Policy Research Institute of Market Economy

آزادمعیشت۔ خوشحال پاکستان

POSITION PAPER[1]

"Alternate Stock Exchange & Indian Precedent"

INTRODUCTION –

In the modern market economy, a stock exchange will be accounted among its most visible icons. Its engagement with general populace is smooth and seamless. Entry and exit in stock trading is easy even for the first time investor. Media loves it, as it can provide daily stream of juicy stories behind high and lows of the stocks. With big money flowing, its operators enjoy strong support among sections of government and corporate sector. In this favorable environment, it is never easy to challenge the conventional wisdom of equating local stock market as the barometer of our economy. Any effort on inducing more competition or pro-market reforms in the local stock market can easily be thwarted by a nexus of state and brokers. Purpose here is not to contest the efficacy of stock market in a country's economy, but to stress upon the rent-seeking structure of local stock exchange.

And case in point is the ongoing saga of demutualization of local stock market. After an over a decade long struggle, government promulgated the Stock Exchanges (Corporatization, Demutualization & Integration) Act in May 2012. Now the question arises that whether this demutualization is favorable for market and its participants. And if it is favorable, then why it has not been implemented even after the lapse of 419 days of the act promulgation? And if it is inefficient that then why all the major stock exchanges of the world have been demutualized? On our end, there seems to be no sense of urgency. It appears that everyone is happy with the status quo and desire to drag the demutualization process as long as possible.

From libertarian perspective, it looks like a classic case of market rigging in favor of few by suppressing competition. This issue will be explored in detail later in this position paper. We will strive to comprehend the process of demutualization and look at a similar precedent in Indian stock markets. Comparison will be made on the economic value addition of the two models in India and Pakistan. And final section of the position paper will propose an action path for PRIME, whereby it may get engaged with state and market stakeholders for pro-market policy initiatives in this regard.

EXPLORATION –

Rationale behind this demutualization drive was to bring local bourses in line with international practices in the sector. Obviously, no market can buck the trend & Pakistani stock markets cannot remain an exception. Purpose of this journey from non-profit to for profit stock exchange structure is to bring in international strategic investor, who will take operational control of the stock exchange with 40% shareholding. Remaining 40% will be distributed among existing stock exchange members & remaining 20% to be offered to general public through IPO. Moot of concern here is not the reluctance of foreign investors in taking a strategic stake in local bourses, but the lack of the vigorous marketing by concern stakeholders.

[1] This position paper is written by Mr. Zia Banday, dated 29th June 2013.

Now, should we blame the typical government lethargy for this delay? We need to stop here, unfortunately in this case, blame for this delay on seemingly efficient market path should be apportioned more on market players. And who are these market players? Indeed, the list includes our respectable & influential broker community along with their associates in financial & regulatory community. Yes, we have deliberately used the word of 'Regulator Community'. In the light of Supreme Court verdict on Chairman SECP, it can be safely assumed that the high pedestal of our bourse's regulator, i.e. SECP, is been run by the lackeys of stock market players, the regulatee. In economic terms, we call it regulatory capture, which means that you have made cat as guard on the milk.

It appears bit paradoxical, as expansion of market should bring more business for market players, but in demutualization case, so called market players are always found dragging their feet on opening of market. Now question is why & answer is rent. Our stock market elite have earned excessive profits owing to inefficient structure of the market. And they like to keep it like that till it is possible. New competition always raises uncertainties; isn't it logical for existing status quo to resist efficient outcomes? We did mention the beneficiaries, but who are the losers, it is us, the people, it is the innovators & in the end it is the economy, which misses opportunities to expand. And we create not a competitive market, but a rigged market.

From libertarian perspective, we remain wary of government intervention in the economy. However, we are equally wary of private interests rigging the market in their favor. It destroys the image of the market in the eyes of the masses. And their start a clamoring of government intervention to correct these excesses of the market players, which does attracts substantial political support. Unfortunately, in our stock market case, it is not the state intervention that is responsible for its non-market tilt. It is led by private interest to manage the monopoly in their favor & use government officials for the purpose. Obviously, we should not be naïve here to think that stock market reforms are initiated by some visionary state functionaries. It was basically financed with multilateral funding, which has its own ways of spending taxpayers' money from developed countries in developing regions. We are not here discussing the merits or demerits of the foreign aid. However, we are more concerned with the opening of the markets. It will be better if state opens up the market on its own. It remains a long-drawn struggle; however support could be picked from unintended quarters, if it doesn't compromise the basic principle of facilitating free markets.

It is imperative to mention here that this acquisition of rents is more of a political process than an economic one. This comprehension is essential here if we desire to take a position & suggest a path ahead. We have to make a political case for free up the market space from so called market players. We do hear from our bourses' elite that Pakistani market is not ready for opening up, it needs time to adjust, etc. They are all excuses to sustain their stranglehold on the market & keep the competition low. And with enormous money, they can buy clout in media & government, who remains indebted to them for their so called contribution to the barometer of economy. It seems to be a cruel joke for the helpless public to sit & observe this chagrin of vested interests.

