail investors. The latter cannot be saved by placing undue regulatory burden on other market participants. For example, the broking industry suffers from the lack of participation of the retail investor, over-regulation and high cost of transactions. The number of registered brokers in the cash segment was 10,268 in the year 2011-12, while that of the sub-brokers was 77,141. The corresponding figure as on 31st December 2014 was 7,350 and 44,540 respectively. This means that around 3,000 brokers and over 30,000 sub-brokers have gone out of business in a short span of only three years. The government, instead of leveraging the pan-India network of brokers and sub-brokers to promote financial literacy and mobilization of savings, has been burdening them with compliances.



According to calculations done by ANMI, government levies account for 54% of the total transaction cost for delivery and a whopping 68% for intraday in the cash market. Government levies in the futures market amount to 52% of the total cost. The benefits of long-term investor in reducing the stock market volatility are repeated ad-nauseam. They provide liquidity and ensure that the market remains efficient. Statutory levies on stock trading like Securities Transaction Tax, Stamp Duty, Service Tax, etc., raise the impact cost of stocks and reduce liquidity. This hampers the efficient assimilation of information in the stock price and reduces market efficiency. To the extent stock market is considered a barometer of the economy such statutory levies interfere with the working of this instrument. These government levies have also led to a shift in the trading activities in Indian stocks to other low-cost markets like Singapore. Not only is the revenue generated from these levies small, they impose a disproportionately huge indirect cost on the economy.

India needs a massive investment in almost all the sectors of the economy. Though the savings ratio of the households (as a percentage of GDP) is high, a large part of it is parked in non-productive sectors like land/real estate, gold, etc., whereas the productive sectors of the economy are either starved of capital or face a prohibitive cost of borrowing. A worrying fact is that the gap between savings in financial and physical assets has increased. According to CSO figures in the year 2009-10, the total household savings was 25.2% of the GDP and investment in financial assets made up 47.6% of this. According to the first revised estimate for the year 2012-13, this share had fallen to 32.4%. The overall household savings rate had also fallen to 21.9% in the meanwhile. The government thus faces a threefold task when it comes to the savings rate: first, to raise the overall savings rate, second, to increase the share of financial assets in the household savings and third, to divert this saving towards the equity market which would be available as risk capital to the industry.

Economic development of country does not necessarily mean overdependence on foreign inflows. These funds do not come to support government's development agenda and will disappear at the slightest hint of economic problem or to earn a marginally higher risk adjusted return if such an opportunity presents itself. Apart from many other benefits, a higher domestic investment in the equity market would also reduce the volatility in the stock markets. In conclusion, it can be said that a significant part of the savings investment gap can be met domestically if we focus our attention on domestic savings and take necessary steps to link it to the wider capital market.

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