Political Economy of Market Development: Why India's Equity Market Reforms Has Developed More than the Corporate Debt Market

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Outline

- I. Background Issues
  - An Essay in Trespassing
- II. Theoretical Framework
  - What is Market Development and why is it always political?
- III. Equity vs. debt market development as a structured comparison
- IV. Conclusion

What do we mean by market development?

- Market development defined as the extent to which markets coordinate economic behavior to enhance societal welfare
- Market development is improving Adam Smith’s contingent “invisible hand”
- Market development can regress, that is, it can devolve into forms of economic coordination that achieve less social welfare than previously

Dynamics of Market Development

Scope		Efficiency: Low	Efficiency: High
	Low	Underdeveloped Market	Exclusive Market
	High	Stagnant Market	Developed Market

Different mechanisms of market development

I. Technology (transportation, communication, informatics)

II. Overcoming mistrust and malfeasance

- social networks, regulation

III. Resolving market failures

IV. Market design

V. Competition between markets

Why Market Development Is Always Political?

I. Markets are underpinned by laws that define property rights and rules of exchange

II. Changing market institutions affects the distribution of goods and services which affects the interests of actors and spurs them to take political action

III. Market Development is a public good

Each mechanism of market development is insufficient without the exercise of power

I. Technology (transportation, communication, informatics)

II. Overcoming mistrust and malfeasance

- social networks, regulation

III. Resolving market failures

IV. Market design

V. Competition between markets

Market Development Can Deteriorate

I. Access to property rights can narrow [de Soto 2000; Acemoglu and Robinson (2012)]

II. Creation of new barriers to entry

1. Limiting access to capital
2. Limiting access to knowledge (IPRs Schwartz 2017)

III. Changes in corporate governance

- Shareholders Value Movement? (Heilbron et al 2014)

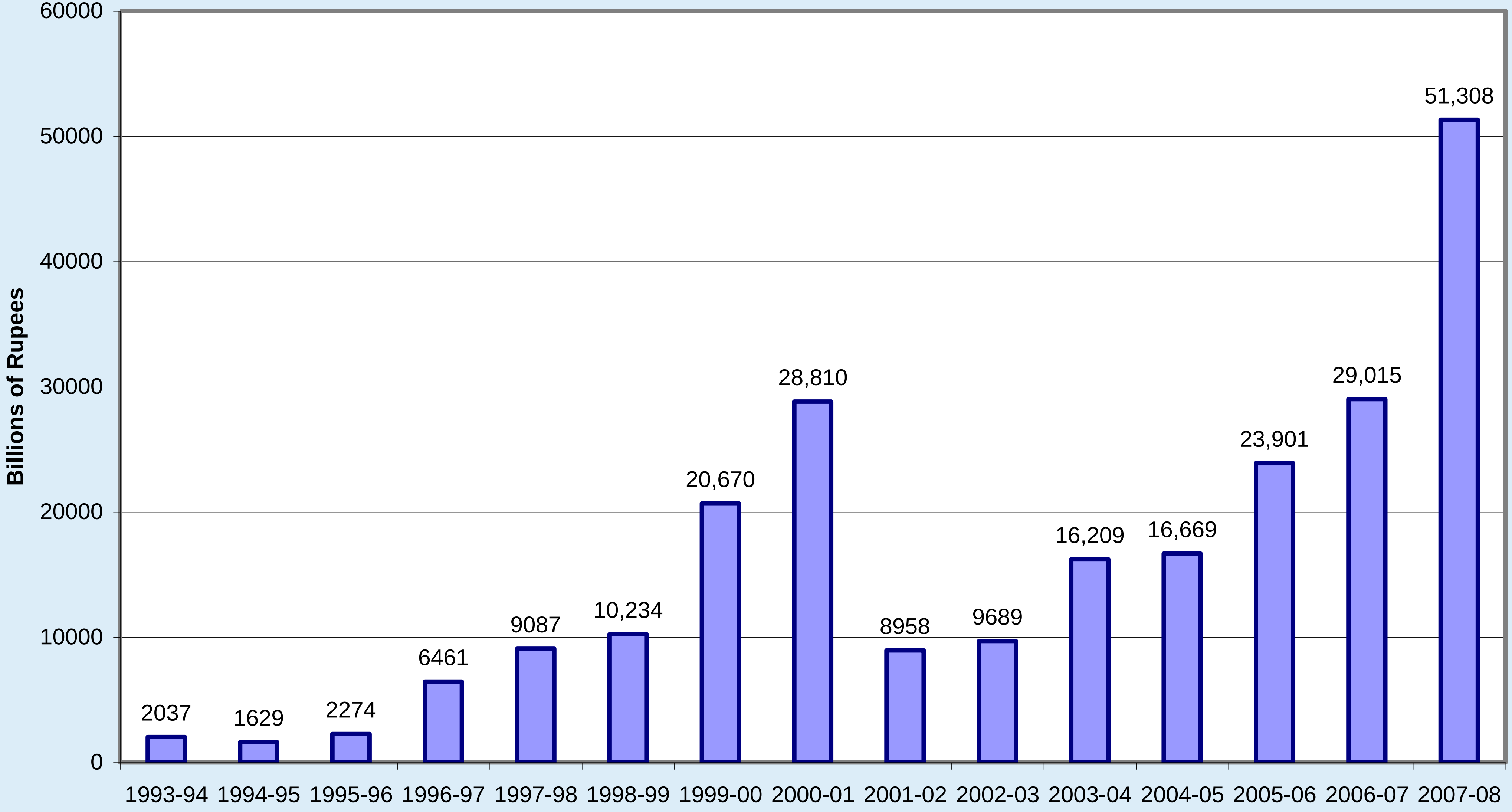
IV. Shifts in balance of power between corporations and consumers

