

**KERALA'S INDUSTRIALIZATION
THROUGH
THE PRIMARY CAPITAL MARKET ROUTE**

by

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THESIS

**Submitted to the University of Calicut
for the Award of the Degree of**

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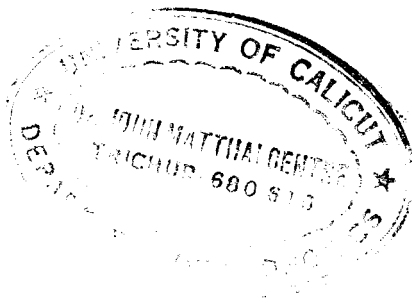
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CERTIFICATE

Certified that this written account on '**Kerala's Industrialization Through the Primary Capital Market Route**', submitted for the award of the Degree of Doctor of Philosophy of the University of Calicut is a bonafide record of research work done Mr.V.K.Vijayakumar, under my supervision. No part of this work has been submitted earlier for any other purpose.

Thrissur,
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DECLARATION

I, V.K.Vijayakumar, do hereby declare that this written account titled '**Kerala's Industrialization Through the Primary Capital Market Route**' is a bonafide record of research done by me under the guidance of Dr. U.T. Damayanthi, Professor in Economics, University of Calicut.

I also declare that this thesis has not been submitted by me earlier for the award of any degree, diploma, title or recognition.

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V.K.Vijayakumar

TO

My companion through thick and thin

My best supporter and discerning critic- **MY FAMILY**

4

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It was more by default than by design that my sister introduced me to the 'dismal science.' When I passed my pre-degree and expressed my desire to do degree in English language and literature, my sister who was already a post graduate in English decreed that two post graduates in English would be 'too many' in the family; instead she suggested economics. Faced with Hobson's choice, I agreed. In retrospect, I salute the wise decision of my sister who paved the way for my humble intellectual pursuit, through the corridors of the great discipline enriched by the footprints of legends from Adam Smith to Amartya Sen.

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“ A book may be amusing with numerous errors,
or it may be very dull without a single absurdity.”

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CHAPTER 1
INTRODUCTION

1.1 NEED AND SIGNIFICANCE OF THE STUDY

1.2 STATEMENT OF THE PROBLEM

1.3 OBJECTIVES OF THE STUDY

1.4 HYPOTHESIS

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CHAPTER 1

INTRODUCTION

Industrialization is the *sine qua non* of economic growth and development. Even in the modern post-industrial economies, where the tertiary sector has emerged as the main job creator and income generator, such an economic situation emerged as a consequence of industrialization. The growth of many directly productive services like transportation, banking, insurance, communication, and employment intensive services like trade is directly related to industrial growth. The multiplier effects of industrial growth on income and employment generation are substantial. Therefore, it would not be an exaggeration to argue that the key to solving most economic problems of developing countries lies in their industrialization.

After independence, the contours of India's industrialization were shaped by the Industrial Policy Resolution 1956 and its philosophy of 'commanding heights principle'. The 'state-led growth strategy' and the predominance given to the public sector led to massive investment by government in public sector undertakings. Even though India had many large private sector undertakings, the private sector as a whole, did not have the financial resources for massive investment, particularly in the core sectors. Therefore, even private sector investment was financed mainly by development banks, insurance companies and later by mutual funds like the U.T.I. Internal resource mobilization through

retained earnings by the corporate sector played only a marginal role in gross fixed capital formation. The role of the capital market in resource mobilization through public issues was also insignificant, till the 1980s.

The situation underwent a sea change in the 1980s. The initial dose of liberalization ushered in by the government in the latter half of the 1980s and some policy initiatives led to a stock market boom, and the primary market also started growing very fast. The total capital mobilized by non-government public limited companies through public issues of shares and debentures shot up from Rs.163.9 crores in 1980 to Rs.6509.9crores in 1990; an increase of 3871.8 percent (Hand book of Statistics on Indian Economy, RBI, 2000.Hereafter, RBI Handbook 2000)¹. This was phenomenal compared to the slow growth in the previous decade: from Rs.66.4crores in 1970 to Rs.163.9 crores in 1980, a growth of only 146.83 percent.

The 1990s saw an explosion in capital mobilization through the primary market initiative. The Structural Adjustment Programme initiated in 1991, included many path- breaking initiatives and sweeping reforms in the capital market. This is discussed in detail in chapter 4, ahead. These reforms, which attempted to remove many distortions in the capital market, strengthened and improved market efficiency substantially, albeit, it could not prevent two stock market scams. These capital market reforms along with the liberalized economic ambience, created a favorable economic environment for capital market growth. Consequently, capital mobilization through the capital market by non-

government public companies witnessed a veritable explosion: rising from Rs.6509crores in 1989-90 to Rs.26416 crores in 1994-95 (Indian Securities Market, A Review, NSE 2002. Hereafter I S M A Review)² and reached a record figure of Rs. 30511crores in 2004(The Economic Times)³. The massive volatility in stock price movements during the 1990s caused big ups and downs in the public issue market also, with spectacular ebbs and flows in public offerings. This led to some structural shifts in the primary market. The public issue market slowed down substantially; but the private placement market leap-frogged. Public issues by non-government companies, declined from a peak of Rs.26416 crores in 1994-95 to Rs.5153 crores in 1999-2000. But, resource mobilization through the private placement route, shot up from Rs.11174crores in 1994-95 to Rs.61259crores in 1999-2000 (I.S.M.A Review)⁴. These structural changes notwithstanding, the primary capital market as a whole, witnessed substantial growth in the nineties; with the total resource mobilization through domestic issues jumping from Rs.14219 crores in 1990-91 to Rs.68963 crores in 1999-2000, an increase of a phenomenal 385 percent. A clear trend of increasing preference of the corporate sector for direct financing through equity and debt, in lieu of, indirect financing through bank intermediated debt, emerged. Raising capital through the securities market route became easy for companies; particularly for those with a good track record, in the new liberalized environment.

Capitalizing on the market boom, many fast industrializing investment-friendly states of India, successfully mobilized huge resources from the primary market

and used it for their aggressive industrialization and growth. There are major inter-state disparities here.

Some pro-reform investment friendly states like Gujarat, Maharashtra, Tamil Nadu, Karnataka and Andhra Pradesh, are far a head of others, in tapping the capital market for mobilization of resources for industrialization. Nirupam Bajpai and Jeffrey D Sachs (2000)⁵ classified Indian states on the basis of their attitude towards economic reforms into three categories, as follows:

- i. Reform oriented states: Andhra Pradesh, Gujarat, Karnataka, Maharashtra and Tamil Nadu.
- ii. Intermediate Reformers: Haryana, Orissa and West Bengal.
- iii. Lagging Reformers: Assam, Bihar, Kerala, and Madhya Pradesh, Punjab, Rajasthan and Utter Pradesh.

The first category of reform-oriented states is far ahead of others in attractive investment and tapping the capital market for resource mobilization. Consequently, they have succeeded in achieving higher rate of industrial and economic growth.

