Study of capital market in emerging economies

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Abstract

The reforms in capital markets in emerging economies are eminent for economic growth. Flow of capital from developed to developing and emerging economies depends on capital market reforms. Since 191, opening of Indian economy, many reforms emerged, enhancing the horizon of Indian capital market. Well integrated capital markets of emerging and other economies are essential for world economic growth. The fact of integration of capital markets worldwide is also emphasized by World Bank & IMF. "Financial inclusion" across the world, particularly in emerging economies will definitely widen the depth of capital markets. Capital market reforms built up confidence of business community, lowering the risk & increasing the percentage of earnings. Stable domestic currencies vis-à-vis foreign currencies also possible by monitoring & measuring the absorbable level of currency fluctuations, capital market in emerging economies, particularly stock markets are optimistically predicted by experts in that area. It is predicted that Indian BSE index may reach up to 100000 beyond by 2030. But all it is not without conditions stable rupee, oil prices, narrowing CAD, Stricter fiscal deficit targets, lowering bank rates, high potential growth of agriculture and industry along with stable and confident global political environment would enable boosting capital markets in emerging economies like India. Unemployment, Poverty, Population also add in the complexities of capital markets. Being foreign funds attracted more FII and FDI liberalization and wider scope for privatization enhances the credibility of Indian capital market.

There are big challenges like sectoral allocation of Capital resources, increase in risk appetite of the industry, long gestation funding like infrastructure projects, ample availability of power and other natural resources for industrial growth, skilled and empowered workforce, simplified tax structure and many other socio- economic factors hindering the attraction of capital markets in emerging economies. There are big opportunities for investors, financial institutions, Government agencies of developed economies to park their funds to earn reasonable good returns instead of their own stagnant or zero growth or negative return economies. But foreign funds waiting on the fence to kick start emerging economies. Funds will always flow with conditions and it is quite logical. Assurance of the sustainable stable return on investment coupled with sizeable control of undertakings or assurance of returns of capital whenever needed, should be guaranteed by emerging economies like India.

Instead of short term investments by hedge funds, long term stable investment may be targeted from NRI's and FDI and foreign government Institutions. Like global markets, markets in emerging countries are also driven by sentiments. Emerging economies should take advantages of Short terms bull and bear run as well as long term structural runs in global markets. Emerging economies should create risk emersion funds for absorbing shocks of global commodity forex and stock markets. Indian capital market is basically conservative which was exemplified in world market crash in 2007 when we were stable. But this should not lead to crony capitalistic approach of policy markets may be hindering long term growth prospects of the economy.

But ultimately question arises where we are? Where we desire to go? And how we could achieve the high growth trajectory by using capital market as an instrument for growth? It is really difficult to answer all these questions considering present state of affairs of Indian economy, but every dark cloud has a silver lining. Optimism backed by curiosity and patience will definitely achieve the desirable targets of growth and capital infusion.

Introduction

Study of Capital Market in emerging economy like India is of immense importance in changing global scenarios. Developed countries like US, Germany, etc., depend on emerging economies for increasing their growth. Worldwide stock markets are stabilizing after absorbing shocks of recession of 2008. There is huge potential for growth of Capital Market in emerging economies like India, Turkey, Brazil, Indonesia, Russia and China.

This paper highlights the conceptual analysis, factors effecting growth and depth of Capital Market, Indian Government's measures to improve capital flows in the country, issues and challenges, future of capital market, etc.

Defining Emerging Markets and Countries

To begin, it is important to define what we mean by an emerging market. As per "The International Finance Corporation" income per capita and market capitalization is relative to GNP for classifying equity markets. If either a market resides in a low- or middle-income economy, or the ratio of investable market capitalization to GNP is low, then the IFC classifies the market as emerging. As per IFC there are 81 countries in their *Emerging Stock Markets Factbook 2000*. Countries that meet the income criteria (and have an investable market capitalization to GNP ratio **in the top 25%** of all emerging markets for three consecutive years become part of the Emerging Markets Data Base Index. Currently, this index is comprised of 30countries.

