

Disciplining stock markets

MIRZA AZIZUL ISLAM

The stock markets of Bangladesh recently witnessed wild volatility. The general index of Dhaka Stock Exchange stood at 4,535 at the end of December 2009, nearly doubled in less than a year to 8,912 on December 5, 2010, suffered drastic loss of more than 1,200 points over a period of two days to dip to 6,499 on January 10, and then regained more than 500 points the next day to reach 7,512 following some policy pronouncements by Securities and Exchange Commission (SEC) and Bangladesh Bank. The index was 7,378 on 17.

In an earlier paper (DS March 25 2009) I noted that certain inherent characteristics of the financial markets expose them to wide volatility. Those include asymmetry of information, adverse selection, herd behaviour by investors and moral hazard. These factors appear to have afflicted our stock markets with vengeance in recent times.

"Asymmetry of information" in the context of stock markets implies that the investors know much less about the inherent worth of the companies' shares which they are buying/selling compared to the managers and sponsors of those companies. Investors' decisions, therefore, may not be based on rational considerations. Perhaps even more importantly, the incapacity or unwillingness to process available information has contributed to large swings.

The investors have not taken into consideration well-known criteria such as net asset value per share and/or price-earning ratio in their decisions even though information regarding these criteria is readily available on the websites of stock exchanges. As a result, all share prices rose or fell more or less in unison, irrespective of differences in fundamentals.

This is also a reflection of "herd behaviour" in the sense that when some investors started buying/selling some shares, others joined in droves to follow suit with-

out discriminating among shares on the basis of their intrinsic worth. "Herd behaviour" has been intensified by the entry of many new investors.

The number of B.O. account holders has skyrocketed to 33 lakhs, many of them having been allured into the stock market by brokers who have opened many branches outside the major cities. Most of these new investors from outlying districts have hardly any knowledge about the basic principles that should guide

probably offered to pay higher interest, depriving investors in the real sectors of the economy.

In addition, the banks themselves invested in stocks and there was diversion of funds ostensibly borrowed for industrial term credit or working capital into the stock market. Subsequently, sale pressure gathered momentum as the investors began to realise that the indices had reached unsustainable levels. This scenario brought into question the effectiveness of monitoring and

and the methods of calculating the ratio. Moral hazard seems to have become entrenched, especially because regulatory authorities have often relaxed their standards in response to destructive activities of a limited number of disgruntled investors.

In addition to the above factors, market manipulation has also been cited as a cause of instability. This is an issue which deserves urgent probe by the Securities and Exchange Commission whose pri-

exception of Grameen Phone. The promised off-loading of shares of 26 state-owned enterprises has not materialised. A large number of shares issued by companies from different sectors would help bring about better balance between demand and supply and enable investors to pick and choose on the basis of fundamentals rather than zooming on a limited number of existing shares, thus excessively inflating their prices and creating

regulatory authorities as well as between them and other stake holders, should be implemented rigorously without being subservient to extraneous influences and should not be changed frequently.

Investor's education: The coverage of existing investor's education programmes conducted by the stock exchanges and SEC is limited. These programmes need to be expanded. Cooperation of both print and electronic media should be sought to educate investors about the considerations that should guide investment decisions. It should also be made abundantly clear to them that they have to bear the losses of wrong decisions themselves and should not expect regulators to undertake salvage operations. They should be made aware that stock prices can not go on rising till eternity.

• **Strengthening monitoring and surveillance:** SEC should strengthen monitoring and surveillance over all direct and indirect market actors. Those include banks, non-bank financial institutions, merchant banks, mutual funds, brokers, the stock exchanges, issuer companies, auditors etc. Appropriate actions should be taken against violators of relevant laws, rules and regulations.

• **Demutualisation:** Our stock exchanges have reached a stage where demutualisation over the next three to five years should be seriously considered. Stock exchange authorities are the front line soldiers for ensuring market stability. A situation of conflict of interest arises when the brokers exclusively serve as members of the Board of Directors of stock exchange and assume the role of primary regulators. Many exchanges around the world have been demutualised to resolve such conflict of interest.

MIRZA AZIZUL ISLAM, PH.D. IS FORMER ADVISER TO THE CARETAKER GOVERNMENT, MINISTRIES OF FINANCE AND PLANNING.