Kerala, unfortunately, is among the lagging reformers. Even though Kerala is far ahead of other states of the union, in respect of social development and Human Development Index, its record in attracting investment and achieving industrial and economic growth, is dismal. While the southern states of Andhra Pradesh, Karnataka, Tamil Nadu and Maharashtra have succeeded in attracting substantial investment through the capital market initiative, Kerala's performance in this area is very poor. During the period 1990-91 to 1998-99, the amount mobilized by Kerala based non-governmental companies through public issues was a meagre Rs.468.96⁶ crores out of a total of Rs.115871 crores for the country as whole; accounting for a mere 0.40 percent of the total.

1.1 Need and Significance of the study

Kerala's industrial backwardness and stagnation is a much-discussed issue. On the eve of independence, Travancore had the highest paid-up capital among the princely states of India. But after independence, particularly after the formation of Kerala State in 1956, industrial investment slowed down. From mid-seventies onwards, with public sector investment drying up due to fiscal constraints experienced by the State, industrial stagnation crept in. There had been many attempts to explain this stagnation in terms of factors such as trade union militancy and labour unrest, poor and inadequate infrastructure, high cost of land, dearth of entrepreneurial talent, absence of an industrial structure capable of producing inter-industry demand and agglomeration economies and so on and so forth. Studies that have been made to explain and analyze Kerala's industrial

stagnation, in terms of the above-mentioned constraints, had come to the conclusion that most of these factors are significant, and perhaps, might have cumulatively contributed to Kerala's industrial stagnation. However, Kerala's industrial performance through the capital market route remains completely unexplored. In this age of liberalization, when the corporate sector is increasingly depending on external indirect funding, slowly replacing bank intermediated direct lending, the capital market route for mobilization of resources, becomes crucial. Therefore, 'the role of capital market in Kerala's industrialization and Kerala's performance vis-à-vis other states, in mobilizing resources through the capital market route', is an area of research, which has great significance and high potential, but remaining largely unexplored at present. The present study is an attempt to compensate this deficiency and, thereby, fill the research gap.

1.2 Statement of the problem

Kerala is, presently, at the cross roads in its path to economic growth and development. Since the State is reeling under a fiscal crisis caused by an unsustainable revenue deficit, it is no longer in a position to lead industrialization through public sector investment. Even if it were feasible, it would be an undesirable contrarian trend, in the modern era of liberalization and privatization. At the same time, Kerala badly needs to break the deadlock of industrial stagnation, to achieve faster economic growth and to generate adequate jobs to address her problem of huge unemployment. If Kerala does not succeed in her

efforts to industrialize, she stands the risk of losing the high levels of social development and quality of life, for which she has become world famous. It is widely recognized that the so-called 'Kerala Model' or 'Kerala Experience' has become unsustainable. The only way to sustain the high level of human development already achieved, and to take it forward is to industrialize the State, focusing on industries suitable to Kerala's unique ambience. The road ahead for Kerala is the road to industrialization.

The 'reform decade' of 1990s witnessed an increasing preference of the Indian corporate sector for external financing through the securities market, slowly reducing indirect financing through bank intermediated debt. Many reform-oriented states succeeded in pushing industrialization into the fast forward mode, by tapping the primary capital market for resource mobilization. Kerala, with her high level of savings, particularly financial savings, high level of bank deposits but low C.D ratio, huge remittances from abroad, a large investor population with high level of awareness about investment in financial securities and one of the largest number of NSE trading terminals in the country, is ideally placed to exploit the capital market route to industrialization. Though, theoretically, the conditions are favorable, in reality, Kerala has failed to exploit this opportunity.

1.3 Objectives of the study

The main objectives of the study are the following:

- i) To analyze the trends and patterns in resource mobilization by the financial system in India and the trends in relative efficiencies of the banking system and the capital market.
- ii) To assess the quantitative and qualitative dimensions of Kerala's performance, in tapping the capital market route for industrialization.
- iii) To identify Kerala's strengths and weaknesses in industrialization through the capital market route.
- iv) To critically examine the managerial and operational constraints in Kerala's industrialization through the capital market route.

1.4 Hypothesis

The primary capital market route to industrialization is a distinct trend in the reform era, starting with the early nineties. Theoretically, Kerala is ideally placed to exploit this route; but, practically, Kerala failed to exploit this opportunity. Worse, exploitation of this route by many reform-oriented states, created a situation of capital flight from Kerala, when Keralites started subscribing to capital issues by companies from other states. Since Kerala has failed to capitalize on its strengths, the hypothesis is that the state has some strong weaknesses and problems, which prevent it from exploiting this opportunity.

1.5 Data and Methodology

The study is based on data available from secondary sources and primary data collected through questionnaire. Data on resources mobilized through the primary capital market and trends in the Indian Stock Market were obtained from publications like 'Indian Securities Market A Review' (NSE India Ltd), 'Handbook of Statistics on the Indian Economy', and various other books and journals. Data on trends in savings, gross domestic capital formation, corporate gross domestic capital formation etc were obtained mainly from RBI Reports. Data on the capital mobilized in Kerala through the primary capital market were obtained from the official records of the Cochin Stock Exchange and the prospectus issued by companies during their Initial Public Offerings (I.P.O.s).

To study the financial performance of companies, Annual Reports of companies that raised capital through the capital market route, were obtained. Financial analysis was done, based on these Annual Reports.

To study the operational and managerial constraints in Kerala's industrialization through the capital market route, primary data were collected from entrepreneurs through a questionnaire. A sample questionnaire is given in appendix. For SWOT Analysis, apart from secondary sources, information elicited from direct personal interviews, was also used.

The study uses the following analytical tools:

1.5.1. Ratio Analysis

For the analysis of the financial performance of companies, Ratio Analysis was used.

1.5.2 Likert Scale

Likert Scale was used to construct the Industrial Climate Index.

1.5.3 SWOT Analysis

SWOT analysis was used to study Kerala's strengths, weaknesses, opportunities and threats in industrialization through the capital market initiative.

1.6 Scope of the Study

1.6.1 Temporal Scope

The time period of the study is the decade of the nineties: from 1990-91 to 1999-2000. The big leap in the Indian capital market began with the initiation of capital market reforms, as part of the Structural Adjustment Programme, in 1991. This is the rationale for the choice of the period 1991-2000.

1.6.2 Spatial Scope

The scope of the study is confined to Kerala. Analysis of the trends, patterns and structural changes in resource mobilization is done at the national level.

1.7 Conceptual Framework

The technical concepts used in the study are explained as follows:

1.7.1 Capital Market

Capital Market is the market for long- term funds; distinct from money market which is the market for short- term funds. Capital market facilitates resource mobilization by the corporate sector, through direct issue of financial securities to investors.

1.7.2 Primary Capital Market

Primary Capital Market is the market where new capital issues to public (Initial Public Offerings and Rights Offerings) are made.

1.7.3 Secondary Market

This is the market where issued securities are listed and traded; narrowly referred to as the Stock Exchange.

1.7.4 Equity shares

Claim to a company's ownership represented by a share certificate.

1.7.5 Debenture

Instrument through which companies raise debt capital. Debentures, which will be redeemed after a stipulated time, as specified at the time of the issue, without being converted into equity shares, are called Non-convertible Debentures (NCDs). Debentures, which will be converted into equity shares, as specified at the time of the issue, are called Convertible Debentures (C.Ds). Convertible debentures are, either fully convertible or partly convertible.

