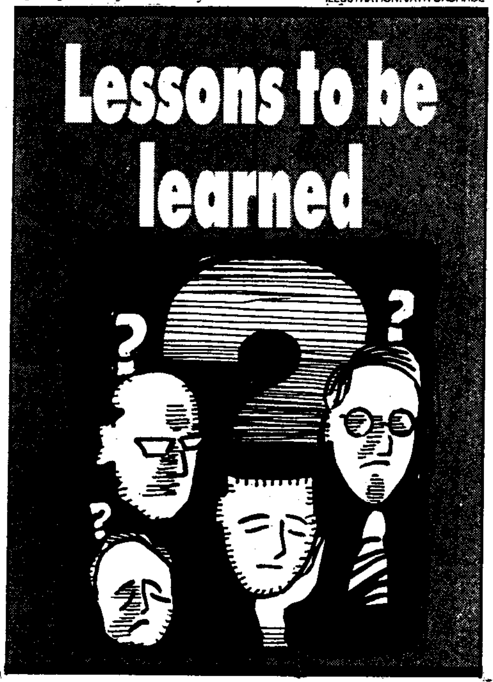

ILLUSTRATION: JAYA DABHADE

The flow of capital can be compared to the flow of water- while the latter tends to flow to the lowest level possible, capital will always flow to the place where the highest rate of return exists. If we try to stop the flow of water, it accumulates; but if the barrier is not strong enough the water bursts through and finds it's own level. Likewise if the rate of return on capital is kept low in a country, capital will never flow in from outside. Rather, whatever capital there is in the country in the country will tend to flow out.

Ever since independence the basic government policy has been to try and bring the rate of discount on capital down. This resulted in people secretly taking the money out against the rules and regulations of the country .With the recent change in policy, many of those restrictions within the stock exchange market have been removed. People think that the return on their savings will be much higher. Using the water analogy again,this is like digging a ditch as opposed to a mound, and water (investments) will start flowing in from everywhere. Remove the restrictions which were keeping the expectations of return on capital low and the NRIs, Europeans and Americans will definitely want to invest in India.

Effects on the stock market

In the stock market you are talking about a situation where people do not know each other personally,in fact they are total strangers. When we move to the Euro Issue, we are talking about a situation where we are selling abroad. Never mind the fact that the investors do not know the people running the company; they may hardly know anything about the country, its economy, or the customs of the people. It then becomes very essential for the management to convince the investor that they are genuine, competent and hard working and will not conceal information from them. This is going to determine the willingness of the Europeans or other investors to invest in India.

One immediate long term effect would be that Indian companies become more professionally managed. You cannot run the company as

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if it is your personal property. There are people abroad who have put money in your hands and expect an accurate and a timely report on how well the company is doing. Selling shares abroad is going to put a lot of pressure on the management to improve the amount of information available. Ultimately how well the stock market functions depends on the quality of information available to the investors about the firm. Although the financial press and business analysts also provide information to the investors and shareholders, both existing and potential, India still has not developed the information market

However, once the quality of financial reporting satisfies the foreign investors it would create the all important "spillover effect" on the companies which have not gone in for the Euro Issue. The long run effect would be to provide the same quality of information for everybody and not just the Euro Issue investors and shareholders.

Another important consequence would be the increase in pressure on the stock exchange. SEBI (Securities and Exchange Board of India),and the Government of India to reduce insider trading. This is an extremely complicated process and a problem which does not have an easy answer. There is no obvious way of getting rid of insider trading and suppose you do find a way it is not clear that elimination of all insider trading is good. For one,it is difficult to define what trading is insider and what is not. As a result of increased holdings of our securities in the European market we would definitely witness a gradual reduction of insider trading.

The third consequence follows from the law of supply and demand. The Euro Issue is going to bring in an additional source (supply) of capital. What then is the price of this capital? This is the return that investors earn on their capital. At the moment these funds are being attracted by the expectation that the return rate would be very high. But gradually these returns are going to come down as more and more funds come in and use up the most profitable business opportunities in India. The result would be that we would be left with opportunities that are not as profitable as the earlier ones. These may still be attractive, but if you follow the law of supply and demand, there is going to be a gradual reduction in the rate of return on investment.

