Assessing a Volatile Market*

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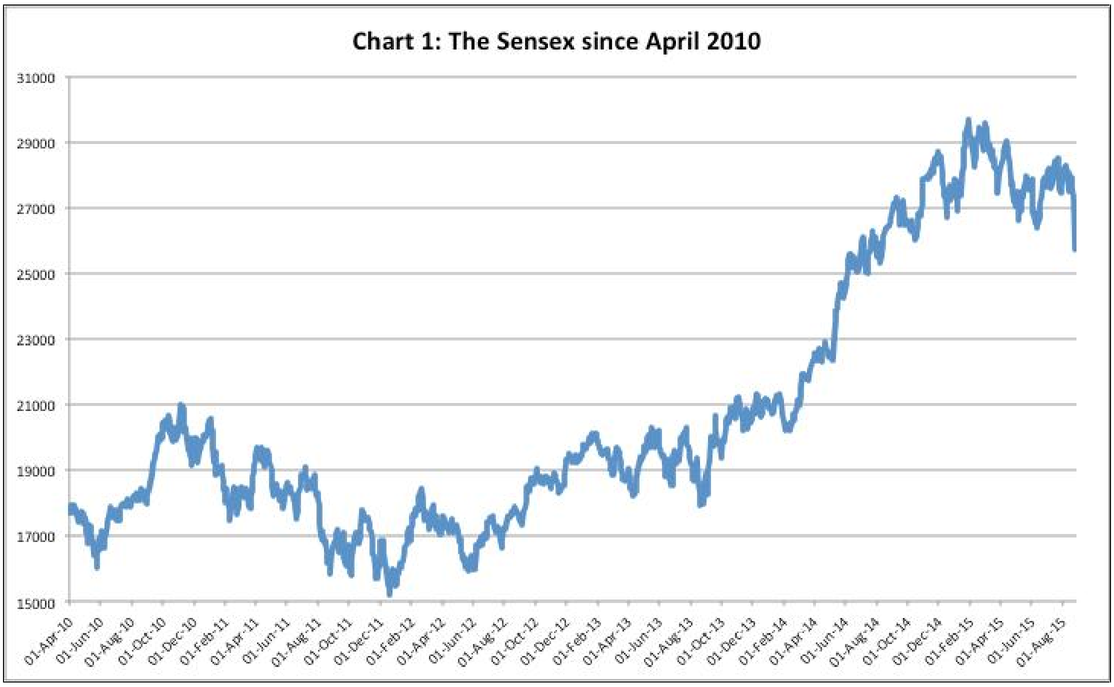
For India's capital market, especially its stock market, the last five years have been remarkable. After some signs of volatility between May 2010 and December 2011, the index rose sharply (despite fluctuations) from just above 15,000 to close to 30,000 in the short period to February 2015, barring the slight hiccup in mid-2013 induced by the announcement of the US 'taper'. Since then volatility has returned, reflected starkly in single-day, 1625-point collapse on 24 August 2015, which was the largest single-day decline in six years (Chart 1).