1.7.6 Market Capitalization

Market Capitalization is the market value of all traded shares. Market Capitalization of a company is arrived at by multiplying the market price of its share by the number of shares. Market capitalization for the entire market is the sum total of the market capitalization of all listed companies.

1.7.7 Market Capitalization Ratio

This is the ratio of market capitalization to G.D.P. The ratio indicates the size of the market.

1.7.8 Turnover Ratio

T.O.R. is the ratio of volume of trading to market capitalization.

1.7.9 Disintermediation

Disintermediation is the transfer of funds directly from savers to borrowers (corporates), without passing through the accounts of financial intermediaries.

1.7.10 Debt-Equity Ratio

Debt – Equity Ratio is calculated by dividing total debt by net worth.

$$\text{Debt – Equity Ratio} = \frac{\text{Total Debt}}{\text{Net worth}}$$

1.7.11 Gross Profit Margin

Gross Profit Margin is the ratio of gross profit to sales.

$$\text{Gross Profit Margin} = \frac{\text{Gross profit}}{\text{Sale}}$$

1.7.12 Net Profit Margin

Net profit Margin is the ratio of net profit to sales

$$\text{Net Profit Margin} = \frac{\text{Profit after tax}}{\text{Sales}}$$

1.7.13 Operating Profit Margin

Operating profit Margin is the ratio of operating profit to sales

$$\text{Operating Profit Margin} = \frac{\text{Profit before interest, depreciation and tax}}{\text{Sales}}$$

1.7.14 Return on Investment (R.O.I)

R.O.I is expressed either as Return on Total Assets (ROTA)

$$\text{ROTA} = \frac{\text{EBIT} (1-T)}{\text{Total Assets}}$$

EBIT = Earnings before interest and tax and T= Corporate tax rate

$$\text{RONA} = \frac{\text{EBIT} (1-T)}{\text{Net Assets}}$$

1.7.15 Return on Share Holders Equity (ROE)

Return on Equity is the ratio of profit after taxes to Equity.

$$\text{ROE} = \frac{\text{Profit after taxes}}{\text{Equity capital}}$$

1.7.16 Earnings Per Share (EPS)

Earnings per share are calculated by dividing the profit after taxes by the total number of equity shares outstanding.

$$\text{EPS} = \frac{\text{Profit after tax}}{\text{Number of shares outstanding}}$$

1.7.17 Cash Earning Per Share (CPS)

Cash earning per share is calculated by dividing profit after taxes, before depreciation, by the number of equity shares outstanding.

$$\text{CPS} = \frac{\text{Profit before depreciation after tax}}{\text{Number of shares outstanding}}$$

1.7.18 Dividend – Payout Ratio

Dividend – payout ratio is the ratio of dividends per share divided by the earnings per share.

1.7.19 Price Earnings Ratio (P E Ratio)

$$\text{Price Earnings Ratio} = \frac{\text{Market price of share}}{\text{Earnings per share}}$$

1.8 Limitations of the study

The study relies to a great extent on secondary data. Primary data collected through questionnaire and interviews with entrepreneurs, though with sound rationale, are not exhaustive. The limitations of these data will naturally be the limitations of this study also. Further, since the study is mainly confined to Kerala, the conclusions may not have general applicability.

1.9. Plan of the study

The study is arranged in seven chapters. The introductory chapter details the need and significance of the study, statement of the problem, hypothesis, objectives, data sources and methodology, research plan and limitations of the study.

The second chapter is a review of literature. This is done in three parts, viz. studies on capital market and the economy, studies on capital market in India and studies on Kerala's industrialization.

The third chapter examines the central problem of resource allocation and the relative efficiencies of the banking system and the capital market in resource allocation. The fourth chapter examines the trends, patterns and structural changes in the Indian capital market. The fifth chapter analyses resource mobilization by Kerala companies during the period 1990-2000 and the financial performance of these companies. The sixth chapter is a SWOT analysis of Kerala's industrialization through the capital market initiative, with special focus on the operational and managerial constraints. The seventh chapter concludes with a summary of findings and policy implications.

* * *

Notes and References

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CHAPTER 2

REVIEW OF LITERATURE

2.1 STUDIES ON CAPITAL MARKET AND THE ECONOMY

2.2 STUDIES ON CAPITAL MARKET IN INDIA

2.3 STUDIES ON KERALA'S INDUSTRIALIZATION

CHAPTER 2

REVIEW OF LITERATURE

This chapter is devoted to a review of the major contributions in the area of capital market, capital market and the real economy, capital market in India and Kerala's industrialization. These contributions have been classified into 3 categories:

- i) Studies on the relationship between capital market and the economy
- ii) Studies on capital market in India
- iii) Studies on Kerala's industrialization

2.1 Studies on Capital Market and the Economy

Economic literature on capital market has been scanty, till recent times. However, recognizing the role of financial markets in economic growth, researchers started focusing on this area in 1980s and 90s, so much so that, currently, economic literature in this field is rich in contributions on capital market and its influence on corporate and economic growth.

Early observations, on the relationship between financial markets and economic growth, came from Gurley and Shaw (1955)¹. Gurley and Shaw found that, as countries develop, self-financed capital development will be increasingly replaced by intermediated debt finance and later, equity markets for raising external funds, emerge and develop. The financial structure – mix of financial intermediaries and markets –changes as countries develop.

Empirical evidence support Gurley and Shaw's view that at low levels of development, commercial banks are the dominant financial institutions and that as economies grow, specialized financial intermediaries and equity markets develop. Studies by Asli Demirguc Kunt and Ross Levine (1996)², on the evolution of financial structure in low, middle and high-income countries have brought out empirical evidences in support of the Gurley and Shaw thesis.

In the 1970s major contributions came from McKinnon (1973)³ and Shaw (1974)⁴, who studied the relationship between financial development and economic growth. According to them, government interventions in setting interest rates and allocation of resources, causes distortions in the economy. These distortions caused by governmental interventions in the financial markets adversely affect allocative efficiency and saving and investment in less developed economies. They argue for financial liberalization for the removal of distortions.

Cho (1960)⁵ took the views of McKinnon and Shaw forward by introducing the role of the stock market, which was not included in the McKinnon – Shaw analysis. Cho's important conclusions were:

Banks cannot achieve efficient capital allocation due to imperfect credit market information.

Equity markets achieve much superior capital allocation due to superior information.

Therefore development of the equity market is desirable and necessary for complete financial liberalization.

A major drawback of the Mckinnon- Shaw- Cho framework is that, it focuses on the allocative function and ignores the impact of the financial market, particularly the stock market on the real economy.

The 1990s saw tremendous growth in literature on capital market and economic growth. Many scholarly works threw light on this contentious issue. The most authoritative study on the relationship between stock market and economic growth came from the World Bank Research Group. This study came in the form of six research papers in a symposium issue on stock markets and economic development (1996) ⁶.

This World Bank Research Group exhaustively studied the relationship between stock market development and financial intermediaries. The research papers focused on and studied the following four issues.

