Capital Market Development : Need for A Responsive Secondary Market

by Maj. Gen. M.A. Matin (retd)

A capital market brings together investors and users of Funds, and is divided into two sectors : (1) securities and (2) non-securities. The securities sector is further divided into (1) debt (money market) instruments, bonds and debentures), and (2) equity (shares) sector. The interaction of sources and uses of funds take place through the capital market and the financial institutions and instruments. In the country main institutions dealing in securities are (1) Investment Corporation of Bangladesh (ICB) and (2) Dhaka Stock Exchange (DSE).

Sound securities market play an important role in facilitating capital formation and promoting economic development. They increase national savings, engender growth, improve economic efficiency, ensure wide-spread public ownership of enterprises, and attract foreign investment. Like all developed financial systems, the securities market encompasses : (1) a PRIMARY MARKET, and (2) a SECONDARY MARKET. The main function of a primary market is to assist enterprises in raising capital by distributing corporate securities to the public.

Savers require liquidity. They want to be able to sell their securities, if they choose to, quickly and at a reasonable cost. This only comes through a "Responsive Secondary Market". A well functioning secondary market is vital to economic growth. It provides the mechanism for efficient allocation of capital. Equally important is its role to the development of a sound and functioning primary market.

Development of a strong secondary market depends on institution building. Securities operations are highly specialised activities requiring well-developed transaction, functional and regulatory expertise. Lack of adequate Government support and regulatory back-up hampered the growth of essential market institutions in many emerging markets. Lack of expertise, capital, and experienced staff further added to the problems.

Secondary Market

At the outset I spelt out that a strong secondary market is essential to the development of a strong primary market. Savers require liquidity, and this cannot be overemphasised. A liquid market can effectively bridged the high liquidity preference of savers with the long-term capital requirements of the private sector. It is impossible to finance large economic infrastructure and private sector projects with capital committed for only the short run. A well-functioning securities market can perform this intermediation function of transforming personal savings to capital available to industrial and national projects for the long run.

Secondary market develops in response to economic demands for more efficient mechanisms to carry out transactions and to collect and disseminate information on the terms of the transaction. The efficiency of a secondary market is a function of its LIQUIDITY, the orderliness of market CONDITIONS, and the quality of a market's ORGANISATION. Each of these aspects is important. Liquidity fosters orderly market conditions and influences the character of a market's organisation. In turn, orderly market conditions add good market organisation promote market liquidity.

MARKET LIQUIDITY has two aspects : (1) certainty of price (liquidity proper) and (2) expected marketability. The degree of certainty or predictability of an asset's underlying value is referred to as liquidity proper. Thus, liquidity proper depends on how much is known about an asset's underlying value, and underlying value refers to an asset's value if no time constraints are imposed on its disposal and if the conditions in the markets remain constant. Securities traded on all organised exchanges are generally high in liquidity proper. Marketability of an asset refers to the expected ease or difficulty in realising the asset's underlying value during the period of time, allowed for its disposal.

"ORDERLY market conditions" is an important concept referring to a situation in which a market operates properly within a given economic environment, and optimal benefits can be realised. Three types of disorderly conditions may exist/crop up in a market :

- when artificial barriers are created to market entry, and the price of a transaction is off a market's demand/supply schedule.
- false rumours may mislead a market's participants and led to price manipulation.
- overreaction to a prior price trend may cause destabilising speculation.

Strict Market Regulation can effectively counter such disorderly market conditions.

The quality of a market's ORGANISATION refers to the operating efficiency of the institutions that directly service a market — brokers, exchanges, clearinghouses, institutional investors, media coverage etc. Developed security marks are highly liquid and have intricate and specialised system for effecting transactions, and for collecting and disseminating relevant information. In such markets, all aspects of a transaction are generally specified, except for level of price.

In their markets it is difficult for brokers to match buyers and sellers. Often the problem stems from the absence of sufficient number of investors. It is desirable to have both (1) a sufficient number of investors and (2) a balance between institutional investors and individual investors. Inadequate financial disclosure makes things difficult for investors to have meaningful idea of the value of the securities available. Additionally weak financial support for the trading system is a big problem.