Asymmetry of information, adverse selection, herd behaviour by investors and moral hazard appear to have afflicted our stock markets with a vengeance in recent times.

decisions regarding investment in stock markets. It is regrettable that even institutional investors behaved in a herd-like manner. Both irrational exuberance and irrational pessimism became pervasive.

"Adverse selection" also came into play to cause instability. The banks as well as non-bank financial institutions generously provided credit to investors in stocks (which are inherently high-risk, but potentially high-yield investments) who

supervisory role of Bangladesh Bank.

"Moral hazard" implies that regulators would rescue the investors though their losses were the consequence of irrational investment decisions. This perception encourages assumption of high risk. In the context of our stock markets, moral hazard has been reflected in changes in policy stance by Bangladesh Bank with regard to exposure of banks to stock markets and frequent changes by SEC in respect of loan margin ratio

mary duty is to ensure fair trading.

To ensure stability of stock markets would require actions on a number of fronts. Some of these are suggested below:

• **Increase in the number of scrips:** There has been an explosion of market capitalisation on the basis of price inflation of existing scrips. There have not been many new issues of initial public offering (IPO) over the last couple of years from the private sector, with the notable

conditions for eventual downside. Furthermore, adverse impact of manipulation by any errant market actor with respect to a few shares would be minimised.

• **Coordinated role of regulators:** Bangladesh Bank and SEC should regularly exchange notes and adopt policies with due regard to interactions between money market and capital market. Policies, once adopted on the basis of mutual consultations between the two

Humanistic border, not nationalistic

SANJAY BHARDWAJ

India and Bangladesh have very close socio-cultural, linguistic and racial affinities, which evolved from a common historical legacy and geographical proximity. Without considering the ground realities and the people's socio-economic lives, Bengal was divided between India and Pakistan in 1947.

However, it did not matter initially to the people as the borders were virtually porous and they could visit each other freely. These intermingled ethnic groups continued their socio-cultural and economic activities, to the extent of getting into marriage alliances. However, these activities were legally put off with the partition of Bengal, and became difficult after the Indo-Pakistan war of 1965 when the land and railways routes were stopped.

The poor people were forced to cross the boundary in search of socio-economic security. During the last decade, due to regional security threats and tightening of control on the borders such activities have become very difficult.

The Indo-Bangla border is the longest land border that India shares with any of its neighbours -- 4,096.7 km. Fifty-four cross-border rivers constitute riverine borders between the two countries.

There is much in common between the two neighbours, but trans-national terrorism, insurgency, smuggling and trafficking have spoiled the environment to the extent that cross-border firing and killings between or by the security agencies have become a regular phenomenon.

A Human Rights Watch Report (2010) stated that in the last decade more than 900 Bangladeshi and Indian nationals were indiscriminately killed by BSF. Hence, bilateral relations have become hostage of the irritants at the border, but the causes of insecurity remain unaddressed.

The Indo-Bangla border has 6.5 km of un-demarcated boundaries,

which are spread over three sectors. The disagreement because each would have to give up small portions of land which are at present in their respective possessions. However, in the 4th meeting of the Joint Boundary Working Group, both sides agreed to resolve the differences and demarcate the land boundary in all three un-demarcated sectors.

There are a number of exchangeable and non-exchangeable adversely possessed enclaves. India has 111 enclaves in Bangladesh and Bangladesh has 51 enclaves in India. In July 2001, the West Bengal government agreed to grant access between Dahagram and Angorporta through Tin Bigha Corridor under the Lease Agreements of 1982 and 1992.

In the 4th JBWG meeting, both sides expressed satisfaction at the electrification of Dahagram and Angarpota. With a view to implementing the decision to allow 24-hour unfettered access through Tin Bigha Corridor, both sides agreed to put in place all the infrastructure and security.

Due to these irritants, neither state is ensured freedom from fear or freedom from want of the people in border areas. They have increased the involvement of local people in crimes committed by violent non-state actors. Hence, the problem of terrorism, insurgency and border crimes correlates with the problem of underdevelopment, and all are a threat to sustainable peace and stability on the border.