Concept of Capital Market

The capital market is a market which deals in long-term loans. It supplies industry with fixed and working capital and finances medium-term and long-term borrowings of the central, state and local governments. The capital market deals in ordinary stock are shares and debentures of corporations, and bonds and securities of governments. The funds which flow into the capital market come from individuals who have savings to invest, the merchant banks, the commercial banks and non-bank financial intermediaries, such as insurance companies, finance houses, unit trusts, investment trusts, venture capital, leasing finance, mutual funds, building societies, underwriters etc.

The capital market functions through the stock exchange market which is a market that facilitates buying and selling of shares, stocks, bonds, securities and debentures. It is not only a market for old securities and shares but also for new issues shares and securities. In fact, the capital market is related to the supply and demand for new capital, and the stock exchange facilitates such transactions.

Capital market comprises the complex of institutions and mechanisms through which medium-term funds and long-term funds are pooled and made available to individuals, business and governments. It also encompasses the process by which securities already outstanding are transferred.

Factors Affecting Growth and Depth of Emerging Capital Markets

The reforms in capital markets in emerging economies are eminent for economic growth. Flow of capital from developed to developing & emerging economies depends on capital market reforms. Since 1991, opening of Indian economy, many reforms emerged, enhancing the horizon of Indian capital market. Well integrated capital markets of emerging and other economies are essential for world economic growth. The fact of integration of capital markets worldwide is also emphasized by World Bank & IMF.

Capital market in emerging economies, particularly stock markets is optimistically predicted by experts in that area. It is predicted that Indian BSE index may reach up to 100000 beyond by 2030, however with conditions- stable rupee, oil prices, narrowing CAD, stricter fiscal deficit targets, lowering bank rates, high potential growth of agriculture and industry along with stable and confident global political environment. Unemployment, Poverty, Population also add in the complexities of capital markets. Being foreign funds attracted more FII and FDI liberalization and wider scope for privatization enhances the credibility of Indian capital market.

1. **Alchemy of Financial Engineering**:

For much of the past decade, global capital market investors have relied on the alchemy of financial engineering to boost returns. Well before the 2008 global credit market crash, the rate of growth of the world economy had been slowing.

2. **Professional Money Management**:

Even as returns on investments in real goods and services were declining, the trend was obscured by healthy-looking gains that professional money managers were able to generate through asset price inflation.

3. **New Regulatory Mandates**:

Capital market turmoil and new regulatory mandates since 2008 have brought have brought the ability to generate gains through asset price inflation to an abrupt end. Facing a prolonged period of capital superabundance, investors will encounter formidable challenges.

4. **Competition for yield will be fierce**:

With capital increasingly concentrated in the hands of professional investment managers, the competition for yield will be fierce. The sheer volume of mobile capital searching for elusive gains that outperform market benchmarks will continue to drive up asset prices in the readily accessible developed markets.

5. **Transparent Investment Opportunities**:

As it is more difficult for the capital based in the mature economies to penetrate the emerging markets, investors attracted to those growth markets will be apt to overbid for the limited number of transparent investment opportunities available to them, thanks to the technological developments facilitating transparent investment opportunities. Capital regulators also work on improvement of transparency and efficiency of capital market.

6. **Shift of power from owners of capital**:

The investment supply–demand imbalance will shift power decisively from owners of capital to owners of good ideas. In this environment, investors' success will be determined less by how much money they command than by their ability to spot an investment's true value creation potential and act on it nimbly.

7. **Promising ways to put capital to work**:

The scramble for more promising ways to put capital to work, which is driving up asset prices, makes it difficult to identify investments that satisfy the risk-return requirements—the hurdle rate that the potential investment must clear to warrant committing capital in the first place.