Market Institutions

Intermediaries such as brokers, dealers and under writers play very vital secondary market role. In all emerging markets, variety of institutions like securities firms, merchant banks, finance companies, development finance banks etc. among other, are involved in these activities. The broker-dealer firm, in many emerging markets, is one of the weakest market institutions. They suffer generally from lack of capital and professional expertise in modern trading skills. In many cases, they are generally one-man professional operation with a few unskilled assistants. However, stock brokers and dealers play important role in the development of an efficient secondary securities market particularly. Regular training programmes to enhance and upgrade their technical and trading skills are absolutely essential. To improve the standard and availability of investment services and to promote competition among existing stockbrokers, the restriction on foreign participation in the provision of these services should gradually be removed.

STOCK EXCHANGES of emerging markets are generally owned by the members of the exchanges. A few stock exchanges are owned and operated by Government agencies (Jakarta Stock Exchange), but the trend is toward more privately-run stock exchanges.

Intense debate is on in many emerging markets (e.g. Pakistan) on the issue of allowing corporate members in the exchanges. Certainly, there are merits in allowing qualified financial institutions as corporate members of the exchanges, since many individual members are constrained in their capital and professional staff development. Corporate members can conceivably better train and develop core professional staff for securities market operations, including latest market techniques. The separation between ownership and management of market institutions would also enhance professionalism in securities business. Corporate members would generally bring more capital to market operations, and would thus enhance the depth and liquidity of the market. Often, individual exchange members are one-man operations. These individual members often represent many years of practical experience, and it would not be advisable to ignore them. Controlled entry of corporate members would encourage all firms, of whatever business form to better capitalise and better prepare themselves to the more competitive environment. It is worth mentioning here that the US Exchanges did not allow corporate members until 1971, decades after securities firms as partnerships had developed a fairly sophisticated market-place in that country.

Institutional Investors

In many emerging markets, "institutional investors" played a very limited role. However, to develop a strong secondary market, active participation of institutional investors is imperative.

Institutional investors provide:

- a constant flow of new funds to the securities market
- a foundation for long-term investment in the securities market, giving it a greater stability.
- the capability to evaluate potential investments on a more professional basis than individual investors, supporting the later in the marketplace especially in reacting more naturally to temporary adverse market developments.

Investment companies manage portfolios of pooled funds for small investors. The most common funds in emerging markets are the open end units etc. There are significant advantages for individuals with small and medium incomes to invest in such investment companies: these include greater access to relevant information, very economical portfolio diversification, and professional management securities transaction. In open-end units, the investor has the great advantage of liquidity, because the unit holder can always sell back his units to the investment companies at a price reflecting the market value of the unit's underlying assets.

This is clearly one of the most effective methods of increasing investor base for securities market growth. Pension Funds, Provident Funds, Insurance companies hold significant financial assets in emerging capital markets. Their capital market role must be increased to enhance the growth of the capital market generally and the secondary market particularly. To encourage a greater flow of these funds into the securities markets, Government should give the guidelines.

In most emerging markets, commercial banks still play dominant roles in the financial system. This condition is mainly due to Government policy orientation. Securities markets are a relatively involved form of business finance, and as a consequence many developing countries have underutilized them.

Market Regulation

Market regulation must assure that orderliness of the market and quality of market's organisation are at the highest levels. Almost every market in the world has had at least one major crisis of speculation or manipulation, followed by significant slump in security prices. After such crisis investors retreat from the market, generally for a period of years. Therefore, effective supervision must be there to handle problems before they grow into gigantic proportions. The agency has to build a record of even-handedness and fairplay. Such supervision will promote growth of the market, close observation of the activities of exchanges, broker-dealers, institutional investors etc. is very important and essential for the supervisory agency. For illiquid markets, special regulatory attention is warranted because they are more susceptible to manipulation. An exchange must maintain first-line regulatory power over the conduct of the secondary market. The major purpose of the exchange is to ensure integrity of its operations and particularly those of its members. To conduct securities business, an individual must pass a test in accounting, finance, clearance and settlement, securities laws etc. Likewise, firms/institutions should not be allowed to conduct business until their officers have passed supervisor's test. Adequate regulatory back-up must be there: (1) to ensure total obedience to disclosure requirements of the securities law, (2) to suspend or revoke the registrations of brokers, dealers and investment companies, who willfully engage in fraudulent and manipulative acts, (3) to prosecute persons, who engage in fraudulent activities, (4) to conduct investigations into complaints or other indications of securities violations, and (5) to obtain court orders enjoining acts and practices that operate as frauds upon investors. Market manipulation undermines investor confidence and tend to set back market development for years. The solution to the problems lies in :