Firstly, it constructed more measures of stock market development than any previous study (Robert A Korajczyk. 1996)⁷. Further, it compared liquidity, concentration, volatility, institutional development and international integration across 44 industrial and developing countries form 1976 to 1993. The data produced are, indeed, voluminous and valuable.

Secondly, the study investigated the relationship between stock markets and financial intermediaries (Demirguc-kunt and Levine 1996)⁸. Producing evidence to the effect that stock market development leads to better development of banks and non-banking financial intermediaries, the study dispels the fear that stock market development steals the business of banks. The fact that stock market development goes hand in hand with general financial development is emphasized.

Thirdly, the study analysed the relationship between stock market development and long run economic growth (Levine and Zervos 1996)⁹. Evidence relating to the positive association of stock market development with long run growth is brought out using cross-country growth regressions.

Fourthly, the Research Group studies the relationship between stock market development and financing choices of firms (Asli Demurguc Kunt and Vojislov Maksimovic 1996)¹⁰. Looking at a sample of 30 industrial and developing economies, they observe that the effect of stock market development on firm's debt-equity ratios, depends on the initial level of stock market development. Improvement in the functioning of stock markets produces a higher debt – equity ratio in firms. Thus, stock market development, while encouraging greater use of equity markets in raising capital, also encourages greater use of bank finance. Stock market development, therefore, increases the quantity of bank loans.

Finally, a theoretical framework is developed (Boyd and Smith 1996)¹¹ to help explain the important aspects and consequences of Demirguc–Kunt and Maksimovic findings, on corporate finance and financial market development. A model is constructed, in which, firms finance capital accumulation externally through a combination of debt and equity, and, the level of development of debt and equity markets interacts with physical capital investment decisions.

The research papers presented in this symposium considerably boost our knowledge of the relationship between stock market and economic development. A deficiency of this study by the World Bank Research Group is that the Papers do not study individual country cases. Another deficiency is that

the research does not shed and light on, when the countries are ready for stock market development.

Researchers have put forward very strong theoretical disagreements with the World Bank's views on stock market development and economic growth. A prominent work in this category is that of Mayer (1989)¹². Based on studies using corporate balance sheets Mayer made the following observations.

- i. Retained earnings are the dominant source of finance in all countries.
- ii. There are variations in the retention-earning ratio across countries.
- iii. In no country do companies raise substantial amount of finance from the securities market.
- iv. Banks are the main sources of external finance in all countries.
- v. There is a strong inverse relationship between the proportions of expenditure financed from retentions and bank credit.
- vi. Small and medium sized firms rely more on external finance than large ones.

Mayer's views, which are totally at variance with the World Bank's views, are based on studies using sample of company balance sheets and not on figures for the entire corporate sector.

2.2 Studies on Capital Market in India

In India, the topic 'Capital Market and Economic Growth' became an issue of interesting debate, thereby, immensely enriching economic literature. Two schools of thought emerged; one advocating capital market reforms and development and the other skeptical of the same. The first group supporting capital market reforms and recognizing their positive effect on corporate and economic growth continued in the tradition of the World Bank's views. Prominent representatives of this group are Shah and Thomas. The other group,

which is skeptical of stock market development, raised some serious issues regarding the not so positive, and, at times negative effects, of capital market development on savings, investment and economic growth in the Indian context. The prominent representatives of this group are Nagaraj and Ajit Singh. The works of these two representative groups are examined in some detail.

Shah and Thomas (1996)¹³ are strong advocates of stock market reform and development. Studying the stock market reform and the banking sector, they reached the following conclusions:

i. The banking system and the stock market compete in two dimensions: to maximize the quality of their information processing, and to minimize the transactions costs that they impose upon households.

In the Indian context the stock market is more efficient than the banking system, in both dimensions. The stock market's superiority in the quality of information processing arises out of its freedom relative to the banking sector, which is subject to a number of controls and constraints. Controls like direct government ownership, entry barriers, high reserve ratios and directives on credit allocation adversely affected the banking system's ability to process information.

ii. The stock market development plays a key role in strongly assisting reforms in the Banking system.

iii. Efficient stock market would contribute to long-term growth in the real economy through efficient allocation of scarce savings and improving utilization of funds.

iv. Foreign capital inflows have a positive impact on the real economy via lowering the cost of capital and the assets effect.

Regarding the transactions costs, Shah and Thomas conclude that India's banking system has been suffering from high costs due to labour problems, low level of technology and lack of competition. On the other hand, the transactions costs in the stock market have declined considerably due to the introduction of On Line trading system, dematerialization of securities etc.

Ajit Singh (1998)¹⁴ examines the growth and evolution of stock markets in India during the 1990s, which, according to him is largely due to internal and external liberalization measures and the general liberal economic ethos created by the reforms. Singh argues that even though the corporate sector considerably benefited from the boom in the stock market by raising huge amounts of capital, including foreign exchange, from the market, the aggregate real economy did not benefit from this. At least in the 1980s, there was no increase in the savings rate in the economy, despite the boom in the stock market. What really happened was a portfolio substitution by households and institutions from bank deposits to financial corporate securities. Singh also argues that it is problematic to attribute variations in corporate investments to variations in resources raised from the stock markets, because, the resources raised from the market essentially replaced the internal resources of the corporations. Also, Singh does not see any increased productive use of investment resources.

Nevertheless, Singh compliments the government for its prudent handling of portfolio capital inflows and ensuring that no loss was suffered on that count to the economy, in spite of large inflows. Singh's conclusion is that despite all the extra ordinary growth achieved by the stock market, as far as the real economy was concerned, it has just been a sideshow.

In conclusion, Singh sounds a note of warning that as the market for corporate control develops with mergers, take overs, acquisitions and divestments becoming commonplace, the situation will worsen and the real economy will be harmed by these developments. According to Singh, the market for corporate control is a 'bridge too far' at the present level of development of the Indian economy.

A comprehensive empirical work came from Nagaraj (1996)¹⁵. Nagaraj's study examines the long-term trends in India's capital markets and the structural changes that have taken place in the country's saving pattern. Examining important indicators like the amount of capital raised, share of equity in total capital mobilized, share of financial saving in Gross Domestic Savings, Gross Fixed Capital Formation; corporate GFCF as percentage of GDCF, corporate profitability etc, Nagaraj comes to the following conclusions:

In India, the growth of the capital market was in fact financial disintermediation, which involved, portfolio substitution by households and institutions from bank deposits to stock market instruments.

There are no correlations between growth rate of capital mobilization and aggregate saving rate, and corporate physical investment and value added.

The positive correlation between the annual growth rate of capital raised externally and the corporate fixed capital formation, which existed previously, has become statistically insignificant in the 1980s.

There is a long-term decline in the contribution of internal finance to corporate fixed investment, despite a fall in the ratio of corporate tax to gross profit.

The growth rate of real value added in the corporate manufacturing sector in the 1980s was lower than that of registered manufacturing sector as a whole

suggesting that the small corporate firms, which did not have access to stock market funds, were able to grow at a faster rate than the larger corporate firms.

