

Inaugural Address by C. Rangarajan Governor, Reserve Bank of India at the Second Annual Indian Stock Exchanges Summit, 1997 Mumbai on May 27, 1997

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1. I take great pleasure to be with you this morning on the occasion of the Second Annual Stock Exchange Summit. As the Central bank of the country, the Reserve Bank is intimately concerned with the developments on the stock exchange because, first, in the evolving financial sector, stock markets are part of the closely integrated financial system and second, the Bank plays an active role in some of the segments of the financial market such as gilt market, forex market and money market. Broadly speaking we are moving towards the second stage of market development leading to greater integration of markets. Financial integration leads to reduction of speculative movements of funds that may occur due to arbitrage that market segmentation offers. In the process it ensures that intermediation is efficient and resource allocation is optimised. The chances of improving the effectiveness of policies are also enhanced as transmission mechanisms function more smoothly as market integration takes place.
2. The capital market plays a critical role in the growth process. It helps to augment capital formation. According to Professor Hicks, the Industrial Revolution in England was ignited more by the presence of liquid financial market than the technological inventions. He writes interestingly -

"What happened in the Industrial Revolution ... is that the range of fixed capital goods that were used in production ... began noticeably to increase....But fixed capital is sunk; it is embodied in a particular form, from which it can only gradually ... be released. In order that people should be willing ... to sink large amounts of capital..... it is the availability of liquid funds which is crucial. This condition was satisfied in England.... by the first half of the eighteenth century... The liquid asset was there, as it would not have been even a few years earlier."

The securities industry matters very much. It acts as conduit for the transfer of long-term funds. The growth of the primary market rests on the development of the Secondary market which provides liquidity to the scrips. The primary market in India has seen a sea change since early 90s. New capital raised by the private sector was only around Rs.600 crore in 1981-82. There was a dramatic rise since the beginning of 1990s. The new capital raised rose to Rs.20,000 crore in 1992-93 and further to Rs.26,000 crore in 1994-95. Since then, there has been a decline and it is reported that the amount raised from the market in 1996-97 was only of the order of Rs.10,500 crore. The proportion of debt in the total capital raised is also higher than in the previous years. Such sudden shifts have implications for the financing of capital formation.

Market Developments

3. In the context of a fairly rapid growth of the securities market, regulation of the market has also assumed importance. It is generally agreed that the regulation is necessary (a) to ensure that the securities markets operate in a fair and orderly manner; (b) the professionals in the securities industry deal justly with their customers and (c) that the

- corporates make public all information about themselves that investors need to make intelligent investment. These are the tasks which SEBI is addressing itself.
4. Development and regulation of markets is a tremendous challenge in the institutional development. Our task is not unlike that seen in many other countries all over the world in the last decade. When institutional richness of financial markets is lacking, it is a considerable challenge to make it materialise. When the institutional design of a market is faulty, we observe breakdowns of market efficiency which causes great hardship to people in the country and distorts resource allocation. We have seen examples of such breakdowns in India as well. These difficulties are a reminder that the development of India's securities industry should be viewed as a challenging part of the liberalisation process. Markets do not exist in the vacuum; markets are composed of economic agents working within unspoken or explicitly specified 'rules of the game'. Barter markets in primitive economies are an example of markets with very little complexity. Such markets spring up almost instantaneously when economic agents feel the benefits from exchange. But barter markets tend to be localised and cater to a small group of people. When it comes to driving resource allocation in a large country, the institutional content of important financial markets of an economy cannot be ignored and their healthy development cannot be taken for granted. It was and is a major objective of reforms in the financial sector to foster the creation of securities markets of highest quality.

Barriers to Change and the Experience of the Equity Market

5. An additional complexity in this process is that whether the established 'status quo' features a healthy set of market or not. The international experience is that market mechanisms are profoundly difficult to change, once they become well entrenched. The established network of exchanges, brokerage firms, traders, users and regulators are all typically committed to one style of functioning. They are composed of a large group of people who have made investments in their human capital that is tuned to the existing design of markets and they often collectively act to block or slow down reforms and modernisation. For example, many OECD countries continue to use trading with market makers and open outcry, even though the best practices available worldwide are clearly identified as computer-driven order matching.
6. The experience of India's equity market is a singular one by international standards. Despite the existence of traditional equity exchanges, India's equity market has now completely transformed the market mechanisms used in trading, clearing and settlement. The electronic trading on the equity market in India is more modern than what is seen in many OECD countries and the transformation of clearing and settlement that we have seen on the equity market over the last two years could easily have taken a decade in other countries.
7. This transformation has swept away a whole host of market practices which were once considered perfectly acceptable and should be viewed as a significant achievement of the liberalisation process. One indicator of the success of this transformation is the fact that the daily volume observed on the equity market in India today is typically four to five times larger than pre-1992 levels.