Classifying Theories of Market Development

Does Economic Coordination Involve Power?

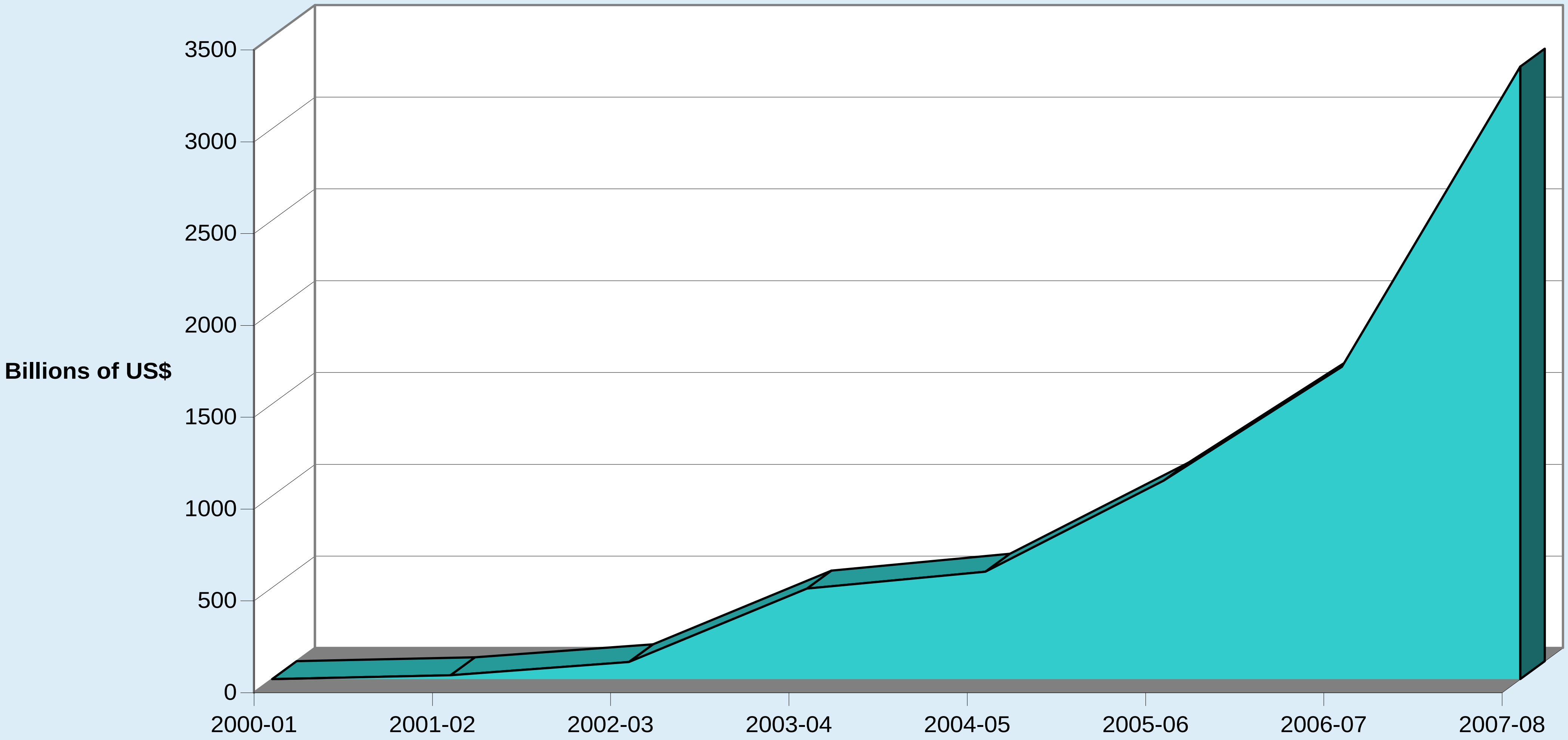
Key Actors and Processes	**No**	**Yes**
A. Private Actors **1. Market Development is bottom-up** **2. Private Ordering**	**Quadrant 1** **Spontaneous Development** Hayek, Coase, Williamson, Fama	**Quadrant 3** **Private Power Development** Rajan & Zingales, Stiglitz Fligstein, Hacker & Pierson
B. Public Actors **1. Market Development is Top-Down** **2. State Regulation**	**Quadrant 2** **Functionalist Development** Pigou, Devp Economists Legal Origins, Ordoliberals	**Quadrant 4** **State-Driven Development** North, Calomiris & Haber Developmental State

