Bangladesh Economist's Forum

Bangladesh Capital Market

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I. INTRODUCTION

1. The recent developments in the stock markets of Bangladesh have given rise to considerable divergence of views about its role in the economic development, more specifically economic growth, of the country. Some policy makers have termed the market as "wicked" and gambling casino. On the other hand officials of the exchanges have been trying hard to project the markets as a potentially major contributor to investment and hence to growth. In this backdrop, the objectives of this article are to (i) provide a brief overview of a priori arguments which lend support to the view that stock markets promote economic growth and related concerns (ii) given an assessment of the present state of development (iii) analyze the causes of the recent crash and (iv) provide some suggestions regarding how the stock markets can be revived so as to play their potential role as a contributor to investment and growth.

II. APRIORI ARGUMENTS AND EVIDENCE

2.1 Potentially positive impact on growth

(i) A developed stock market may yield higher returns on savings. The preferences of savers may shift away from holding their savings in the form of cash or fixed income yielding assets compared to which higher returns can be usually obtained from stocks. Thus the stock markets create an opportunity for the savers to diversify their portfolio and associated higher returns may encourage higher level of savings.

(ii) Irrespective of the level, stock markets enable greater mobilization of savings for investment. These supplement other institutional arrangements to mobilize savings such as banks.

(iii) Stock markets lower the cost of raising finance capital for investment. This can increase the level of investment and adoption as well as development of improved technologies to accelerate growth.

(iv) Stock markets permit substitution of equity finance for debt finances. The vulnerability of firms to fluctuations in earnings and interest rates is thus reduced with beneficial impact on investment.

(v) The intensity of adverse selection effect sometimes associated with financing by banks can be reduced by stock markets. If the prevailing interest rates are high, safe borrowers are discouraged from seeking credit. On the other hand, the banks may be tempted to finance projects which promise potentially high returns but fraught with higher risks. The resultant defaults in some cases may encourage banks to shun new borrowers.

(vi) The stock holders have the incentive to acquire information about the operational efficiency of the firms the stocks of which they have bought. If necessary, they can also effect changes in management leading to better corporate governance and improved use of resources.

(vii) Regulatory requirements of listed companies generally encourage adoption of improved accounting and reporting standards. These can lead to greater transparency and efficiency.

(viii) Finally, stock markets can attract foreign investment which can help bridge the well-known dual constraints faced by developing countries, namely, saving-investment gap and foreign exchange gap.

2.2 Contrary views

(i) A higher return on savings does not necessarily guarantee higher savings. “The level of savings is subject to two countervailing effects. The decision of the household on how much to save depends on its preference with regard to present versus future consumption. The higher return induces the household to give up present consumption for higher consumption in the future: the household’s members save more. This is called the substitution effect. However, the higher return on savings implies that the household needs to save less to obtain the same level of future consumption as before. In a sense, the higher rate makes the household wealthier, so it wants to consume more today. This is called the income effect, which leads to lower saving rate. Empirical studies have not provided a conclusive answer as to which effect dominates; that may vary across the population” (Catalyst Institute, undated, p.6)

(ii) There is a “free rider” problem. With many investors in a company very few may be willing to incur the cost of acquiring information relating to the operational efficiency of the company. The problem of information asymmetry between the managers and the shareholders may not be thus addressed and the supposed benefits of the improved corporate governance not realized.

(iii) In presence of the above scenario, investment decisions in the stock market may be influenced by movements in the prices. Pricing inefficiency may lead to a high degree of volatility resulting in speculative bubble and eventual bust with irrational change in market sentiment.

(iv) The bust may cause fall in other asset prices, create problems for banks with exposure to stock market, generate negative effects on confidence and thereby reduce consumption and investment and hence growth.

(v) An economic system based on equity system may discourage longer-form, somewhat riskier investment as firms become preoccupied with short term financial returns for shareholders (Feldman and Kumar, 1995).

2.3 Empirical Evidence

2. The above discussion suggests that the impact of stock market on growth in the final analysis is essentially an empirical question. There have been many studies which examine the link between the developments of the financial sector generally and economic growth. But studies which investigate the relationship between the development stock market specifically and growth are rather few.

3. There can be various measures to assess stock market development. Those include the number of companies listed on the stock exchange (Table 1), market capitalization as proportion of GDP (Table 2), turnover ratio i.e. Value of shares traded as proportion of market capitalization (Table 3), and market liquidity i.e. Value of shares traded as proportion of GDP (Table 4).