- improving the quality of securities professionals working in the market-place.
- strengthening regulatory authorities.
- strict enforcement of market regulation.

Bangladesh Stock Market

Stock market of Bangladesh started functioning from 1976 with the revival of DSE. Recreation of ICB gave further impetus. Both DSE and ICB have been playing their significant roles in developing country's stock market. The growth of a stock market can be visualized from : (1) the trend of increases in the number of enlisted companies, (2) paid up capital , and (3) market capitalisation. The STOCK EXCHANGE STATISTICS (as on 31 Dec. 1988) give a clean picture of DSE' position compared with that of India, Malaysia and Nepal:

- India — 5,841 firms listed at 16 stock exchanges with total market capitalisation of US$ 34,370 million or 15.55% of GDP.
- Malaysia — 295 firms listed and total market capitalisation of US$ 36,537 million or 109.83% of GDP.
- Nepal — 31 firms listed and total market capitalisation of US$ 36 million or 1.33% of GDP.
- Bangladesh (DSE) — 111 firms listed and total market capitalisation of US$420 million or 2.28% of GDP.

The annual turnover value of DSE was only US$ 4 million or 0.96% of total market capitalisation, which indicates how then the trading was.

To develop a sound and responsive secondary securities market in the country, the structural and operational limitations of DSE must be looked into.

International Finance Corporation consultant Prof. Sidney M. Robins in his report in 1980 recommended many changes, and the Government must look into it.

Conclusion

Development of a strong secondary market largely depends on building of institutions (market infrastructure) both in private and public sectors.

Securities operations are highly specialised activities, and therefor needs well-developed transaction, functional and regulatory expertise. Institution building takes time and requires careful strategy and long-term commitment by the Govt. and market participants.

A strong, dynamic secondary market for securities is essential for national growth, and of course for the development of a strong primary securities market. And to conclude, for the development of the country's capital market the following steps are imperative:

- institutions (market infrastructure) must be developed both in private and public sectors.
- supply of securities must be increased, and it is possible through:
  (1) more enlistment of new companies for public issue.
  (2) rapid industrialisation and rehabilitation of sick industries to qualify for public issue.
  (3) privatization of Government owned enterprises
- demand of securities must be increased, and it is possible through:
  (1) internationalisation of the capital market
  (2) institutional activities must be geared up to mobilise savings and to broaden the base of investment.
- capital market regulatory system needs to be revamped.

We must remember that for resource-poor Bangladesh a sound and developed capital market only can ensure a balanced economic growth to lift millions out of poverty.