Figure 2: Turnover in the Capital Market Segment of India's Stock Exchanges, 1993-94 to 2007-08

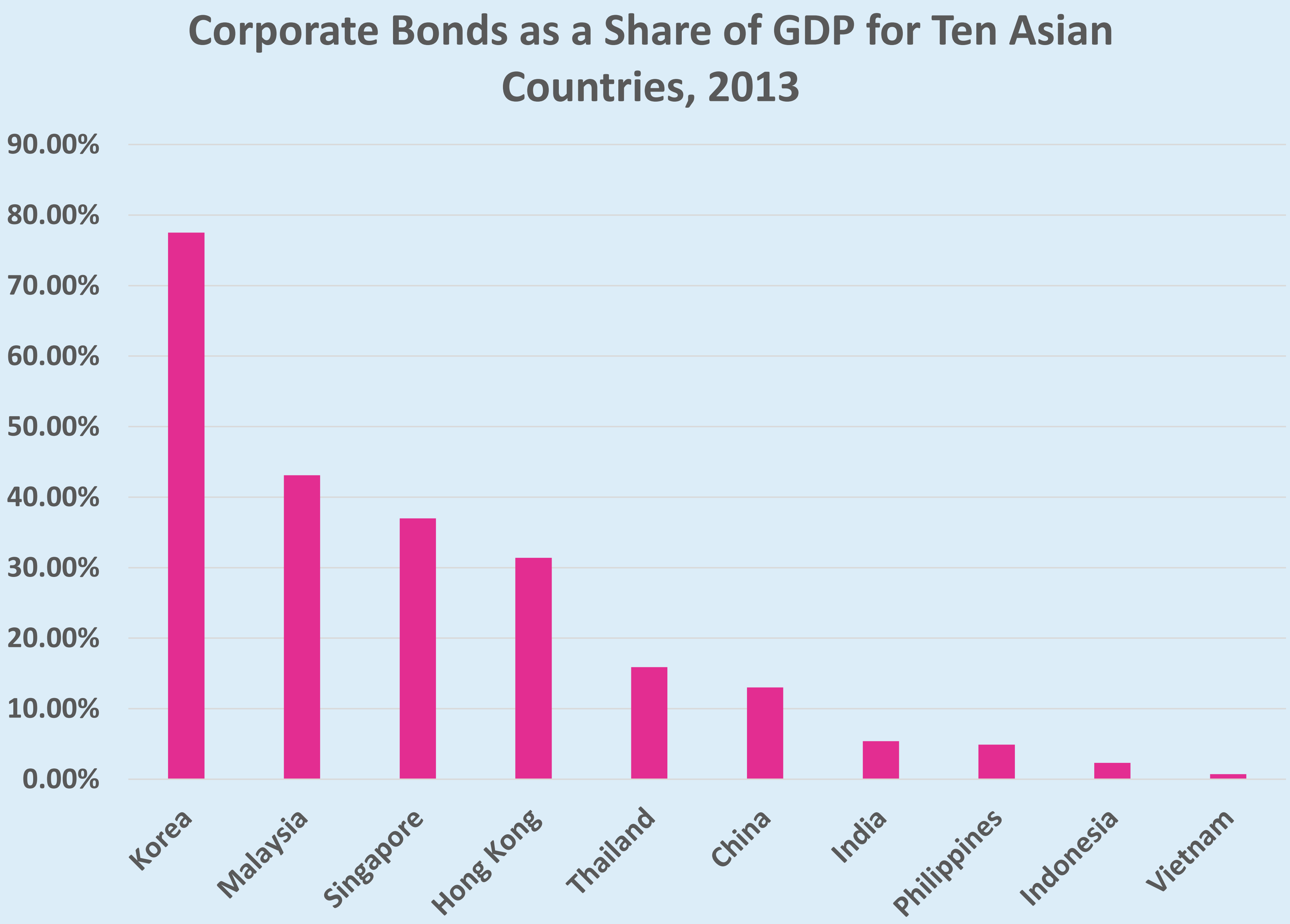


Source: Indian Securities Market Review 2004, 2008. Mumbai: National Stock Exchange, 2004, 2006, p. 10 (2004) and p. 9 (2006).

Figure 1: Turnover of the Derivatives Segment of India's Stock Exchanges 2000-01 to 2007-08



Source: Indian Securities Market Review 2008. Mumbai: National Stock Exchange, 2008. p. 9


Corporate Bonds as a Share of GDP for Ten Asian Countries, 2013
90.00%
80.00%
70.00%
60.00%
50.00%
40.00%
30.00%
20.00%
10.00%
0.00%
Korea
Malaysia
Singapore
Hong Kong
Thailand
China
India
Philippines
Indonesia
Vietnam

Resources Mobilized by the Corporate Sector- Total Annual Public and Private Placement Debt Issues (Rs. Cr.)
public
private
total debt
700000
600000
500000
400000
300000
200000
100000
0
1995-1996
1996-1997
1997-1998
1998-1999
1999-2000
2000-2001
2001-2002
2002-2003
2003-2004
2004-2005
2005-2006
2006-2007
2007-2008
2008-2009
2009-2010
2010-2011
2011-2012
2012-2013
2013-2014
2014-2015
2015-2016
2016-2017

Dynamics of Market Development Reforms

T_1

Power Structure

Institutional Capacity

Ideas

T_2

Power Structure

Institutional Capacity

Ideas

Political Economy & Reform Trajectories

Political Cost-Benefit Ratio	Institutional Capacity: Low	Institutional Capacity: High