4. Atje and Jovanovic (1993) examined a sample of forty industrial and developing countries and found that the higher the ratio of stock market trades to GDP, the higher the growth of per capita income. A significantly positive relationship between initial stock market activity and subsequent growth was found in an extensive study by Levine and Zervos (1995). This finding is supported by another study (Filer, et al,1999). These authors also find that turnover ratio Granger-causes growth, but only for high and low income countries, but not for middle income countries and that there is no evidence that a change in the number of listed companies is linked to differing rates of economic growth. Mohtadi and Agarwal (undated), based on analysis of time series and cross-section data of 21 centuries for the period 1977-1997 find that stock market development has a positive impact on growth even after controlling for lagged growth, initial level of GDP, foreign direct investment, domestic investment and secondary school level enrollment. The positive influence is exerted both by turnover ratio and market capitalization ratio.

III. BANGLADESH SCENARIO

3.1 Bubbles and Busts

(i) The story in numbers

5. Bangladesh stock market has a chequered history. Dhaka stock exchange (DSE) started its journey as an incorporated body in 1954. However, formal trading began in 1956. Trading remained suspended during the 1971-1976 periods because of the liberation war and the socialist policy stance of the immediate post-liberation government and resumed in 1976 (Rayhan et al, 2011).

6. There was a big bubble in 1996 followed by a catastrophic crash. DSE index jumped from 957 on 2 November 1996 to a record high of 3649 on 5 November 1996. The index continued a downhill march thereafter with the lowest level record on at 463 on 3 May 1999. Since then the market remained in a state of doldrums. It started on a path of resurgence from 2003 (Islam, 2005).

7. The stock markets of Bangladesh witnessed another bout of wild crash in 2010. The general index of Dhaka Stock exchange stood at 4535 at the end of December 2009, nearly doubled in less than a year to 8912 on 5 December 2010, suffered drastic loss of more than 1200 points over a period of two days to dip to 6499 on January 2011 and then regained more than 500 points on the next day to reach 7512 following some policy pronouncements by Securities and Exchange Commission (SEC) and the Bangladesh bank. The index was 7378 on 17 January 2011. The downward march continued thereafter. As of now, index seems to have reached unjustifiably low level equalizer at around 4500.

(ii) The underlying causes

8. There are certain inherent characteristics of the financial markets which expose them to wide volatility. Those include asymmetry of information, adverse selection, herd behavior by investors and moral hazard. These factors appear to have afflicted our stock markets with vengeance in recent times.

9. “Asymmetry of information” in the context of stock markets implies that the investors know much less about the inherent worth of the companies shares of which they are buying/selling compared to managers and sponsors of those companies. Investors’ decisions, therefore, may not be based on rational considerations, perhaps even more importantly 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-earnings 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 behavior” in the sense that when some investors started buying/selling some shares, others joined in droves to follow suit without discriminating among shares on the basis of their intrinsic worth. The number of B.O. account holders skyrocketed to 3.3 million, many of them have been allured into the stock market by brokers who 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 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.

10. “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-yielding investments) who probably offered to pay higher interest, depriving investors in 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 realize that the indices reached unsustainable levels. This scenario brought into question the effectiveness of monitoring and supervisory role of Bangladesh Bank.

11. “Moral hazard” implies that regulators would rescue the investors though their losses were the consequences 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, frequent changes by the Securities and Exchange Commission (SEC) in respect of loan margin ratio 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.

12. In addition to the above factors, market manipulation has also been cited a cause of instability. This is an issue which was investigated by a probe committee headed by Mr.Ibrahim Khaled. The report submitted by the committee in 2011 cited market manipulation.

3.2 The state of development

13. Apart from wild booms and busts followed by prolonged stagnation, the stock market of Bangladesh is characterized by a poor state of development. As noted before, among the criteria for assessing the state of development of a country’s stock market are the number of companies listed, market capitalization as proportion of GDP, turnover ratio and market liquidity.

14. The number of companies listed in Bangladesh is similar to that of Nepal (Table 1). But the size of Nepal’s GDP is less than one-fifth of Bangladesh. Among the ten Asian countries as of 2012, Bangladesh had the lowest market capitalization as proportion of GDP (Table 2). However, it ranked second in terms of turnover ratio (Table 3) and fifth in terms of market liquidity (Table 4).

15. The stock market of Bangladesh has also been very ineffective in playing the role of intermediary between savers and investors in the real sector. This is reflected in the fact that the fund raised from the initial public offers on the capital market is insignificant compared to the fund raised through loans and advances (Chowdhury, 2014). The relevant numbers are presented in Table 5.

16. In high of above analysis, it is obvious that the stock market of Bangladesh remains in a state of underdevelopment. In the wake of dramatic crash of December 2010, SEC announced a market rejuvenation package (for details see Moazzem and Rahman, 2012). Some of the measures contained in the package have been implemented. Notable among these are the installation of surveillance software in SEC, demutualization of exchanges and establishment of an investment fund to give relief to small investors who suffered heavily in consequence of the crash. Nonetheless, as noted earlier, the market has not turned around on a sustainable basis.

IV. THE PATH TO BETTER FUTURE

17. Many analysts have suggested a variety of measures that need to be implemented to reinvigorate the stock makers of Bangladesh (see, for example, Islam, 2011; Islam 2012; Moazzem and Rahman, 2012). The suggestions that are considered to be of seminal importance and highlighted below.