Nagaraj's findings regarding the corporate GFCF as percentage of GFCF and corporate GFCF as percentage of GDP, as statistically insignificant are actually not as insignificant as he suggests. Both these indicators as percentages more than doubled in the 1980s and early part of 1990s when compared to 1960s and 1970s. Further more, if the spurt in capital mobilization through the capital market is due to portfolio substitution of bank deposits with corporate securities, then, there should have occurred a corresponding decline in the growth of bank deposits. There is no evidence to this effect in Nagaraj's findings.

Parantab Basu and Mathew R Morey (1998)¹⁶ analyzed the impact of economic reforms (since 1984) on stock market prices in India. They employed the non-parametric variance ratio tests spanning over the period 1957 to 1996. The study showed that from mid 1980s, equity prices in India behaved like a 'random walk' suggesting that the market obeyed Fama's Efficient Market Hypotheses, till the securities scam of 1991 – 92.

Lalitha (1995)¹⁷ examined the new issue market with special reference to public issues by the private corporate sector in 1998. Public issues were analyzed on the basis of (a) type of industry (b) Size of firm (c) age of the firm and (d) size of issue. The study examined the factors, especially the policy initiatives by the government, like the introduction of new securities, rising of interest rates on debentures etc that influenced public issues. The study pointed to the need for spreading the 'equity cult' throughout the country.

2.3 Studies on Kerala's Industrialization

The state of Kerala was formed in 1956 through the unification of the princely states of Travancore and Cochin and British Malabar. The colonial influence on the region had started shaping its economy, particularly through investment in plantations and agro-processing industry, from the 19th century onwards. Therefore, the study of Kerala's industrialization has to begin with an inquiry into the historical factors, which influenced industrialization.

A major work, with a broad historical perspective, on Kerala's industrialization, came from Thomas and Tharakan (1986)¹⁸. Their paper is an attempt to interpret industrial growth as well as backwardness in terms of class analysis. The Study traces the birth and growth of the indigenous capitalist class and the politico-economic environment, which facilitated its growth. According to Thomas and Tharakan, commercialization of the Travancore region under colonial influence, led to the emergence of a capitalist class from among Syrian Christians, Muslims, Chettis and Gujarathis. By 1930s industrialization gained momentum due to active support from the Travancore rulers, and a modern industrial sector started emerging. However, a major role in this industrialization was played by migrant capital, particularly Tamil capital. The role of the indigenous capitalist class was only marginal. This slow growth of the indigenous capitalist class and their lack of dynamism prevented them from exploiting the opportunities thrown up by the withdrawal of European capital.

Another important work came from Raman Mahadevan (1988)¹⁹, who throws light on the type and nature of entrepreneurial response to the industrialization initiatives of the thirties and forties. Mahadevan points out that it was the migrant capital that responded positively to the industrialization initiatives while the indigenous capital remained shy. This was because of their low rate of

capital accumulation. This prevented them from forcing into the modern, industrial sector, which required large capital. Mahadeven also points out the role played by higher costs of labour and power in the forties, in the eventual decline of migrant capital in the Travancore region.

Another major historical inquiry into Kerala's industrialization came from Ram Mohan (1988)²⁰. Ram Mohan views the industrial development of Travancore after First World War from the perspective of development throughout the country consequent to the change in the policy and attitude of the British Government. A major factor, according to Ram Mohan, which prompted migrant capital to invest, was the poor labour conditions and the consequent low wages in the region.

Subramanian and Mohanan Pillai (1986)²¹ attempted to identify the weak links in Kerala's industrial structure in an inter-regional framework of analysis. The Study made detailed analysis of Kerala's industrial base, rate of growth in industrial output, specialization coefficients in different regions in India, wage productivity relationship in the large scale industrial sector of Kerala, patterns of cost of production and profitability in major industries, industrial cost structure of major states, industrial structure in Kerala based on share of industry groups in value added by factory sector etc.

On the basis of the detailed study and analysis, the paper concludes that:

Viewing industrial stagnation in terms of region specific factors like labour characteristics, nature of trade unionism and quality of entrepreneurship is illogical and irrelevant in the Kerala context.

The high wage-cost hypothesis, to explain Kerala's industrial stagnation, is devoid of empirical support.

There should be more focus on industrial structure hypothesis, which emphasizes inter-industry demand and agglomeration economies as factors determining the growth pattern.

Based on the above findings, the authors argue for a more dynamic role for the state, to take the lead for Kerala's industrial modernization and diversification, through increased public sector investment and by creating a climate of confidence for private investment.

This 'Exploration of Alternative Hypothesis of Kerala's Industrial backwardness' exposed many myths and populist perceptions regarding Kerala's industrial backwardness. The empirical support and arguments are indeed convincing. But, the concluding suggestion imploring the state to play a leadership role, even an entrepreneurial role, is not relevant in the present context of privatization and the state's fiscal crisis. The emphasis on the state's role in creating a climate of confidence for private investment is, indeed, laudable.

'The Alternative Hypothesis' on Kerala's industrial backwardness developed by K.K. Subramanian and P.Mohanan Pillai, is further developed by K.K. Subramanian (1990)²². The Study starts from the apparent paradox in Kerala's development experience reflected in low per capita productivity, especially of manufacturing output, by a state enjoying high rank in the country in per capita consumption expenditure and PQLI. The author differs from scholars who view Kerala's industrial backwardness through 'resource endowment approach', analyzed in terms of region-specific factors such as labour militancy, excessive trade unionism and lack of entrepreneurial talent. Rejecting these region-specific constraints as lacking in empirical evidence, the author analyses the

problem in a framework based on 'the principle of circular and cumulative causation.' On the basis of this analysis, Subramanian traces the root cause of Kerala's industrial stagnation to the State's fragile production base. Particular attention is drawn to the lopsided manufacturing base, characterized by serious gaps in engineering and modern 'footloose industries.' Kerala could not benefit from industrialization based on ever increasing differentiation of processes and specialization in human resource. Thus, Kerala lost the competitive advantage, which she could have realized.

This Study makes strong case for public policies to promote the development of an industrial base capable of ensuring a faster growth in industrial output and employment in Kerala. The prescription for policy, put forward by Subramanian, is slightly different from that suggested by Subramanian and Mohanan Pillai in their earlier study: 'Kerala's Industrial Backwardness: Exploration of Alternative Hypothesis.' This time, Subramanian suggest restructuring the role of the state more as a catalyst than as an entrepreneur/promoter. Perhaps, this slight change in perspective is in keeping with the policy of liberalization that has become the major trend now. The Study calls for the realization of the fact that our future lies in pursuing a path of industrialization based on sunrise industries producing skill intensive and technology based high value added items.

This argument, is taken forward with some modification by Subramanian and Abdul Azeez (2001)²³ while analyzing Kerala's industrial performance in the post – reform era. The Study examines kerala's industrial performance over a long period of 17 years and analyses her industrial performance in the pre-reform and post-reform period. The seventeen-year period is divided into two sub- periods: (a) 1981-82 to 1990-91, and, (b) 1991-92 to 1996-97. The Study

finds that while the manufacturing sector grew by only 3 percent during the seventies, it grew by 4.25 percent during 1981 to 91 and by 4.9 percent during 1991 to 1998. However, the growth rate in Kerala lagged far behind the national average. This relative lag in the industrial growth of Kerala is very conspicuous in the net value added (NVA) in manufacturing in the factory sector. The annual growth rate of manufacturing in the factory sector during 1991 to 1998 in Kerala was only 5.39 percent against the national average of 9.06 percent. Thus, in spite of the pick up in industrial growth, the problem of relative slow growth continues.