Successive governments have remained tied up with a narrow conception of border management, which envisages nothing more than the establishment of static border posts, regular patrols, ambushes and so on. The Indian government has accorded topmost priority to erecting fences along the border.

Viewed against the backdrop of rapidly changing meanings of internal as well as external security, it is apparent that border management is

not simply a matter of policing along the border; it is an issue that needs a comprehensive and holistic treatment.

Indeed it is being increasingly realised now that border management must include defending the border in times of war; securing the border in times of peace; stopping unauthorised movement of people; coordinating intelligence inputs

in Dhaka must realise that a humanitarian border is more stable than a nationalistic one.

• **When the whole world is getting integrated,** India and Bangladesh should also reduce the distance between each other. The Indo-Bangladesh border has a higher potential for trade than any other border of India. Therefore, both the governments need to take immedi-



In ensuring human security, sustainable peace and development both the countries should also establish joint ventures and develop business-related infrastructure on border areas.

from various agencies and, above all, ensuring socio-economic development of the border areas.

With the problems being trans-national, a unilateral approach to border management cannot resolve them; only bilateral or multilateral approaches of development can ensure human security across the border. The ongoing bilateral Joint Working Group and JBWG meetings

ate measures for the removal of all the barriers to ensure legal trade. The implementation of the recommendations should not be nationalistic but humanistic. Both the countries have agreed to organise border haats on a pilot basis at Sunamganj and Kurigram from February 2011. Liberalising immigration and visa policy, and facilitating trade and investments are

measures that could minimise illegal trade and migration across the border;

• **Consequent to the LBA of 1974,** the "Joint Indo-Bangladesh Guidelines -1975" were framed for the border forces of both the countries. The aim was to ensure cooperation between them to exchange information and intelligence at appropriate levels. The guidelines were meant to prevent development work of any nature within 150 yards on either side of the international border. However, both countries recently reached an understanding where India can have constructions at 12 points and Bangladesh at 11 points within 150 yards of the zero-line. This will create a conducive environment to remove the fear among the people of the border areas;

• **In the 4th JBWG Meeting,** both sides agreed that the issue of enclaves and adverse possessions should be addressed in a pragmatic manner and necessary steps should be taken to facilitate the exchange of these enclaves in the light of jointly assessed ground realities. Involving the border population in resolving border problems, particularly the problem of adversely possessed enclaves, or chittmahals, would build confidence among them. In reality, these are stateless people with no road, no electricity and no education;

• **Bilateral mechanisms for the exchange of information on border areas,** implementation of a single information system with databases, intelligence gathering, joint training and certification for personnel directly involved in border control activities would make a stable and peaceful border. At the recent meetings of BSF and BGB, both sides agreed on joint patrol to check terrorism, smuggling and trafficking, not to fire on innocent people, and also to develop awareness among the bordering people

to obey the rules;

• **India and Bangladesh have signed a deal of \$1 billion soft loan,** particularly for infrastructure building. Both have also agreed in principle to provide transit facilities to connect with Nepal and Bhutan and India's North Eastern states. Similarly, both the governments should also take up a comprehensive approach to develop infrastructure and people's livelihood in the border areas. These initiatives would help in filling critical gaps in the social and physical infrastructures on either side of the border, and also inculcate a sense of security and integration among the population of the eastern South Asian sub-region;

• **Inclusion of local self-government and local people and civic bodies (gram panchayat and salish) would help in factoring the aspirations of the border population into a comprehensive border management policy.** The coordination between the local law enforcement agencies, civil administration and civil society stakeholders can also help to build a humanitarian border.

Some of the recent initiatives may ensure freedom from fear, but freedom from want can only be achieved through a comprehensive border development approach. The border area population could be involved in holding of joint socio-cultural and economic activities like melas, haats, and cultural programmes.

In ensuring human security, sustainable peace and development both the countries should also establish joint ventures and develop business-related infrastructure on border areas, which will focus on improving employability and developing entrepreneurship. This would help to develop a humanitarian border.

SANJAY BHARDWAJ IS ASIA FELLOW, (ASIA SCHOLARSHIP FOUNDATION), UNIVERSITY OF DHAKA, AND ASSISTANT PROFESSOR FOR BANGLADESH STUDIES, SIS, JAWAHARLAL NEHRU UNIVERSITY, NEW DELHI.