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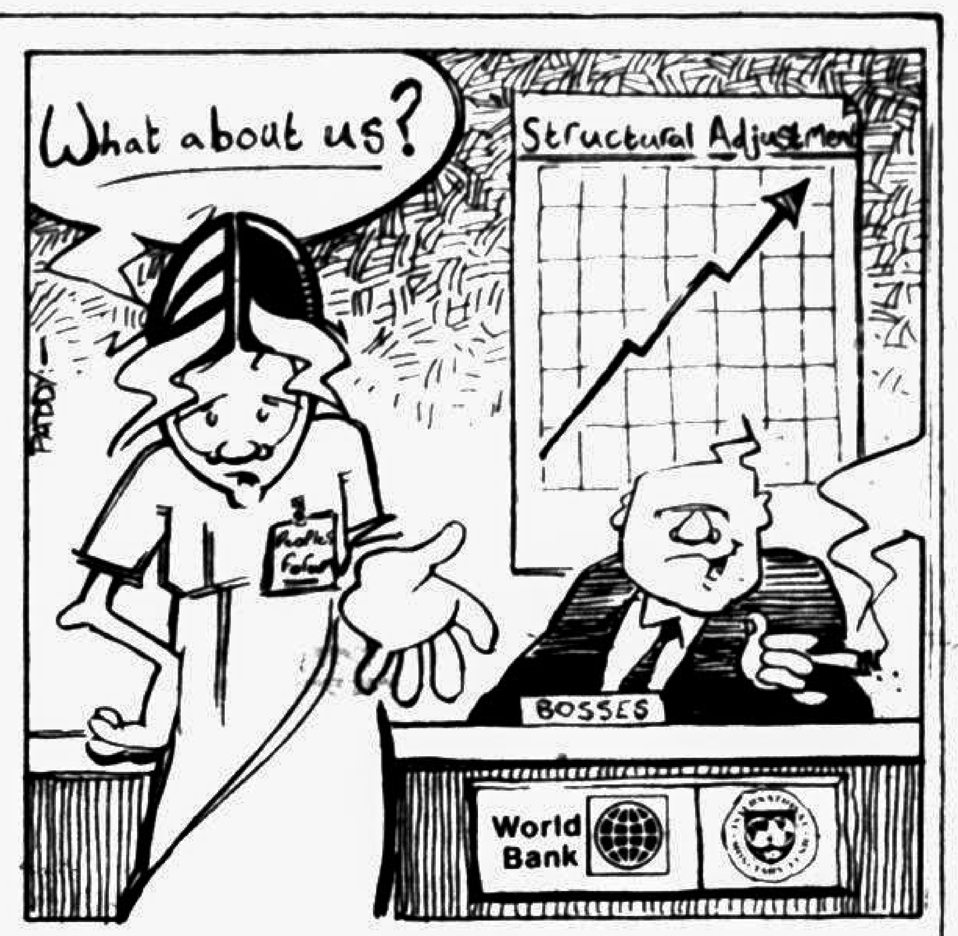
Blue Suits Versus Sandals at Bangkok Money Olympics

The World Bank and International Monetary Fund met in their usual splendour in a flower-festooned conference centre in Bangkok. Across the street, the "People's Forum," of non-government organisations decried the crushing poverty in Thailand and criticised what it saw as environmentally-damaging World Bank policies. Gemini News Service reports on the ongoing battle between the bankers and the groups working at the grassroots. by Gillian Forrester



THE battle pitting non-government organisations against two of the world's most powerful economic organisations, the World Bank and the International Monetary Fund, has come to Thailand.

It is a war between ordinary people and those who control the world economy — irrational, shrill little people versus big business.

But at this year's annual meeting in Bangkok of the World Bank and the IMF — sometimes called the money Olympics — the fight was relatively civilised. The last time such a meeting was held away from Washington, in Berlin in 1988, the city erupted with angry protesters blocking traffic and harassing delegates.

This time, Thailand's military government issued warnings to potential troublemakers in order to avoid embarrassing situations. The only real skirmishes occurred before the conference got under way, when slum dwellers were evicted to make way for meeting facilities.

Non-government organisation workers known causing disturbances instead channeled their energy into the People's Forum, organised by Thailand's Project for Ecological Recovery. Attended by its large community of non-governmental organisations (NGOs), the Forum sought to show the underside of development measured only by numbers.

The contrast between the two events — and two of thinking — was striking.

With standard flare, the World Bank/IMF meetings were held in a $100-million mega-complex full of smiling Thai attendants and surrounded by manicured lawns, fountains, flowers, freshly-fixed roads and tidied-up slums.

Police forces were beefed up, public buses with routes near the centre were repainted, slum dwellers were asked to keep their vending carts off the streets and holidays were declared to try to thin out Bangkok's notoriously heavy and slow-moving traffic.

The People's Forum, by contrast, was organised by Thailand's Project for Ecological Recovery, held in the modest facilities of a local university and attended by grassroots NGO representatives.