The Paper calls for a new vision and strategy to push forward the signs of revival in industrial activity observable since the late eighties. The new vision suggested calls for taking advantage of Kerala's comparative advantage in developing and diffusing knowledge and promote knowledge-based industries. Particular mention is made of the information technology, hospitality and entertainment industries, where knowledge and skills are the crucial inputs. The authors view the goal and the vision of Kerala's industrialization as "the accelerated growth of income and employment from a knowledge based economy." The authors also call for a change in the strategy of industrialization from a public sector led strategy to a private sector-led strategy. It is interesting to note that Subramanian, in conformity with the spirit of economic reforms and at variance with his earlier views, upholds the new vision and strategy.

An important study of the traditional industries of Kerala came from Pyaralal Raghavan (1986)²⁴. The Study focused on the crisis in traditional industries and its impact on the performance of the co-operatives in traditional industries. Raghavan found that, in spite of the organization of the traditional industries like handloom, coir and beedi under the co-operative umbrella, the performance

of these industries showed a deteriorating trend, in terms of employment generation and financial viability. Declining demand for coir products, shortage of raw materials, bureaucratization of the co-operatives etc., added to the woes of the industry. The study of handloom co-operatives, revealed the fact that, despite the success in raising wage rates, the co-operatives could not prevent decline in the number days of employment. Here also, the inability of the industry to diversify and bureaucratization of co-operatives were major problems. In the case of the beedi co-operatives, Raghavan found that they were more successful, compared to coir and handloom co-operatives. The industry succeeded in increasing employment for workers, while maintaining its financial viability.

Yet another study on industrial co-operatives was made by Mridul Eapen (1991)²⁵. This study on the functional performance of HANTEX, found that the society failed in satisfactorily assisting the primary weavers credit societies. The society was found to have a dismal financial track record, despite getting good funding from government. The failure of the society was found to be due to its poor marketing strategy and organizational failures. The failure of the society to adapt, in tune with changes in the demand pattern, was found to be an important reason for its failure.

The performance of marine products export industry attracted attention of many researchers. John (1977)²⁶, Mathew (1986)²⁷ and Shajahan (1987)²⁸ studied the origin and growth, changing trends, structure and performance of this industry. The studies found that the location advantages of the industry in Kerala and the attractive prices for prawns in the international market helped the growth of the industry. But, the initial promise could not be sustained due to inferior quality

of prawns, fluctuations in the availability of the catch and competition from other countries.

Oomen's (1979)²⁹ study on inter-state shifting of industries was an attempt to examine the high labour cost hypothesis in Kerala industries. The Study examined the relative cost structure of selected industries and implementation of labour welfare measures. Opinion of entrepreneurs who shifted from Kerala was also elicited. The study found the unit cost of production in industries such as foundry, cashew and coir to be very high in Kerala, thereby, creating a favorable environment for labour exploitation in the neighboring states. Oomen's policy recommendation of implementation of National Minimum Wages, howsoever desirable it might be, lacks practicability in the Indian context.

An important study on state sector enterprises came from Pillai (1994)³⁰. Pillai attributes the dismal performance of state enterprises to their poor financial management and obsolete technology. The financial problem of P.S.U.s, according to Mohanan Pillai, is due to the state spreading its meagre resources too thinly across different industries. Moreover, the high debt-equity ratio of these P.S.U.s, created a capital structure that made the enterprises unviable.

Beena (1991)³¹ attempted a comparative study of state sector and private sector manufacturing enterprises. The physical and financial performance of P.S.U.s was compared with that of private sector enterprises, based on a sample of fourteen companies. The study found that while the P.S.U performance was better in physical performance like growth of output, value added etc., the private sector performance was better in terms of gross fixed capital formation, employment etc.

Attempts to study specific product groups, also, have been made by scholars. Subramaniam and Joseph (1988)³² studied the growth of the electronics industry during the period 1978-84. The study found that the growth of the industry was influenced by government policy. The first phase of the growth of the industry was during 1950s to 1970s. This was the import-substituting phase. The second phase from 1980s onwards, was the liberalizing market oriented phase. This phase saw jump in industrial growth and changes in the structure of production and ownership in India. But in Kerala, while the electronics industry started growing with the establishment of KELTRON in the 1970s, the growth decelerated since 1980s when the industry in the rest of India started growing. According to Subramaniam and Joseph the poor performance of the industry might have been due to the constraints imposed by the limited resources of the state sector.

Many studies were done on the small industries of Kerala. Oomen (1972)³³ studied the development programmes for the growth of the small industry. The study goes in detail into programmes for small industries development like modernization of the traditional sector, industrial estates, rural industries project, provision of financial and marketing services etc. The study found that these programmes did not succeed in realizing their objectives. According to the author, the reasons for the failure of the programme were, among others: bad planning, poor assessment of available resources and taking up non-viable projects.

Bose (1987)³⁴ studied sub-contracting by KELTRON and its impact on the company and its small-scale sub-contractors. The study found sub-contracting to be beneficial to the company but not so to its sub contractors. Even though

KELTRON could benefit from the flexibility in employment and wages provided by sub-contracting, it failed to make a dent in the highly competitive national market. The low volume of production, compared to the private sector majors, prevented the company from reaping economies of scale.

A study of some trends in small-scale industries was attempted by Joseph (1995)³⁵, focusing on a case study of diamond industry in Kerala. The study examined the reasons for the relocation of the industry from its traditional strongholds like Surat to places like Trichur in Kerala. The study found the relocation process to be caused by deglomeration tendencies in the industry. Going into the reasons for the growth of the industry in places like Trichur in Kerala, the study found favorable locational advantages, linkages with industrial cities like Coimbatore, linkages between diamond industry and gold jewellery industry etc., to be the reasons facilitating its growth. The study found certain new trends like 'worker turned entrepreneur' emerging in the industry.

Arun (1991)³⁶ studied the inter-regional characteristics of industrialization focusing on Kerala's industrial growth vis-à-vis other states of South India and the country as a whole. Regarding the trends in industrial growth in Kerala vis-à-vis the national average, the study found that Kerala lagged behind the national average, and that, the lag got aggravated in the 1980s. The study also examined the structural issues of industrialization. Taking cue from an earlier Paper by Subramaniam and Mohanan Pillai, the Study found the structural deficiency in Kerala's industrialization as reflected in a bias towards agro-based and chemical industries and a low proportion of engineering industries, to be a major constraint in Kerala's industrialization.