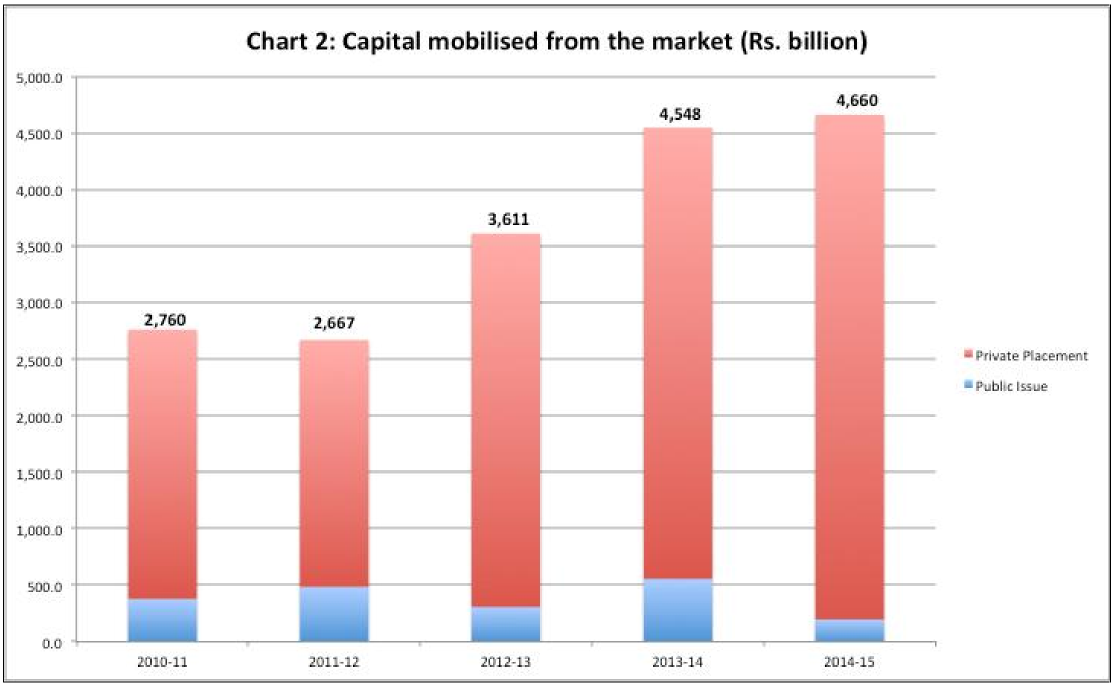


There is consensus on the issue that global uncertainties are increasing volatility in India's stock market. But what matters is the principal way in which those uncertainties are transmitted to Indian markets. This is through the decisions of foreign investors who are important players in these markets and holders of legacy investments made in the past but eligible for repatriation. Their decisions influenced by global developments increase volatility, and that increased volatility, in turn, generates responses that intensify instability. If the ultimate consequence is a large and extended exit of foreign investor capital from the market, the process soon tells on the value of the currency, and generates turmoil in the currency market as well. Together these trends have ripple effects that in the final analysis affect investment and growth in the real economy.

Given these consequences, the net benefits that India derives from these markets, and the institutions, investors and instruments that populate them are in question. A really potent argument in their defence could be that the markets for equity and debt serve as the sites for mobilising permanent or long-term capital for investment and capital formation in the economy. Does the Indian capital market in general, and stock market in particular, show signs of serving that purpose as the market ostensibly "matures"?

If the market is to serve as a source of finance, what matters is the primary market, where companies for the first time or as a follow up of previous efforts issue new paper in the form of equity, debentures or bonds and mobilise capital. It has for long been held that the primary market for equity in India is miniscule and volatile in terms of amounts mobilised, and that the corporate bond market is so inactive as to be virtually absent. But evidence from the years after the global financial crisis seems to suggest that things are changing.

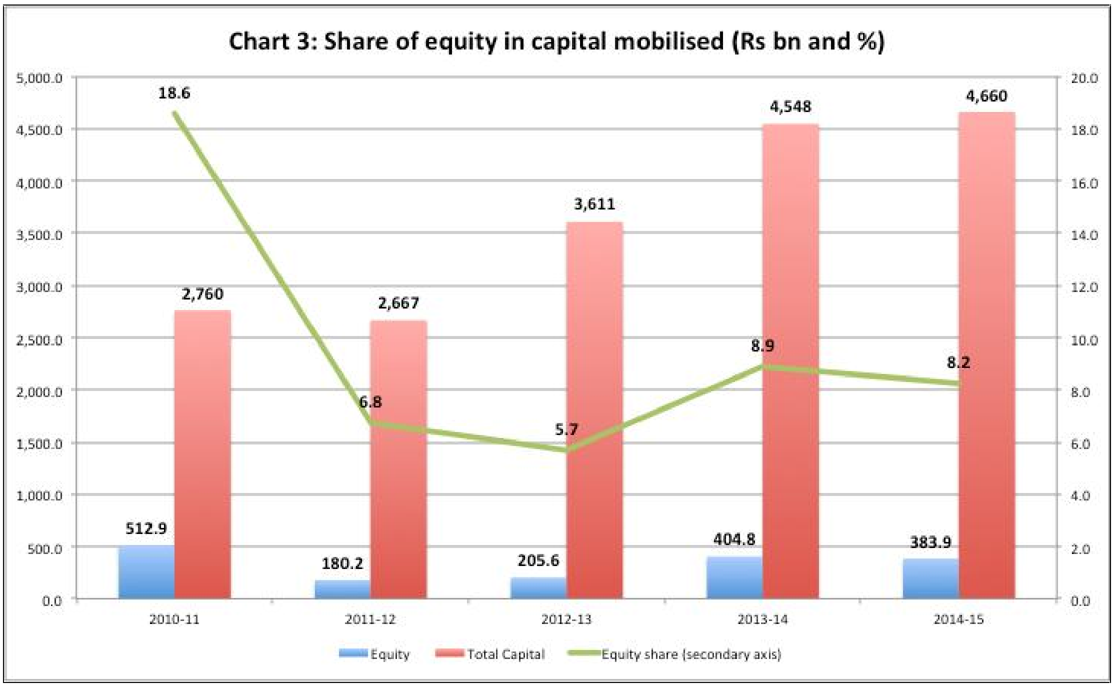
According to figures from the Reserve Bank of India, sums mobilised from the primary market for equity and debt rose from Rs. 2,760 billion (Rs. 26,601 crore) in 2010-11 to Rs. 3,611 billion in 2012-13 and Rs. 4,660 billion in 2014-15 (Chart 2). This implies that the ratio of capital mobilised in these forms (which exclude ADR/GDR issues) to Gross Fixed Capital Formation fluctuated between 29 and 34 per cent during 2011-12 and 2014-15. Those are by no means magnitudes to be scoffed at, and call for greater scrutiny.