The difference between the two events was clear when one Thai slum dweller described her impression of the new convention centre : Looking in the building's windows, she said, made her think of a place where angels live — angels who come in on flying boats (airplanes).

Many Forum participants spoke of the effects which the projects and policies of the IMF and the World Bank have had on their lives. Particularly vocal were residents of north-east Thailand who are losing their land to the Pak Mun dam — a project they want the World Bank to stop funding.

"We feel humiliated, exploited and taken advantage of," said one villager whose home was hit by rocks from explosions caused by dam construction. "They threaten us — they don't ask first," he said of projects officials. "They just come and say, 'If you don't sign, you get no compensation.'"

Other speakers from 43 countries told the Forum tales of deepening poverty, homelessness, ruined land and water and lost traditional ways of life.

But they had success stories too : Thailand's Buddhist monks teaching people to care for their forests and live self-sufficiently rather than take government subsidies to grow crops they can sell, farmers learning to mix their crops and rely less on pesticides, and slum dwellers banding together to stand up for their rights not to be evicted.

Representatives of both sides of the battle met when the Bank, which is the biggest single money lender to developing countries, invited the NGOs, to a public seminar. Forum organisers showed up just long enough to tell Bank officials that they would refuse to meet on anything but equal terms. The Bank had snubbed their attempts to set up a joint meeting where both sides would have a say in setting the agenda, arguing that it would turn into a "shouting match."

Many NGOs did stay at the seminar, however. One was the United States-based International Institute for Energy Conservation, which is to receive financing from the Thai government for a programme which could save the country some 200 megawatts of power , the equivalent of 15 hydro-electric dams. The Bank is not sponsoring the $30-million energy-efficiency project but the IIEC hopes the Bank will promote the project in other countries.

Nonetheless, many NGOs see working with the Bank as a dangerous idea — view reflected by one NGO representative who wanted to know where the IIEC would get the high-tech equipment it needed for its energy-conservation programme.

"From the US right now," came the answer.

The NGO delegate smiled and nodded knowingly : Just another money-making scheme for the rich West. "And even if it does save energy," she argued afterwards, "the programme isn't going to get people to take responsibility for the energy they consume. It simply allows the old ways to continue."

Mark Cherniak of the IIEC countered that no country had come up with an overall model of sustainable development. "You do what you can," he said.

World Bankers appeared uncomfortable and on the defensive during the NGO meeting.

But there are signs that public pressure has had an effect on the Bank. It has, for example, tried to appease NGOs by publishing statistics showing ever increasing co-operation and consultation with them. Last year, moreover, the Bank began issuing an annual environmental report. And its new, outspoken environment director, Mohomud El-Ashry, has said he believes the world has to find a whole new model of development — one which incorporates respect for the environment.

NGOs denounced this year's environment report with standard swiftness, citing controversial projects which contradict the Bank's stated concern about acid rain, forest preservation, public opinion and human rights.

But the solutions presented by NGOs at the Forum were small, localised ones — not ambitious enough to convince the IMF representative at the meeting that they could solve what he called global problems requiring global solutions. Said Ernesto Hernandez-Cata of the IMF : "The only answer is to increase a country's ability to make money. We have to increase the size of the pie in order to have more to spread around." Once a country has more money, he argued, it has more choices and can do better things for its people and environment.

In the theory endorsed by the IMF and World Bank, a free-market system devoid of subsidies, trade barriers and government intervention in the economy will free individuals to use their own resources to make money and create their own destinies — the unleashing of the human spirit, it is said.

Forum participants countered that this very obsession with making money has caused many of the problems faced by poor communities since it treats humans and the earth merely as resources to be exploited. In practical terms, they said, a system which places money ahead of all else makes it harder for grassroots priorities to be heard.

"When the World Bank says they're looking for solutions, they're looking for global, prescriptive solutions they can impose on people," said Joan French of Jamaica. "That top-down approach is what the problem is. The answers have to come from the people most affected.

