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Indian Capital Market: Issues and Challenges

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ABSTRACT

Capital market deals with medium term and long term funds. It refers to all facilities and the institutional arrangements for borrowing and lending term funds (medium term and long term). The demand for long term funds comes from private business corporations, public corporations and the Government. The supply of funds comes largely from individual and institutional investors, banks and special industrial financial institutions and Government. Modern capital markets are almost invariably hosted on computer-based electronic trading systems, most can be accessed only by entities within the financial sector, but some can be accessed directly by the public. Despite fast economic growth, India still faces massive income inequalities, high unemployment and malnutrition. India needs to follow through with deeper and more wide ranging reforms which will bring the regulatory environment and the framework of the economy to a level which can cope with the challenges of growth. The present paper aims at focusing the issues and challenges of Indian capital market in current scenario and also suggests necessary policy reforms for a relatively effective capital market.

KEYWORDS : Capital Market, Government, Funds and Economic

INTRODUCTION

A capital market is a market for the buying and selling of long-term debt or equity-backed securities. In other words, it is defined as a market in which money is provided for a period of more than a year. These markets direct the wealth of savers to those who can put it to long-term productive use, such as companies or Governments making long-term investments. The capital market includes the stock market where the equity securities are traded and the **bond market** where the debt securities are traded. Financial regulators, such as the India's Securities and Exchange Board of India (SEBI) or the U.S. Securities and Exchange Commission (SEC), administer the capital markets in their designated jurisdictions to ensure that *investors are protected against fraud*, among other duties. Certain rules and regulations are formulated by them which must be stick on to so as to safeguard the interest of the investors. Modern capital markets are almost invariably hosted on computer-based electronic trading systems, most can be accessed only by entities within the financial sector or the treasury departments of Governments and corporations, but some can be accessed directly by the public. There are many such systems, most serving only small parts of the overall capital markets. Entities hosting the systems include stock exchanges, investment banks, and government departments. Physically the systems are hosted all over the world, though they tend to concentrate in the countries like USA, U.K etc.

DIVISION OF THE CAPITAL MARKET

A division within the capital markets is between the primary markets and secondary markets. In primary markets, new stock or bond issues are sold to investors, often via a mechanism known as underwriting. The main entities seeking to raise long-term funds on the primary capital markets are Governments and business enterprises. Governments tend to issue only bonds, whereas, companies often issue either equity or bonds. The main entities purchasing the bonds or stock include pension funds, hedge funds, sovereign wealth funds, and less commonly wealthy individuals and investment banks trading on their own behalf. In the secondary markets, securities existing are bought and sold among investors or traders, usually on an exchange, over-the-counter, or elsewhere. The existence of secondary markets increases the willingness of investors in primary markets, as they know they are likely to be able to rapidly cash out their investments if the need arises.

Based on the type of securities traded capital market is divided into two parts i.e., stock market and bond market.

Capital Market = Bond Market + Stock market

(i) Bond Market - The bond market which is also known as the credit, or fixed income market is that part of capital market where participants buy and sell debt securities which are usually in the form of bonds.

(ii) Stock Market - A stock market or equity market is a public entity for the trading of company stock i.e., shares and derivatives at an agreed price. For Example: Bombay Stock Exchange or BSE is one of the oldest stock exchanges and also enjoys its stature of being the fourth largest stock exchange in Asia, deals with the trading of securities where about 5,085 Indian companies are listed.

The Securities Industry and financial markets Association (SIFMA) classifies the bond market into five different specific segments:

- Government & agency
- Funding
- Corporate
- Municipal
- Mortgage backed, asset backed, and collateralized debt obligation

ROLE OF THE INDIAN CAPITAL MARKET

The primary role of the capital market is to raise long-term funds for Governments, banks, and corporations while providing a platform for the trading of securities. This fundraising is regulated by the performance of the stock and bond markets within the capital market. The member organizations of the capital market may issue stocks and bonds in order to raise funds. Investor can then invest in the capital market by purchasing those stocks and bonds. The capital market, however, is not without risk. It is important for investors to understand market trends before fully investing in the capital market. To that end, there are various market indices available to investors that reflect the present performance of the market. Ratios relating to Indian capital Market are presented below in the table 1.