Recent trends in Kerala's Industrialization especially in the post-reform period, has been the subject of a study by Mani (1996)³⁷. The study commences with a brief narration of the salient features of the Industrial Policy 1991 and then attempts at analyzing the sectoral distribution of Industrial Entrepreneurs Memoranda (IEM) filed by investors after July 1991. Mani draws certain inferences about the investment preferences of entrepreneurs before and after liberalization. He cites the phenomenal increase in investment in food processing industry after liberalization. He goes on to argue that the higher rate of growth since 1993 is largely contributed by significant improvement in capacity utilization of existing enterprises. In the background of the reforms and the performance of the industrial sector in the post – reform period, the study analyses the investment possibilities in Kerala.

Sunil Mani summarizes the constraints on Kerala's industrialization into three categories, viz.:

The psychological fear caused by militant trade unions.

The high cost of land acquisition.

The worsening power situation.

Then he goes on to examine whether there has been a radical improvement in easing these constraints.

To study the impact of the psychological fear caused by militant trade unions, Mani conducted a survey among industrialists classified into three groups. They were asked to rank the various factors constraining investment in Kerala. All industrialists unanimously pointed to the fear of the militant nature of trade unions combined with the rather high wage rates of casual and head load workers as the main reason for poor investment in Kerala. Further, pointing to the fact that the number of man days lost due to strikes and lockouts have

increased between 1991 –92 and 1994 –95, Mani concludes that the labour problem has not improved in Kerala during the post-reform period.

Regarding the power constraint, Mani sees an attempt to remedy the problem in view of the large number of IPP projects coming up in the state. The land constraint continues to be a major factor, in spite of the fact that KSIDC has been developing the concept of industrial parks to address the problem.

Finally the author goes on to list and compare the new industrial policy initiatives of Kerala, Tamil Nadu and Karnataka and draws attention to the fact that Kerala has offered a better range of incentives than Tamil Nadu and Karnataka. But the response of the private industry to these governmental initiatives has been lukewarm, with Kerala attracting only less than 1 percent of the investment intentions in the country. Sunil Mani concludes his study by listing a set of industries most appropriate to the unique Kerala situation, such as Electronics and computer software, Rubber-wood based industries, and Tourism related services that can attract substantial investment.

Padmanabhan (1990)³⁸ examined the financial performance of the private corporate sector in Kerala through a sample study of 50 non-government companies in manufacturing industry in Kerala for the period 1971 –72 to 1984 –85. Preparing a combined balance sheet of all companies and deriving standard financial ratios from that, she assessed the financial performance of these companies. These ratios were then compared to those of the private corporate sector for the whole of India, compiled by the RBI. Comparing the financial performance of the private corporate sector of Kerala based on gross profit to sales ratio and net profit to sales ratio, Nirmala Padmanabhan concluded that in both respects, their performance has been far inferior to that of the Indian corporate sector as a whole.

Thampy (1990)³⁹ examined Kerala's industrial stagnation through a study of organized small-scale sector. Pointing to the deficiency in Subramanian and Mohanan Pillai's study on Kerala's industrial backwardness viz., confining the study to the large scale industries covered by ASI only, the author attempts to remove the deficiency through his study of the small scale sector. The wage-cost in the small-scale sector of Kerala is compared to those in other major industrialized states. The inferences drawn indicate higher wage –costs in Kerala and contradicts Subramanian and Mohanan Pillai's view that "there is no empirical evidence to support the high wage cost hypothesis." Thanmpi's views are more in tune with that of Sunil Mani, who feels that the trade union militancy and the large number of man-days lost due to strikes, have created a negative image of Kerala as an investment destination. The 'psycho-phobia' among entrepreneurs has certainly adversely affected investment decisions. The study concludes that the high wage-costs and psychic costs have contributed to poor industrial investment and consequent industrial stagnation in Kerala.

Mohan and Raman (1990)⁴⁰ inquired into the consequences of the growth of Cochin Stock Exchange on Kerala's savings. Their inference is that the growth of the Cochin Stock Exchange has harmed rather than helped the Kerala economy. The phenomenal growth of the Cochin Stock Exchange and the 'equity cult' that it helped to spread, led to over whelming responses from Malayalees to the public issues by non-Kerala companies. Thus, a large part of savings of Kerala had been diverted for investment in other states.

Albin (1990)⁴¹ examined the role of structural and regional factors in explaining the trend and pattern of Kerala's industrial growth experience. The disaggregated analysis of the growth of value added and employment in the

factory sector in Kerala showed that there has been a decline in the growth rate of both, since the 1970s. The conclusion is that the low level of industrial growth in Kerala can be better explained in terms of regional factors rather than structural factors.

In the area of industrial relations, a work that is worth mentioning is Ramachandran Nair's (1993)⁴² study. Ramachandran Nair examined the trend of industrial relations in Kerala to test the hypothesis of labour militancy. The study found that the argument of labour militancy is highly exaggerated, even though there is scope of substantial improvement in industrial relations.

A recent study examining the reforms in Kerala's industrial scene in the post – liberalization era comes from Pillai (2001)⁴³. The study examines the policy initiatives taken by the government for industrial development in the liberalization era. The need for private sector-led industrialization is emphasized in the backdrop of the dismal performance of the P.S.U.s. The author commends the 'cluster approach to growth' that promotes networking of enterprises, inter-industry linkages and agglomeration economies. The Paper calls for further creative intervention by the government at the micro-level to facilitate the development of existing clusters and support measures for firm specific infrastructures, provisioning of institutional skills and training, credit disbursement preferences, introduction of quality standards etc.

The review of literature reveals a clear research gap. Even though many aspects of Kerala's industrialization have been studied and researched, so far, there has been no attempt to study Kerala's industrialization linking it with the very important area of the capital market. The present study would, hopefully, fill this research gap.

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CHAPTER 3

CAPITAL MARKET AND RESOURCE ALLOCATION

3.1 FINANCIAL SYSTEM AND ECONOMIC GROWTH

3.2 THE CENTRAL ISSUE OF RESOURCE ALLOCATION

3.3 STOCK MARKET AND ECONOMIC GROWTH

3.4 CAPITAL MARKET THEORY

3.5 RESOURCE ALLOCATION: THE INDIAN EXPERIENCE

CHAPTER 3

CAPITAL MARKET AND RESOURCE ALLOCATION

This chapter mainly provides a theoretical background to the issue of capital market and resource mobilization. It examines the role of the capital market in resource mobilization and its contribution to economic growth. It starts with the contribution of the financial system to economic growth and goes on to examine the relative efficiencies of the banking system and the stock market in resource mobilization. Then, the relationship between stock market and economic growth is discussed along with capital market theory. The chapter concludes with a discussion of the trends in efficiency in resource mobilization in India during the pre-reform and post-reform periods.

3.1 Financial system and economic growth

There is a close relationship between the development of an economy's financial system and its economic growth. This argument was first strongly made by Hicks (1969)¹, while discussing the economic circumstances that made the Industrial Revolution possible. Hicks argued that the Industrial Revolution was not the immediate consequence of a series of new technological innovations. In fact, most of those innovations that were exploited in the early years of the Industrial Revolution, had taken place some time earlier. The implementation of these innovations on a large scale required massive capital (sunk capital) investment for long term. Investors would not commit funds to such investments, in the absence of well functioning capital markets that can provide them with liquidity. This condition was satisfied in

England by the first half of the 18th century. The Industrial Revolution, therefore, had to wait for the financial revolution. This explains the correlation between the development of the financial system and economic growth.