"In Jamaica," she added, "we don't have a government;" we have puppets of the World Bank and the IMF. We used to have a good health-care system, for example, but in order to qualify for loans and pay back debts, the government has cut back on services and abandoned the people."

World Bank and IMF representatives readily admitted that they do not understand why unemployment and poverty are growing even in countries where other aspects of the economy are performing well. But, said Hernandez-Cata : "We are not responsible for the environment — we are economic experts. And for poverty, the only thing we can do is increase the demand for labour."

One French banker who asked to remain anonymous had a different, less confident view. "After the Second World War," he said, "we thought we had the answers. Now we know it is not working, but we don't know what else to do. I think it's the people who have to stand up for themselves and demand better treatment from their government. That's the only way anything will change."

Dr Ramesh Manadhar, who works with slum dwellers in Papua New Guinea, agreed. His main priority was not to change the World Bank, he said : "Life's too short for that. The only real change has to come from the people and I can see it happening."

— GEMINI NEWS

JUICE MARKET JUICY

According to a new ITC market study, international sales of fruit juices have shown spectacular growth over the last few decades, increasing threefold in value terms since 1980. Total world trade in fruit and vegetable juices reached almost US$4 billion in 1989 and went up to an estimated $5 billion in 1990.

The new study, entitled *Fruit Juices, with Special Reference to Citrus and Tropical Fruit Juices: A Study of the World Market*, stresses that this trade is especially important for developing countries, as they account for about half of total world exports. Although one of them, Brazil, is by far the largest juice exporter, a number of other developing countries also supply fruit juices and pulp on the international market, and several additional ones have the potential to do so. The major exporters among developing countries, apart from Brazil, are Argentina and Mexico. Among other developing countries in this trade are Thailand, Morocco, Philippines, Belize, Chile, Turkey, India and Kenya.

The leading import markets for fruit and vegetable juices are the United States (with imports worth $900 million in 1989), Germany ($637 million), United Kingdom ($386 million), Netherlands ($305 million) and France ($293 million). Together these five purchased almost two-thirds of total world juice imports that year. Other markets in decreasing order of import value in 1989 were Canada, Japan, Belgium and Luxembourg, Italy, Saudi Arabia, Sweden, Austria, Switzerland and the Republic of Korea. Markets that appear to offer increased sales opportunities in the next few years are Japan, the Republic of Korea and several other Asian countries that have not traditionally been major consumers.

Of the various juices, orange predominates on the world market. It accounted for $2.2 billion in sales in 1989, or 56% of the total traded. Imports of pineapple juice were at approximately $174 million, grapefruit juice about $158 million, other citrus juices at around $109 million and tomato juice at $22 million. Imports of juice of other fruits or vegetables (for example apple and grape) totalled $987 million, while mixtures of juices reached about $116 million that year.

Tropical fruit juices and concentrates (other than pineapple) are not shown separately in trade statistics. According to estimates, however, annual world trade in these items (excluding pineapple) range from 175,000 tons to 200,000 tons in single-strength equivalent, valued at between $175 million and $200 million. The three leading tropical fruit juices traded, apart from pineapple, are banana, passion fruit and mango, which together account for about three-fourths of world exports of tropical fruit juices and pulps excluding pineapple.

The prospects for individual fruit juices, concentrates and pulp vary from one market to another. In general, however, citrus juices, and in particular orange, are expected to remain in the lead in world trade, since these juices exist in large quantities and are well accepted by consumers in most markets.

The 282-page study covers general trends in the world market and also contains individual chapters on market prospects in Belgium and Luxembourg, France, Germany, Italy, Netherlands, Sweden, Switzerland, United Kingdom, Canada, United States and Japan. Annexes provide names and addresses of trade contacts in the main countries surveyed. The publication updates a similar study issued by ITC in 1982.

The market study is free of charge to exporters, importers and trade-related organizations in developing countries and government officials in all countries. It is available for sale to others for $80 (by surface mail) or $85 (airmail). (Paid orders must by accompanied by a check or money order made out to: International Trade Centre UNCTAD/GATT, Palais des Nations, 1211 Geneva 10, Switzerland.)