Table 1: Market Capitalization to GDP Ratio (percent)

Year	BSE Market Capitalization to GDP Ratio	NSE Market Capitalization to GDP Ratio	Derivatives Segment (BSE + NSE)
2010-11	87.7	86.0	375.2
2011-12	69.2	67.0	358.3
2012-13	63.2	61.7	382.6
2013-14	65.3	64.1	417.7

Source: SEBI Annual Report, 2013-14

In the table 1, the ratios such as market capitalization to GDP (m-cap ratio), traded value to GDP (traded value ratio) and price to earnings per share (P/E ratio) are monitored to gauge the extent of development of stock market. After declining for three successive years the market capitalization ratios have improved during 2013-14. The BSE market capitalization to GDP ratio has increased from 63.2 percent in 2012-13 to 65.3 percent in 2013-14. Similarly, at NSE also the ratio has increased from 61.7 percent in 2012-13 to 64.1 percent in 2013-14. The all-India cash turnover to GDP ratio however declined further in 2013-14 to 29.5 percent from 32.2 percent in 2012-13. In the derivative segment, there was a substantial increase in the turnover-GDP ratio from 382.6 percent in 2012-13 to 417.7 percent in 2013-14.

ISSUES AND CHALLENGES OF THE INDIAN CAPITAL MARKET

Indian Economy is the tenth largest economy in the world by nominal GDP and the fourth largest by purchasing power parity (PPP). Following a strong economic reform post-independence socialist economy, the country's economic growth progressed at a rapid pace, as the LPG policy was implemented in 1991 for international competition and foreign investment. Despite fast economic growth, India still faces massive income inequalities, high unemployment and malnutrition.

Given below are the significant issues and challenges of the Indian capital market:

- **Inflation** – Inflation is the rate at which the prices for goods and services are rising and subsequently, purchasing power is falling. The inflation situation in the economy continues to be a cause of concern. Despite tightening of the monetary policy by the apex of India, RBI and other steps taken by the government, inflation continues to remain close to the double digit mark. High international oil prices, high global food prices are some of the causes of high inflation.
- **Non uniform Tax reforms** - With the non uniformity in the tax system across the states it is a difficult task to carry out the businesses which resulted in undergrowth of the same. The different tax rates implemented in some states across pan India is a major challenge to carry out the business smoothly and also it accounts for a reason of increasing prices of goods and services.
- **Population** – The current population of India is over 1.27 billion, making it the second most populous country in the world after China, with over 1.35 billion people. India represents almost 17.99% of the world's population which is a serious concern. If the trend of growth continues, the crown of the world's most populous country will move on India from China by 2030. The population growth rate is at 1.58% with which it is predicted India would reach 1.5 billion mark by 2030.
- **Education and Unemployment** – 9.4 % of the population is unemployed which is yet another alarming issue for the growing nation. The literacy rate in India is 74.04% as of April 2011 population census which constitutes of 65.46% females and 82.14% males. The literacy rate is increasing but the rate of increment is low, which again is a matter of concern.
- **Index of Industrial Production** – Weakness in industrial production trend continues to be a point of concern for the economy. The recent IIP numbers was registered below expectation. Weakness was seen with growth in the capital goods segment, intermediate goods segment and consumer goods segment which slowed down drastically during these months.
- **Foreign Policy** – Foreign investment flows into India saw a dip of about 3% in the year 2013 over the previous year. This dip is largely on account of a slowdown seen in case of FDI. In 2012, India attracted US$ 22.78 billion of FDI, which was reduced to US$ 22.03 billion in 2013.
- **Poverty** – About 37 % of Indian population lies below poverty line which is a very alarming situation for a growing economy like India. The main reason for such diversity is the uneven distribution of wealth in the economy where a handful of people are the owner of maximum revenue and the majority of the population is too poor to even arrange for their daily bread. The poor people are high in number, while the high net worth people is very few in numbers.