(i) Increase in the number of scrips

18. There was an explosion of market capitalization on the basis of price inflation of existing scrips. There were not many new issues of Initial Public Offering (IPO) of significant size over the last few years from the private sector with the notable exception of Grameen Phone. The promised off-loading of shares of 26 state-owned enterprises has not materialized. 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 conditions for eventual downslide. Furthermore, adverse impact of manipulation by any errant market actor with respect to a few shares would be minimized. In order to ensure stability in the future, depth of the market needs to be increased by bringing in more IPOs.

(ii) Coordinated role of regulators

19. 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 consolations between the two 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.

(iii) Investor's education

20. The coverage of existing investor's education programmes conducted by the Stock exchange 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 cannot go on rising till eternity.

(iv) Strengthening monitoring and Surveillance

21. Both stock exchanges and SEC should strengthen their 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.

(v) Demutualization

22. 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 demutualized to resolve such conflict of interest. Bangladesh has recently followed suit and demutualized both exchanges (Dhaka and Chittagong). In order to derive the potential benefits of demutualization it is essential that the Boards of Directors operate independently and fairly. They also have to ensure that their regulatory responsibility is not subordinated to profit motive (Siddiqui, 2013).

(vi) Improvement of corporate accounts

23. In Bangladesh questions are often raised about the truthfulness, completeness and transparency of audited statements of corporate accounts. This is a vital prerequisite for stock investors to be able to make informed decisions. The establishment of the proposed Financial Reporting Council to exercise oversight over the auditors remains in a state of limbo. The relevant law which has remained in a draft form for a long time needs to be enacted soon.

(vii) Strengthening SEC

24. Despite some increase in manpower in recent times SEC probably remains understaffed. Perhaps even more importantly, SEC should be allowed to offer competitive wages so that competent staff can be hired. Moreover, the chairman and members of the commission must not be selected on the basis of political affiliation. The criteria should be competences integrity and capacity to exercise legally vested authority fairly and independently.

(viii) Concerted and speedy enforcement action

25. A perennial problem in Bangladesh is that wrong-doers in the capital market either go unpunished or there are long delays in disposal of cases. It is important that there is close coordination among relevant agencies to ensure speedy legal action against manipulators. Otherwise it will be hard to restore investors' confidence in the market.

Table 1. Listed Domestic Companies (Numbers)

	2000	2005	2012
Bangladesh	221	262	229
India	5,937	4,763	5,191
Indonesia	290	335	459
Malaysia	795	1,020	921
Nepal	110	125	216
Pakistan	762	661	573
Philippines	228	235	268
Sri Lanka	239	239	287
Thailand	381	504	502
Vietnam	-	33	311

Source: The World Bank, *World Development Indicators*, various issues.

Table 2. Market Capitalization (% of GDP)

	2000	2005	2012
Bangladesh	2.5	5.0	15.0
India	32.2	66.3	68.0
Indonesia	16.3	28.5	45.2
Malaysia	129.5	126.3	156.2
Nepal	14.4	16.5	21.9
Pakistan	9.0	42.0	19.4
Philippines	34.4	39.0	105.6
Sri Lanka	6.6	23.4	28.7
Thailand	24.5	70.8	104.7
Vietnam	-	0.8	21.1

Source: The World Bank, *World Development Indicators*, various issues.

Table 3. Turnover Ratio (Value of shares traded as % of market capitalization)

	2000	2005	2012
Bangladesh	74.4	31.5	61.2
India	133.6	92.2	54.6
Indonesia	32.9	54.2	23.3
Malaysia	44.6	26.9	28.6
Nepal	6.9	4.4	1.2
Pakistan	475.5	376.3	31.3
Philippines	15.8	20.1	16.2
Sri Lanka	11.0	24.3	9.2
Thailand	53.2	73.9	70.4
Vietnam	-	24.8	13.2

Source: The World Bank, *World Development Indicators*, various issues.

Table 4. Market Liquidity (Value of shares traded as % of GDP)

	2000	**2005**	**2012**
Bangladesh	1.6	1.7	10.8
India	110.8	52.0	33.5
Indonesia	8.7	14.7	10.4
Malaysia	64.8	34.8	40.8
Nepal	0.6	0.6	0.3
Pakistan	45.0	128.8	5.3
Philippines	10.9	6.7	13.9
Sri Lanka	0.9	4.7	2.8
Thailand	19.0	50.6	62.7
Vietnam	-	0.2	2.2

Source: The World Bank, *World Development Indicators*, various issues

Table 5. Funds raised from the stock market and from the banking system (Billion Taka)

Year	Amount from the stock market	Amount from banking system
2010	2.46	483.95
2011	2.41	638.41
2012	7.74	646.48
2013	8.38	388.71

Source: Chowdhury, 2014

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