8. **Lowering the hurdle rates**:

By lowering their hurdle rate, investors can bring more potentially attractive investment targets into range. For companies that are unable to distinguish between those that have long-term potential to outperform and others that risk ending up as bubbles, however, a lower hurdle rate can add complexity and noise to investment decisions.

9. **Filter out the volatility**:

Companies and investors that are able to filter out the volatility can take advantage of the sustained low interest rate environment to acquire new assets, penetrate new markets and cement long-term competitive advantages that will pay off for years to come.

10. **Identifying owners of good ideas**:

In today's capital-abundant times, the ability to identify owners of good ideas and help them achieve their full potential will be the hallmarks of investing success. Companies and investors that will thrive in this environment will be those that are best able to identify opportunities that play to their core competencies.

11. **React with speed and adaptability**:

Owners of good ideas also will take care to develop a repeatable model that enables them to apply their organization's unique strengths to new contexts again and again. Those that can react with speed and adaptability will be best able to identify the winners, steer clear of the bubbles and generate superior returns.

Government measures to improve capital flows in the country

Recent Measures Towards Liberalization of Capital Outflows from India

- Investment in overseas Joint Ventures (JV) / Wholly Owned Subsidiaries (WOS) by Indian companies have been permitted up to 400 per cent of the net worth of the Indian company under the Automatic Route.
- Indian companies have been allowed to invest in energy and natural resources sectors such as oil, gas, coal and mineral ores in excess of the current limits with the prior approval of the Reserve Bank of India.
- Listed Indian companies have been allowed for portfolio investment abroad up to 50 per cent of the net worth from the earlier limit of 35 per cent of the net worth.
- The earlier limit for prepayment of External Commercial borrowings (ECBs) without the Reserve Bank approval have been increased from USD 400 million to USD 500 million, subject to compliance with the minimum average maturity period as applicable to the loan.
- The aggregate ceiling for overseas investments by mutual funds registered with SEBI has been increased from USD 5 billion to USD 7 billion.
- The earlier limit under Liberalised Remittance Scheme (LRS) has been enhanced from USD 100,000 to USD 200,000 per financial year.
- FDI limit in railway enhanced to 100%
- FDI in Insurance sector likely to be raised to 48%
- Defence is also opened up for foreign investments: According to a pressed note issued by the Department of Industrial Policy and Promotion (DIPP) the FDI limit in the sector has been raised from 26% to 49% through approval route subsuming the 24% cap for portfolio investment.
- New measures in Real Estate and Infrastructure Development: In view of depleting FDI inflow in construction and real estate sector in the last couple of years. The government relaxed rules for FDI In the construction sector by reducing minimum built up area as well as capital requirement and easing the exit norms. In a bid to attract large scale investments in infrastructural sector, the union budget has proposed to provide a

conducive tax regime for the investors by setting up Infrastructural Investment Trusts and Real Estate Investments in accordance with the regulations of the Securities and Exchange Board of India.
- Promotion of Smart cities: The grandiose promise of building 100 smart cities has been part of Modi's 'Achhe Din' Vision from the outset.
- Commitment for 24 hour power throughout the country: To ensure 24x7 uninterrupted power supplies in rural areas, union budget 2014 has announced Deendayal Upadhyaya Gram Jyoti Yojna and earmarked Rs. 500 Crores for the scheme.
- Investment in North east region of the country.
- Opening up of for branded retail segment.

Issues and Challenges

There are big challenges like sectoral allocation of Capital resources, increase in risk appetite of the industry, long gestation funding like infrastructure projects, ample availability of power and other natural resources for industrial growth, skilled and empowered workforce, simplified tax structure and many other socio- economic factors hindering the attraction of capital markets in emerging economies.

There are big opportunities for investors, financial institutions, Government agencies of developed economies to park their funds to earn reasonable good returns instead of their own stagnant or zero growth or negative return economies. But foreign funds waiting on the fence to kick start emerging economies. Funds will always flow with conditions and it is quite logical. Assurance of the sustainable stable return on investment coupled with sizeable control of undertakings or assurance of returns of capital whenever needed, should be guaranteed by emerging economies like India.