High	No Reform	Minor Reforms Corp. Debt Market Reform Hyp II
Low	Incremental Reforms Badla Reform Corporate Debt Market Reform Hyp I	Substantial Reform Equity Market: NSE

Power Structure & Political Cost-Benefit Ratio

- Equity Markets
  - Ministry of Finance
    - Government commits to raising investment through domestic & international private sector
    - Securities Contracts (Regulation Act) 1956 gives MoF authority to abolish exchanges
  - Brokers
    - Small numbers
    - Low social status
  - Firms
    - Most investment from banks and retained earnings
    - Limited numbers of opportunistic
    - manipulators

- Corporate Debt Markets
  - Ministry of Finance
    - Govt. commitment to increase investment
    - Appoints RBI Governor
    - Legislative Initiative
  - Reserve Bank of India
    - Regulates Banks, Credit Default Swaps, Repos
    - Bank-led system
    - Issuer and Regulator of Govt Securities
  - SEBI
    - Regulates Exchange traded debt
  - Firms
    - Politicized relational banking
    - Cash Credit System

Political Economy & Reform Trajectories: The NSE and Computerized Trading

Institutional Capacity

Political Cost-Benefit Ratio	**Low**	**High**
High	**No Reform**	**Minor Reforms**
Low	**Incremental Reforms**	**Substantial Reform** **Equity Market: NSE**

