

THE STOCK MARKET AS AN INSTRUMENT OF NATIONAL DEVELOPMENT

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In this paper I will try to identify what in my view are the national expectations from the stock market and its major players. I begin with the presumption that the existence and flourishing of the stock market is not intrinsically good. It is not an end in itself. The progress of the stock market is desirable only if it contributes to national development.

Economic theory has traditionally emphasized the efficiency enhancing role of the stock market. The capital market facilitates the movement of capital from low to high profit earning sectors assuming perfect information, negligible transaction costs and universal max-min rationality. The Efficient Market Hypothesis holds that share prices can guide money capital to firms which can employ it most efficiently. Fund managers and brokers specialize in the conception and articulation of efficient accumulation strategies. They are, therefore expected to be more rational than shareholders, specially small shareholders. However, 'insiders' have the ability to violate general system rules with impunity as the Enron crisis of 2002 has shown. Moreover, today information has become a traded commodity and it is asymmetrically distributed. Relocation of money capital in the financial markets may therefore not lead to efficiency gains in the real economy. Speculative activity distorts the efficiency enhancing capability of the stock market. This is specially true of relatively "thin" markets such as ours with few suppliers of long term finance and new listings lagging significantly behind the growth in aggregate capitalization.

Empirical studies of the Karachi stock exchange have shown high volatility of stock prices. Studies have shown that there are few long-term investors. The market has become incessantly dominated by speculators who invest only in order to make large short-term gains. A large majority of investors enter the market when it is strong and

abandon it when it falls. There is a strong positive correlation between the volume of trading and expected rates of return. The contribution of the stock market to financing long-term investment is, therefore limited.

The growth of the stock market must be seen as a means for increased domestic resources mobilization, enhancing the supply of long term financing and encouraging the efficient use of existing assets.

In a long term perspective, stock markets are expected to play several key roles. First, spreading the risks of long-term investment projects. The growth of stock markets can lead to a lower cost of equity capital and thereby stimulate investment and growth. Second, by imposing a degree of control over the investment behavior of companies through continuous monitoring of their share prices and thereby of the implied possibility of merger and takeover, stock markets can contribute to more efficient investment. Thirdly, by attracting foreign portfolio flows, the expansion of stock market can serve to enhance the supply of investable resources.

It would be erroneous, however, to assume that widespread agreement exists among economists or in the broader policy-making community about these aspects of the stock market, or about their effectiveness and desirability. This is part of a wide-ranging debate about the kinds of financial markets and institutions that best serve economic growth. Analysis, mostly in the context of developed countries, shows that the risk sharing and efficiency enhancing functions of the stock market are not without cost.

A fundamental cost relates to the efficiency with which project risks are diversified and priced. Are the capital markets functioning, in practice, in the manner prescribed by modern financial theory or are there binding imperfections and distortions? For example, much research claims that observed volatility is not warranted by changes in fundamentals and that this has adverse implications for capital formation and social welfare.

The East Asian crises of 1997 and 1998 give some evidence to substantiate the view that stock market behaviour is not related to fundamentals. The 'fundamentals' of South Korea, Malaysia and Thailand did not suddenly deteriorate. Investors displayed herd behaviour and there was massive exit of capital from equity and currency markets within a space of four to six months. Once the stampede got underway, it became rational to leave as soon as possible for there is no international lender of last resort in the world economy. This underlines the fact that one very important cost of relying on stock markets is that such an investment strategy is highly risk prone and the countries, which adopt it, open themselves to unpredictable and cascading speculative attacks. However, the same can be said of an investment sourcing strategy, which relies primarily on short-term foreign borrowing or structured finance deals with the international banks.

Emergent markets are usually characterized by pricing inefficiencies reflected in first order serial correlation in stock prices. The sign of the serial correlation in such markets suggests an interesting hypothesis. Positive serial correlation is likely to result

from slow incorporation of new information, insider dealing, or frequent trading. There are good reasons to believe that there are informational inadequacies in Pakistan's capital markets; there are barriers to the dissemination of information and companies appear to divulge less information with a greater time lag than is the norm in developed markets. Moreover, if the cost of capital to the speculator is high, which is likely to be so in an incompetently regulated financial system, then the volume of trading (and particularly the volume of arbitrage) will be lower than is necessary for efficient pricing. On the other hand, negative serial correlations are more likely to occur in thin, speculative markets

Stock market functioning must thus facilitate.

- **Provision of new long term capital inflows**
- **Diversification of risk**
- **Efficient allocation of resources through optimizing the impact of financial capital transfers on physical capital formations within the country**
- **Attraction of the right type of non destabilizing portfolio capital from abroad**

In order for the capital market to adequately perform these functions the most important requirement is the credibility of its governance processes. If those responsible for the loss of billions of Rupees during the January 2005 to March 2005 KSE upheaval are not identified and punished, the market governance process will not be recognized as credible and equitable by local and foreign investors.

Availability and disclosure of accounting, financial and strategic information to outside investors are also important. Audited corporate financial information conforming to the standards of generally accepted accounting principles is needed. Disclosure and immediate widespread dissemination of that information to investors and their agents are necessary conditions for an adequate level of pricing efficiency in the stock market.

Finally, the volatility of portfolio investment also needs to be stressed. The east and south east Asian capital markets seemed to be meeting most of market efficiency criteria and billions of dollars worth of portfolio capital flooded in during the early 1990s. But in 1997 and 1998, there was massive capital flight and asset prices collapsed. The more open an economy, the greater the impact of capital flight. Opening up the stock market thus establishes the market dominance of international fund managers and increases the macroeconomic destabilizing potential of the capital market. The continuing upheaval in the global accounting industry—with KPMG almost following Arthur Andersen and Deloitte involved in several litigations—has demonstrated that capital markets cannot be left to regulate themselves. The world's leading investors lobby group—the International Corporate Governance Network, ICGN, has been agitating to promote stronger shareholders' rights, particularly the right to nominate and unseat directors on company boards. Corporate governance systems are being redesigned in the E.U to accommodate a more specific legal recognition of investors rights.

Governments have also taken steps to streamline regulatory regimes. South Korea has made tax performance examination procedures more stringent in May this year, and

India has tightened IPO allocation rules to help small investors. SECP should carefully investigate this initiative as the small investors remain the main victims of stock market volatility. This victimization has two aspects.

- First nobody is answerable when they lose billions of rupees due to market manipulation, insiders deals and accountancy frauds. Secondly, small businesses—the repair workshops, the roadside restaurants, the small software producers, the peri urban schools—never receive stock market funds. Mutual funds remain a stock market instrument for transferring money from the small investor to the large corporation, over which he has no control. The stock market thus cannot contribute to the growth of productivity of the vast majority of business enterprise of the country.

I have argued that the growth and profitability of the stock market is not an end in itself. It is a means for national development. The regulatory regime and associated corporate governance systems should be so devised that the national development impact of stock market growth is maximized. In order to do this, issues outlined in this paper will have to be addressed securely. I hope that the eminent panelists will provide effective solutions to the problems. I have discussed that the growth of the capital market makes a significant contribution to our national development.