SUGGESTIVE REFORMS

India needs to follow through with deeper and more wide ranging reforms which will bring the regulatory environment and the framework of the economy to a level which can cope with the challenges of growth. The following reforms are suggested:

- Expand the retail investor base for a developed Capital market, and also enhance the investor morale and domestic allocation. Investors' confidence need to be rebuilt through, enhanced investor protection, better transparency, market integrity, market efficiency and enhanced quality of supervision over market intermediaries.
- India has to streamline financial market regulatory architecture and move to single window approval process because there is an urgent need of redefining regulatory architecture gaps. The over lapping regulatory body is the major cause of ineffective regulations, inability and delay in exploring new markets and products design etc. for e.g. the most recent conflict between IRDA and SEBI over Unit Linked Insurance Plans (ULIP).
- Target Tier II and Tier III cities because, the share of household savings invested inequities are low and there is availability of immense potential in Tier II and Tier III cities. These cities should be the central point to attract investment in Capital Markets. This can be achieved by organizing investor awareness programmes and also few special incentive schemes may be launched for these regions.
- An initiative has to be taken for the increasing amounts of domestic savings and global investment into the infrastructure sector and other productive sectors. Initiatives required to be taken is (i) liberalizing buyback regulations to allow vendors of major equipments to hold equity in initial stages and buying back such equity when projects get operational; (ii) Allowing Private Equity Funds as bidding partners in infrastructure projects (iii) allowing pension funds to invest a greater part of their corpus in equities either directly or through mutual funds to infrastructure projects; and (iv) encouraged private initiatives.
- To focus on other instruments like Mutual Funds other than the equities where the funds are managed by big firms and portfolio managers.
- India's warrants market is underdeveloped due to challenges in participation, product design and pricing, therefore allow registered, well-capitalized entities with risk management capabilities to act as third-party issuers for warrants, trading of preferentially allotted warrants in the secondary market and introduce multiple warrant products to meet diverse investor needs.
- Interest-rate derivatives are needed to hedge rate risks, the largest macro-economic risk. Globally, interest rate derivatives constitute the largest part of derivatives turnover on both exchange traded as well as OTC products. In India, interest-rate derivates account for less than 1 per cent of turnover.
- Deepen corporate bond, Deepen warrants market, Deepen interest futures market and streamline securities lending and borrowing. Allow pension funds to invest in investment-grade corporate bonds, credit hedging instruments such as Credit Default Swaps and insurance companies to invest in all investment-grade corporate bonds, creating a liquid benchmark index that can be used for pricing.

CONCLUSION

India has successfully implemented the first phase of reforms in 1990s which slowed down. India needs to follow through with deeper and more wide ranging reforms which will bring the regulatory environment and the framework of the economy to a level which can cope with the challenges of growth. Emerging economies like India have an advantage of learning from the mistakes of others. Policy makers must ensure broad and deep financial market. A practical approach is required by both regulator and service provider. Regulation must not create hurdle for financial engineering and innovation and service providers must not create a situation of moral hazard by insensitive approach. Innovate for inclusive growth rather growth of balance sheet figure. As India is poised to develop as a super economic power it must address various challenges associated with the development of capital on priority. It has scope of development in sectors like Pharmaceuticals, Retail industry, Automobiles, Education, etc. FDI should be allowed in sectors to attract the foreign investors though keeping our own economy stable of its own and not mostly dependent on global market. Inter and Intra terrestrial issues should be dealt with proper policy making and private players should be encouraged in other sectors also so as to enhance the overall growth of the capital market and the economy.

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