Institutional Capacity: Computerized Trading at the NSE

- High
  - 1985 report of the High Powered Committee on Stock Exchange Reform convened by the ministry
  - Pherwani Committee 1991
  - Technocratic team delegated by the IDBI let be R.H. Patil
  - Subcontract firm from Hong Kong to acquire Canadian system
  - Hire TCS to adapt to local circumstance

Institutional Capacity: From *Badla* to Rolling Settlement and Derivatives

		Institutional Capacity	
		Low	**High**
Political Cost-Benefit Ratio	**High**	**No Reform**	**Minor Reforms**
	Low	**Incremental Reforms** **Badla Reform**	**Substantial Reform**

Institutional Capacity: From *Badla* to Rolling Settlement and Derivatives

- Crises in the 1980s and 1990s make it clear to all that *badla* plus two week settlements provide 100% leverage leading to reckless speculation
- *Badla* repeated banned in the late 1980s and 1990s, but restored when brokers pointed to reduced liquidity
- Dematerialization
  - 1996 Parliament passed the Depositories Act
  - NSE joins with IDBI and UTI to create National Securities Depository Ltd.
  - 1998 SEBI begins to compel dematerialization
- Rolling Settlement
- Derivatives

Political Economy & Reform Trajectories:

Corporate Debt Market Reform: Hypothesis I

		Institutional Capacity	
		Low	**High**
Political Cost-Benefit Ratio	**High**	**No Reform**	**Minor Reforms**
	Low	**Incremental Reforms** **Corporate Debt Market Reform Hyp I**	**Substantial Reform**

Institutional Capacity: Corporate Debt Market Reform Hypothesis I

- Institutional Capacity is Low
  - Corporate debt is risky since the private debt market is tied to the market for government securities and since purchasers of debt: banks, insurance companies, pensions have vital strategic importance for the economy
  - Global Financial Crisis makes financial products like CDS and repos more risky
  - Establishing an effective yield curve for government securities would require ending the ban on short-selling which some view as risky
  - Linkage among government debt financing, financial repression, bond market infrastructure and bond market regulation is extremely complex and not well understood

PCBR and Institutional Capacity:

Corporate Debt Market Reform Hypothesis II

		Institutional Capacity	
		Low	**High**
Political Cost-Benefit Ratio	**High**	**No Reform**	**Minor Reforms** **Corp. Debt Market Reform Hyp II**
	Low	**Incremental Reforms**	**Substantial Reform**

Corporate Debt Market Reform Hypothesis II:
Institutional Capacity

- Corporate debt market development has been on the agenda for over 20 years. Beginning with the RH Patil Committee in 2005, there have been eight studies of the corporate debt market highlighting many of the same problems which could be addressed through obvious measures.
  - Need to liberalize restrictions on institutional investors
  - Need to make stamp duty uniform across states
  - Creation of a centralized database of all bonds issued by corporates
  - Take measures to provide support for municipal bonds

Political Cost Benefit Ratio:

Corporate Debt Market Reform Hypothesis II

- In contrast to equity reforms where the MoF had strong authority over the main opponents of reform -- the BSE brokers – corporate debt market reform involves the RBI which exercises over CDS, Repos, foreign investment inflows, banks and other financial institutions.
- Corporate debt market development would require substantial changes in India’s fiscal politics reducing government deficits because:
  - Financial repression would need to be eased by liberalizing the restrictions on institutional investors
  - The interest rate spread between India’s relatively high interest rates and lower rates abroad would reduce incentives to raise debt abroad
- Corporate debt market reform requires reform of India’s bank-led financial system, especially its politicized relational banking since otherwise, corporates will prefer private placement not public issues

Conclusions

- While India's equity market reforms have been more successful relative to the corporate debt market, many problems remain:
  - The share of household savings invested in shares and debentures has declined
  - Trading in derivatives flees to deeper and more efficient exchanges abroad like the SGX
- Political change may provide limited reasons for optimism with regards to the corporate debt market
  - Grudging progress on fiscal politics
  - IBC and RBI's imposition of tighter standards on bank loans to corporates
  - Corporate debt market development is moving from minor reforms to incremental reforms