The management of capital flows is a complex process encompassing a spectrum of policy choices, which inter alia include: the appropriate level of reserves, monetary policy objectives related to liquidity management and maintenance of healthy financial market conditions with financial stability. In view of the above, some of the major issues as well as emerging challenges in respect of management of capital flows to India include the following:

Short term and long term Inflow of funds:

Implicit distinction between durable flows and transient flows is necessary. If capital flows are deemed to be durable and indefinite, questions arise regarding foreign exchange management. If the flows are deemed to be semi-durable, essentially reflecting the business cycle, the task of monetary and liquidity management is to smoothen out their impact on the domestic economy, finding means to absorb liquidity in times of surplus and to inject it in times of deficit. In the short term, daily, weekly or monthly volatility in flows needs to be smoothened to minimize the effect on domestic overnight interest rates.

Interest and Monetary Policy:

In the event of demand pressures building up, increases in interest rates might be advocated to sustain growth in a non-inflationary manner but such action increases the possibility of further capital inflows if a significant part of these flows is interest sensitive and explicit policies to moderate flows are not undertaken. These flows could potentially reduce the efficacy of monetary policy tightening by enhancing liquidity. Such dilemmas complicate the conduct of monetary policy in India if inflation exceeds the indicative projections.

Currency Management:

As far as the exchange rate is concerned, the large inflow of remittances and major and sustained growth in software exports coupled with capital inflows have the potential for possible overvaluation of the currency and the resultant erosion of long-term competitiveness of other traditional and goods sectors. It has so far been managed by way of reserves build-up and sterilization, the former preventing excessive nominal appreciation and the latter preventing higher inflation. However, the issue remains how long and to what extent such an exchange rate management strategy would work.

Effects of deregulation:

A further challenge for policy in the context of fuller capital account openness will be to preserve the financial stability of the system as greater deregulation is done on capital outflows and on debt inflows. This will require market development, enhancement of regulatory capacity in these areas, as well as human resource development in both financial intermediaries and non-financial entities.

Effect on Banking Sector:

Another aspect of greater capital market openness concerns the presence of foreign banks in India. With fuller capital account convertibility and greater presence of foreign banks over time, a number of issues will arise. First, if these large global banks have emerged as a result of real economies of scale and scope, how will smaller national banks compete in countries like India, and will they themselves need to generate a larger international presence? Second, there is considerable discussion today on overlaps and potential conflicts between home country regulators of foreign banks and host country regulators: how will these be addressed and resolved in the years to come?

Capital Markets By 2020

Global capital markets have been in a state of turmoil since the financial collapse in late 2008. Ongoing intervention by fiscal policy makers and central banks to stimulate growth since then has heavily impacted equity and bond markets and depressed benchmark interest rates in many markets to historic lows.

By 2010, global capital had swollen to some $600 trillion, tripling over the past two decades. Today, total financial assets are nearly 10 times the value of the global output of all goods and services. Even with moderating financial growth in developed markets, the fundamental forces that inflated the global balance sheet since the 1980s—financial innovation, high-speed computing and reliance on leverage—are still in place. Moreover, as financial markets in China, India and other emerging economies continue to develop their own financial sectors, total global capital will expand by half again to an estimated $900 trillion by 2020 (measured in prevailing 2010 prices and exchange rates).

To navigate the shifting currents of global growth in a time of capital superabundance will require financial market participants to recalibrate their expectations, acquire new skills for spotting and managing risk, and exercise enormous investment discipline. Successful corporate and financial investors will be challenged to adapt to four new imperatives.

