

TOWARDS BUILDING A MODERN ECONOMY



DHAKA TUESDAY
FEBRUARY 20, 2018
FALGUN 8, 1424 BS

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DHAKA STOCK EXCHANGE LTD



Our stock market is far from reaching a stage where it can serve as an alternative to banks and transform our economic aspirations to reality.

For a vibrant financial sector

Reforming Bangladesh's stock market in a modern competitive economy



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An "economic miracle"—that's how leading international newspaper the *Financial Times* described Bangladesh in an article last year as it showered praises over our economic achievements. High GDP growth, middle-income status and the explosive rise of our manufacturing sector, to name a few.

These days, we are all hoping to see two central engines—public and private investment—shift into overdrive and carry our economy onto the next stage of development: eight-percent growth with greater shared prosperity. And it goes without saying that catalysing investment will need easy access to affordable and long-term capital. But a financial system almost monopolised by an ailing banking sector cannot do that. If banks lend long-term with their relatively short-term deposits, they will undoubtedly get into trouble, sooner or later.

Herein lies the need for a vibrant stock market. One that can raise long-term capital for private and government projects in a way the banking sector never could, where inefficiency and corruption led to borrowers paying too much to get loans and depositors receiving less than they should (the high interest rate spread problem).

Sadly though, our stock market is far from reaching a stage where it can serve as an alternative to banks and transform our economic aspirations to reality.

DISCONNECT BETWEEN MARKET AND ECONOMY

To be sure, there were some developments in the market worth writing home about. Biggest of these was perhaps demutualisation of the bourses. It is fair to say that separating traders from owners will modernise the stock market from multiple dimensions. It is our hope that

demutualisation will result in a governance structure that makes the market more flexible in responding to changing economic conditions, reduce concentration of ownership power in a small group of people, and of course improve transparency.

Another reform that is likely to bring transparency is the Financial Reporting Act which was passed in 2015. No one needs reminding that the market has long suffered from crafty accounting manipulations that made a firm look a lot more valuable than what it was worth. And ingenious investors were the first to fall prey to such innovative financial engineering. The combined effects of just these two reforms could go a long way to rebuilding the confidence investors lost after the infamous crash of 2010. Then again, regulators will have to convince ordinary people that they can ensure strict compliance and impose penalties in case of deviations from best financial practices.

For now, investor confidence remains low. So much so that the market has remained in doldrums for several years following the 2010 crash. While we saw occasional rallies over the next few years, there was never really any discernible upward trend in the general market index for a long time—especially one that we could tag to positive economic development like an increase in industrial production.

Some will argue we saw a big rally last year. Make no mistake; that had little to do with sound economic fundamentals. Stock prices soared to unprecedented heights, driven primarily by banks at a time when the banking sector is going through one of its most difficult times with skyrocketing bad loans. What really happened was that the Bank Companies (Amendment) Act 2017 was passed which allows a greater number of directors from a single family in a bank's board as well as increases their tenure. Naturally, sponsor-directors of banks invested heavily as they expected the amendment to the Act, while small investors got caught up in the rally and simply followed the big ones. Speculation on dividends added fuel to the fire. That the Act will probably worsen the perennial problem of non-performing loans had little bearing on retail investors' reasoning.

Sure enough, the market's performance in the first two months of 2018 leaves little doubt that it is still woefully delinked from its growing economy,

where many sectors continue to flourish year-in and year-out. The first week of February saw the benchmark index suffer its worst fall in over four years! True, we can lay the blame on moderate political tensions or a slightly tighter monetary policy. But if the common

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people truly had confidence in their investments they would not run for cover at the first sign of trouble. After all, the economy is still growing at seven-plus percent.

Three important lessons stand out from last year's rally and this month's dramatic correction. First, genuine investors still sorely lack confidence and rely more on rumours instead of carefully looking at a company's financials, business model and management integrity. Most are looking only for short-term investments. Second, the market is severely under-represented by hundreds of big corporations which have ignited economic activity in Bangladesh for the last decade. Third, foreign institutional investment remains too small to have any sizeable impact on our market; if they did, then we would probably see fewer episodes of unexplainable spikes and corrections.

THE REFORM AGENDA: WHAT WILL IT TAKE?

It is fair to say that regulators have their work cut out for them. Not least because there is still serious lack of coordination between major regulatory authorities: Bangladesh Securities and Exchange Commission (BSEC), Bangladesh Bank and the finance ministry. It was this lack of coordination that played a crucial role in bringing about the crash of 2010 that wiped out savings of millions of retail investors. And that is where the reform agenda must start: better policy coordination. For instance, with 50-plus financial institutions listed in the market (banks and non-banks), how effectively these organisations work together will shape money market developments which in turn will affect the equity market's medium- and long-term stability.

Regulators, together with professionals working in the market, must play their part in educating retail investors about the hazards of relying on rumours like ABC company's share price will shoot up suddenly without proper economic or financial reason. Carrying out minimum due diligence before investing is not an option, it's a necessity.

If regulators are serious about raising confidence and bringing vibrancy to our market, they have to ensure that big firms with strong business models go public. Market capitalisation to GDP ratio, which is a fancy term that indicates how much of an economy's monetary value is represented in the stock market, remains only around 20 percent. For the record, it is well over 30 percent in Vietnam, 45 in Indonesia, 70 in India and over 100 in Malaysia. The blame lies squarely on big corpora-

tions, particularly multinational corporations (MNCs), which hold oligopolistic power in several sectors like telecom and consumer packaged goods but refuse to come to the market.

For much of the last decade, more than 50 MNCs profited from a burgeoning middle-class and rising consumerism while only 13 have been generous enough to come to the stock market and share a sliver of their massive profits with the common people (through dividends and capital gains). Since only these few corporations hold around 25 percent of the stock market's total value, the ramifications of merely doubling the total number of MNCs in the market are huge. We remain convinced that their presence will raise investor confidence, encourage long-term investment, attract foreign institutional investors, reduce influence of so-called "gamblers" and in general bring a level of dynamism never seen before in our stock market.

That brings us to the need for substantial reforms in tax policy. At the end of the day, these profit-maximising firms need to be given the right incentives. Regulators should seriously consider further reductions in corporate tax rates—say, to 20 percent—for listed companies. Further tax incentives could be offered if corporations consistently offer attractive dividends and/or offload a large share of stocks (say 30 percent) instead of just the minimum required to go public (10 percent). Needless to say, these rates should be the same for all sectors, including banks and telecom, which isn't the case at the moment. To be sure, some MNCs might still not want to go public simply because they don't have to. If that happens, regulators need to muster some serious political will and persevere the idea of mandatory listing of MNCs after they have operated in Bangladesh for a certain period of time.

The MNC factor aside, there is consensus among economists and finance professionals that the market desperately needs more diversity. Stocks alone cannot attract institutional investment, particularly foreign portfolio investment. All around the globe, capital markets are characterised by a combination of stocks and bonds. A foreign fund manager interested in Bangladesh will only park substantial capital here if he can create a hedge between stocks—which by definition have inherent risks—and bonds. Particularly vital is

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