We understand that stock market is an important component in a market economy. However, the way the stock market being operated in this country, does it fulfill the criteria of market efficiency? It has a monopoly status, but barriers to entry for membership remains high. How much has it contributed in capital formation in the country? Not much, it appears more of a casino for the benefit of few with the price paid by many. It is not a sustainable model & fortunately market offers many solutions with precedents available.

We'll be building our case on similar precedents, whereby proponents of competition decisively altered the paradigm against market riggers. And in our issue, we will undertake a comparative view of evolution of stock markets in Pakistan & India. We'll talk in figures, so that it becomes an objective take on the underlying matter. In nominal terms in 2012, estimated GDP of Pakistan stands at USD 230 billion, whereas Indian GDP aggregates around USD 1.947 trillion. India has two main stock exchanges namely Bombay Stock Exchange (BSE) & National Stock Exchange (NSE), whereas there are numbers of regional exchanges. However, 98% of the share turnover takes place in BSE & NSE. Likewise, Karachi Stock Exchange (KSE) remains the premier exchange of the country. For comparison purpose, we'll be using data of BSE, NSE & KSE.

In terms of structure, NSE was established as a demutualized corporate body since its inception in 1993. BSE has become a demutualized corporate body in 2005. As of 2012, market capitalization of BSE stands at USD 1.203 trillion with 5163 listed companies, making it the 10th largest stock market in terms of capitalization. NSE is the 11th largest stock market of the world with a capitalization of USD 1.178 trillion & 1646 listed companies. If we look at KSE, it is at its historic high with a market capitalization of USD 51.36 billion & 569 listed companies.

Besides liquidity, worth of the stock market can be gauged from its role in capital formation in the economy. In last 5-years, 409 companies in India have raised USD 49.44 billion of money from BSE & NSE. In case of KSE, we have actually seen the increase in delisting. In last 5-years, only 19 new companies were listed on KSE, whereas total listed companies have been reduced from 651 to 569. In terms of product offering & reach, KSE has no match with NSE & BSE. We do not want to go into details here, but Indian stock markets offers an array of equity & derivative products available in any developed market of the world. This is the reason that registered Foreign Institutional Investors in India has increased over two-fold from 833 in 2006 to 1742 in 2011. Their average annual portfolio investments have remained over USD 10 billion in last 5-years. And we should well understand here the contribution of Indian stock markets in the sustenance of annual 7% average GDP growth. Can we talk same about the KSE? Regretfully, we can't give it that distinction.

However, this is not the whole picture of Indian stock market evolution to this world class status. It remains a struggle of intrigues and vested interests over many years. In order to shorten the story, we take 1994 as a cut-off year, when NSE started its operations. Those were the days of BSE monopoly, with its strong broker community calling the shots on the reform front. Just like KSE in our case, BSE had always erected roadblocks in execution of any reform in its running. In Indian case, it was the bureaucracy in SEBI & public sector development bankers, who took the mettle to compete with established BSE with a totally new stock exchange. Nobody expected that these public sector bankers can compete with entrenched players of BSE. However, commencing their journey with state of the art trading technology, where they used satellite for connecting their trading terminals, NSE literally swept BSE by exceeding its share turnover in just 3-years time. Now, this is what we talk about the pent-up demand in the Indian stock market & power of competition. After that, there was no looking back for NSE. It enjoys over 2/3rd of the shares turnover & has trading terminals in over 1500 cities all across India. This remains an amazing success story, where a new kid on the block has dictated terms of doing business to an over 100-year market player.

***POSITION* –**

Based upon our findings and libertarian principles, we hereby adopt a stance that Pakistan requires an alternate stock exchange for inducing greater competition and enhancing investors' choices. The existing structure of stock market possesses more elements of anti competition and rent seeking. Even in the demutualized state, the shadow of current stakeholders will loom large, which will impede implementation of international best practices and broadening market base. Stock Exchange is a market of exchange, whose rules should not favor few. We support opening up of such market to more competition and new products. In this manner, interest of all stakeholders including market operators, government and investors will be served optimally.

***ACTION* –**

It appears that we need some similar shock therapy in Pakistan. As citizens of this country & participants in its economic activities, the issue of allowing another stock exchange in the country needs to be risen with SECP. In this regard, necessary case should be prepared for presentation at the regulator end, as well as for the parliamentary committee on finance. Stock market remains an economic good, but we need to understand here that a political struggle has to be waged for saving this economic good from crony malice. It can become a worthy & profitable cause for enlightened entrepreneurs in Pakistan & abroad. We conclude this short position paper on our reiteration that only competitive markets can create sustainable prosperity for wider population in any society. And stock market in Pakistan is a test case for us in this regard.