1. Competitive Interest Rates: A prolonged period of capital surplus will be characterized by persistently low interest rates, high volatility and thin real rates of return. Some big institutional investors, like pension funds, will face large gaps between the returns they will need to meet payouts to beneficiaries and what markets will generate. To get into sync with these new conditions, all investors will need to ratchet down their market interest rate expectations and revise their internal investment hurdle rates and portfolio investment return targets accordingly. Without these adjustments, they may end up keeping their capital on the sidelines indefinitely while waiting for higher-return opportunities that will not materialize. To defend themselves, companies will need to strengthen their bubble-detection capabilities by building on insights derived from the long-term fundamentals of their businesses. Banks, hedge funds and other financial intermediaries that enhance their risk-pricing skills will be better positioned to generate above-market returns over the longer term, earning them a competitive edge.

2. Brevity in Managing Assets: Capital superabundance will require even the most traditionally stable businesses to operate in much the same way as many hedge funds do, by actively managing their mix of long and short positions to insulate themselves against a more volatile macroeconomic environment across their portfolio of business activities. For nonfinancial businesses, in particular, an extended period of abundant capital will change the balance sheet from an object of thrift, to be managed to minimum size, into an important strategic platform with defensive and offensive potential. **Leading companies will actively use the balance sheet, using cash and financial instruments, among other tools, to stabilize and enhance their core business strategy.**

3. More opportunities in emerging markets: The capital needs of the faster-growing emerging markets would appear to make them a natural destination for the large stock of financial assets that remain concentrated mostly in the advanced economies. In an ideal world, capital would flow toward the best growth opportunities based on risk-adjusted returns; and indeed, capital has been migrating toward developing nations over the past several years. But the movement of funds from the US dollar, euro and yen markets to the capital-scarce emerging economies around the world has not been as strong as might be expected given the large growth differentials. Emerging markets' financial systems often lack liquidity, depth and breadth, and they need to develop the "trust architecture" of workforce talent, regulatory consistency and flexibility, and political stability to attract and distribute the flow of capital on a global scale. Those bottlenecks may gradually ease over the course of the decade, presenting attractive prospects for the financial services industry and enabling global investors to penetrate deeper into more emerging markets. Financial firms headquartered in the emerging markets are especially well positioned to play a leading role by tapping their own institutional connections and trusted networks to facilitate capital flows.

4. View the wider horizon: Capital superabundance will shift the balance of power from owners of capital to owners and creators of good ideas—wherever they can be found. But as yield-seeking capital increasingly crowds into all available asset classes, diversification will become even harder to achieve. Indeed, over the past decade the returns among assets that have traditionally been negatively correlated—equity values moving up as bond yields decline, for example—have begun to move in the same direction. Over the coming years, both financial and strategic investors will need to extend their time horizons in order to find diversification and solid returns.

Recent News on Emerging Capital Markets

Gold rebounded from 15th December's biggest drop this year as investors sought a haven amid turmoil in emerging market economies and falling commodities. Russia's ruble plunged to a record low after the country's largest interest rate increase in 16 years failed to revive confidence in the currency.

The Turkish lira also tumbled to an all-time low. Equities around the world retreated as oil extended a route and data signaled a contraction in Chinese manufacturing. Industrial metals declined.

"Gold is finding support from the risk- off moves seen across many asset classes," Ole Hansen, Head of Commodities Strategy at Saxo bank A/S in Copenhagen, said by e-mail. "The risk-off is related to Russia and the ongoing sell-off in emerging market currencies." Gold for immediate delivery rose 1.8% to $1214.18 announce at 12:45 pm in London. Monday's 2.4% drop was the biggest since December 19, 2013. Gold futures for February delivery increased 0.6% to $1214.40 on the Comex in New York, erasing an earlier drop.

Conclusion

Like global markets, markets in emerging countries are also driven by sentiments. Emerging economies should take advantages of Short terms bull and bear run as well as long term structural runs in global markets. Emerging economies should create risk emersion funds for absorbing shocks of global commodity forex and stock markets. Indian capital market is basically conservative which was exemplified in world market crash in 2007 when we were stable. But this should not lead to crony capitalistic approach of policy markets; may be hindering long term growth prospects of the economy.

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