Another consequence would be the rise in block trading. If you look at the typical fashion of trading of the Indian companies in the stock market, you would find that, in the past, most of the large blocks of stocks in the market were held by government financial institutions who were not active traders. Then there were the smaller investors whose trading did not amount to much. When the Financial Institutions from Europe buy large blocks of stocks they are not going to hang onto them forever. If they see that the company or the Indian economy is not a good prospect anymore they will get out of it.

The kind of procedures used for large block trading is different from what is used for small blocks. Every stock exchange in the world has different procedures for handling large blocks.

There is going to be a mild problem in creating a regulatory structure for the Indian stock exchange. The small investors are less likely to be informed on how the market functions, with the result that the large investors are going to write the rules of trading and exchange. A rise in block trading is going to give rise to the regulatory aspect also. Are we going to go by the old rules or are we going to create new ones? The moment we create a new set of rules for the big players we are going to be subject to criticism.

In fact, it was only about a year ago the Securities and Exchange Commission in the US permitted unregistered securities to be sold in large blocks to Institutional Investors. These investors do not need the government protection of registration of securities before deciding to buy it. This is the first time that the US is incorporating a two tiered regulatory system to keep trading within the US. Prior to this the rules were all focussed on the small investor to give them a fair chance. As a result, they found that many of the large investors were going to the London Stock Exchange because they can do bulk trading there. This two tiered regulatory system can become a very sensitive issue politically.

In a way it is a game that is very difficult to win either by the government or the regulator. No matter which way you go you are subject to criticism. The subject of Euro Issues is going to give rise to this problem.

Effect of disclosure

Accounting and disclosure rules differ from country to country. In the US it is the Securities and Exchange Commission and the Financial Accounting Board, which is a private organisation, which sets the accounting and disclosure rules. In most countries it is the government who sets the rules.Although in the UK they have a private board, but even that works within the framework of the Companies Act,UK. For international investors, this is a crucial factor because every company operates under a new set of rules and makes comparison very difficult. There is an international organisation,IASC (International Accounting Standards Council) which consists of representatives from 30 to 40 countries that has been trying to develop an international set of accounting standards in order to provide a minimum common denominator for all countries.

There will now be a greater pressure on Indian companies to adopt the IASC standards because this would show the foreign investors that our accounting reports have been prepared in a standard that they are already familiar with.

Have you ever wondered why there has been no US issue? It has to do with the inability of most foreign firms to meet the stringent US requirements. Of course, this has caused its own controversy in the US over the years. Most Japanese and German companies do not meet this disclosure requirement and as a result their shares cannot be traded in the US. Most US investors who own their stock would like to trade them and earn their commission,but the Securities and Exchange Commission have declined to lower their regulatory standard. Daimler Benz, the big, profitable company who are able to meet worldwide standards were not permitted to trade in the US market because their financial statements did not meet the rigid American standards. Eventually, Benz complied.

Therefore, Indian companies thinking of trading in the US market have to pay attention to their stringent laws. Even if we do not meet their standards now or for the next few years, Indian companies and the Indian stock exchange will have to start considering this. With internationalisation, creeps in a whole set of norms, rules and standards into the Indian market from all over the world.

Lessons for the Indian capital market and corporate sector

One balance of payment implication that emerges is that if the company does not fulfill the expectation of the investor, the capital coming in would flow out just as easily and foreign exchange reserves would go down.

A country gets rich by putting its money in the most profitable areas. The fundamental function of the stock market is that capital should go to those areas where a high rate of return is expected. Thus, if a public sector Euro Issue can generate more wealth than the private sector, then that is how it ought to be. The reason behind this being that the limited amount of savings or wealth that we have should be put to the best use. The investors will expect not only good professional management, well prepared timely, honest financial reports and disclosure of important events but also minimal insider trading at the expense of other shareholders.

As told to S R Josse

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