What is remarkable is that, despite fluctuation a very large and sometimes dominant share of this capital was mobilised by the private sector. This points to the fact that mega-disinvestment issues by public sector companies (such as Coal India in 2010) were not the only source of this primary market buoyancy. What is not clear from the figures quoted thus far is whether this reflects a process of disintermediation in which investment is now being financed in significant measure by direct mobilisation of market funds by investors, rather than by investments and loans intermediated by the financial sector. Is corporate financing in India gradually shifting in favour of a more market-based model?

One reason this need not be true is that public issues can be subscribed to by promoters (especially in rights issues) as well as the government and government owned or sponsored financial institutions, with a relatively small direct financing role for the “public”. Thus, even during the partly scam-induced, retail investor boom of the early 1990s, Reserve Bank of India data suggests that the absorption of new issues by promoters, governments, financial institutions and insurance companies exceeded 50 per cent of the total capital mobilised through that route. However, since then the role of the financial institutions in corporate financing has diminished and many have disappeared. Moreover, mutual funds are now the new intermediaries through which savers access capital markets, though the net funds mobilised by them has tended to be volatile and significantly negative (because of large redemptions) in some years.

The real twist however comes from two other sources. The first is that private placements of equity and debt instruments, rather than prospectus and rights issues of equity and the public issue of debt (debentures and bonds), accounted for an overwhelming share of the total new capital mobilised. Over the counter negotiations between large players and investors rather than market forces are likely to be more important here. The share of private placements in total capital mobilised fluctuated between highs of 82 per cent in 2011-12 and 96 per cent in 2014-15. This is an active market indeed, but it is not the stock and debt markets with trading desks and screens that seem to be delivering the capital.



A second, related characteristic is that debt rather than equity issues were the instruments that garnered much of the capital. The share of equity in the total capital mobilised in both the market and the private placement segments combined fell from its not too high value of 19 per cent in 2010-11 to 6 per cent in 2012-13 and then settled in the 8-9 per cent range over the next two years (Chart 3).

There are two implications of importance to be derived from these trends. The first is that, whatever else we may say of equity markets in India, the primary market for equity either in the form of stock markets or the private placement route is still largely inactive, despite occasional signs of buoyancy. It is only the secondary market, which directly delivers nothing by way of capital for new investment, that is active. Unfortunately, that is the market into which the foreign investor capital that generates volatility flows. Secondly, to the extent that the primary market is significant, that seems to be the result of increased activity in the (private placement) debt market. The world economy is still awash with the cheap liquidity infused into the system in response to the financial crisis and economic recession. Exploiting that, players hoping to profit from differentials in interest rates between developed economies and emerging markets, have discovered Indian debt markets as one among the lucrative sites for alternative investments. Those inflows too are volatile, as the flight of capital during the "taper tantrum" amply illustrated. Increased uncertainty rather than increased financing for investment seems to be the benefit delivered by India's capital market. This makes a case for taking stock and assessing whether some restraint on investor and market freedoms is warranted.

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