Safe Trading between Strangers

8. Clearing is a particularly important area which merits mention. Markets in their early stages often evolve as 'clubs' where known counterparties deal amongst each other, in an attempt to avoid the credit risk of dealing with strangers. This is a particularly important issue in India given the slow redressal of disputes by the legal system.
9. It is well known that club markets effectively throw up entry barriers and hurt the large-scale growth of market participation, hurting in the process liquidity. Hence 'novation', i.e. the introduction of a clearing house as a counterparty to both legs of every trade as a concept assumes critical importance in financial markets. This concentrates a great deal

- of risk-taking upon the clearing house, something which is completely different from the traditional perception of clearing, which was simply about the movement of funds and securities.
10. This is a useful illustration of the theme of institutional development that I emphasised earlier. The traditional clearing house was a challenge of administrative efficiency; the modern clearing house is a challenge of risk measurement and containment. Our challenge in India is to develop strong institutions which have such skills. The modern clearing house enables safe trading between strangers, and hence fosters a huge increase in market participation and market liquidity. This is an important new phase in India's financial markets.
 11. The Reserve Bank is fully conscious of the uniquely important role that the payments system plays in the creation of safe clearing systems which require the minimum in working capital on the part of market participants. We will work towards creating EFT systems which are directly connected to all the important institutions of the financial sector even though the VSAT system that we are planning to introduce is expected to be linked mainly to banks initially.
 12. The final stage of trade is where securities change hands. Systems in India have been plagued by the use of physical certificates made of paper. Back-office cost and fraud risk have been part of the transaction costs associated with such a system. On the other hand, the depository is an institution which maintains an electronic record of ownership of shares. India's first depository was inaugurated in November 1996. Depository system would have achieved its goal only when a sufficient critical mass of paper has been converted into electronic holdings. I am sure you would be discussing the various issues associated with the enlargement of the scope of depositories.

Market and Financial Institutions

13. In every economy, there is a problem of linking up savings of households to investment by firms. This allocation of funds as resources for the purpose of investment is a crucial function of the financial system. There are two major alternative mechanisms through which such allocation of funds can be done. One is via banks and other financial institutions and the other via financial markets. For long, India's financial system was dominated by banks and other financial institutions. One of the major changes that has taken place in the last five years is the rise of financial markets as an alternative route for resource allocation. What the country needs ultimately of course is an efficient system which minimises transaction costs. The information processing and transaction costs are different for banks and financial institutions on the one hand and the market on the other. Perhaps what is needed is an appropriate blend of the two, in the mobilisation and allocation of resources.
14. As I mentioned before, there is a growing concern about the behaviour of the secondary and primary markets. After having been used to raising fairly substantial funds from the primary market, the corporate sector is faced with a situation where the amounts raised have dropped substantially in the last two years. Very often it is said that it is the high rate of interest which has led to less amount being raised in the primary market; in 1995-96 the contrary is the case. It was the shortfall in the amount raised in the capital market which put considerable pressure on the banking system which led to the rise in the rate of interest. As I have repeatedly mentioned, the increase in the non-food credit made available by the banking system in 1994-95 and 1995-96 were Rs.45,775 crore and Rs.44,938 crore respective ly. These were substantially higher than in the previous years. It is being repeatedly suggested that the only way by which the private corporate sector can raise more funds from the primary market is by ensuring that middle class investors are lured back to the market. One of the reasons cited for the disenchantment of the investors has been that the corporates have not lived upto their promises in the case of issues made in the early nineties. Ultimately confidence can be built only if the corporates perform well and the investors are convinced of the future profits of the issuers. This is as

important as improving the functioning of the market. We need to go ahead with all the steps that are required to make our markets deep and liquid as well as efficient. But at the same time corporates must deliver on their promises.

15. It gives me great pleasure to be here at a conference which is thoughtfully organised around the themes of trading, clearing, settlements and derivatives. I am sure that this conference will make an important contribution towards the institutional development of the securities market which is an integral part of the growth and development of the economy.