3.2 The central issue of resource allocation

A central problem of every economy is that of resource allocation. To reap the gains of economic efficiency, resources have to be mobilized and made available for the most productive uses. In every economy, major part of savings comes from households. But, business firms make investment. Mobilizing the idle resources of households and making it available to firms for productive uses, is the function of the financial system. Economic efficiency and growth are crucially related to the efficiency with which the financial system performs this allocative role.

3.2.1 Gains of efficient resource allocation

If the allocative function is performed efficiently, some desirable economic consequences follow. These are:

- a) Households receive the best returns.
- b) Resources go into the most productive uses, benefiting efficient firms.
- c) The economy reaps efficiency gains via optimum resource allocation and favourable changes in capital – output ratio.

The central issue, therefore, is one of efficient resource allocation. The crucial questions are:

- a) how can optimum resource allocation be achieved?
- b) Which mode or system of resource allocation is more efficient?

3.2.2 Resource allocation –alternate systems

The financial system that performs the allocative function can be broadly classified into two:

- a) The banking system, which includes banks and other financial institutions, and,
- b) The capital market

The banking system, in the context of the present study, connotes the system that includes commercial banks and other financial institutions including term-lending institutions. The capital market connotes the market for corporate debt and equity capital. These two components of the financial system are competing financial intermediaries. The banking system can mobilize the savings of households and make them available for investment by firms. Alternatively, households can directly buy financial securities like debentures and equity issued by firms, thereby, contributing to the gross domestic corporate capital formation.

Which system is superior?

What are the strengths and weaknesses of these competing systems?

3.2.2 Relative efficiencies of alternate systems

The strength and efficiency of the two systems mainly depend on the following two factors (Shah and Thomas 1996)²:

- a) Transactions costs, and,
- b) The quality of information that forms the basis of allocative decisions

Transactions costs of banks are determined by their administrative expenses. The higher the administrative expenses, the higher would be the transactions costs. The transaction costs of the capital market are determined by factors

such as brokerage, market impact cost (the percentage mark up faced while trading) and back office work expenses.

The quality of information processing of banks depends on their ability to process economic and financial signals that come from the economy, the corporate sector and their potential borrowers. It would be ideal to charge variable interest rates depending on the default risk of various borrowers. Charging very competitive interest rates on optimal borrowers and charging high interest rates on doubtful borrowers or rejecting loans to them, can achieve the twin goals of maximizing returns for banks and optimizing the efficiency for the economy via lower capital – output ratio. The quality of information processing of the capital market depends on their price discovery and signals emanating from prices. Market is regarded as very efficient when market prices of securities reflect information about their potential returns. Market efficiency leads to resource allocation among firms based on their risk- return profile.

3.3 Stock Market and economic growth

The secondary segment of the capital market (the stock market) is the more conspicuous of the two, and is widely regarded as the barometer of the economy. Of course, the growth of the primary market is crucially dependent on the performance of the stock market. The crucial, albeit controversial, question is: can the markets perform the allocative function more efficiently than the banking system? Before going into this, it would be meaningful to examine the role of stock markets.

3.3.1 Role of the stock market

The most important function of stock markets is that of resource mobilization for firms. In the present context of liberalization and privatization, which imply huge demand for capital by the private sector, this role assumes added significance. Well functioning stock markets facilitate efficient resource mobilization by firms.

From the investors' point of view, the stock markets enable them to diversify their investment across a wide variety of asset class. This helps in risk minimization and achievement of optimum returns from investment.

Stock markets can substantially contribute to improving corporate governance. The stock prices reflect the judgment of a large number of market participants. Performance of firms and changes in profit potential are immediately reflected in stock prices. This screening and monitoring role facilitates improvement of corporate governance.

Even though the capital market and the banking system compete in resource mobilization, they are complementary in certain respects. The stock market together with the banking system, enable firms to achieve the right equity – debt mix. Seen from this perspective, stock market development contributes to the development of the banking system.

It is often claimed by votaries of stock markets that it is a leading indicator of the economy. This is a controversial issue, since there are evidences in support of and contrary to this claim. However, there are evidences for positive correlation between stock market development and economic growth. It can also be argued that the capital market is a better allocator of resources than the banking system.

The argument in favour of the capital market is that, the banking system, particularly in developing economies, constrained as it is by complex regulatory framework and structural deficiencies, fail in quality information processing. On the contrary, the capital market, if it functions efficiently, reflect price signals, which provide adequate information. Therefore, firms that perform well (firms with attractive stock prices) find it easy to mobilize resources for expansion and growth. This further means, denial of funds for less productive (poor performing) firms, industries and segments. Further more, the performance of firms are continuously screened, monitored and evaluated through their stock prices. Along with this continuous evaluation, the threat of take-overs (facilitated by laws relating to acquisitions and mergers) disciplines firms. Thus, market efficiency, in addition to resource allocation, ensures efficient resource utilization also. This facilitates achievement of higher economic growth.

This argument is supported by empirical evidence. The most exhaustive and authoritative study on the relationship between stock market growth and economic development came from the World Bank Research Group. The study came in the form of six Research Papers in a symposium issue on 'Stock Markets and Economic Development' (The world Bank Economic Review 1996)³. The empirical evidence on the positive correlation between stock market growth and economic development came from Ross Levine and Sara Zervos (1996)⁴. Levine and Zervos found that the stock markets impart and facilitate liquidity, risk diversification, information about firms, corporate control and savings mobilization. By changing the quality of these services, stock markets alter the rate of economic growth.

Liquidity is a major factor that can influence economic activity. It is a fact that many projects with high profitability potential require long-term capital commitment. However, generally investors would be reluctant to part with their savings for long periods. The capital market solves this problem by providing liquidity to investors. This facilitates investment in high-return projects, which would not materialize in the absence of capital markets that provide liquidity. Obviously, this has a favorable impact on economic growth.

Stock market development influence economic growth through risk diversification also. Projects with high profit potential are inherently risky. Risk diversification through internationally integrated stock markets via foreign portfolio investment can promote investment in projects with higher returns.

Stock markets can stimulate acquisition of information about firms. Information will enable investors and traders to trade and make profits. The scope for making profits from information will encourage research into firms' performance. This better information, in turn, facilitates better resource allocation leading to higher economic growth. Another influence of stock markets is via corporate control. According to Jensen and Murphy (1990)⁵, efficient stock markets couple manager compensation with stock performance. This aligns the interests of managers and owners, thereby, promoting better corporate performance. Better performance, higher profits, higher stock prices and better manager compensation moves in a circular cumulative causation.

Yet another interesting influence of the stock market is its ability to discipline the management and maximize a firm's stock price through take-over threats. Efficient stock markets can promote efficient resource allocation and growth via better management achieved through take-over threat.

Though differing views about stock market development and economic growth exist, increasing availability of information point to a favorable impact. The most exhaustive study done so far is by Levine and Zervos (1996)⁶. Their study is based on data for forty-one economies for two periods: 1976 -85 and 1986-93. The forty-one economies studied include low-income countries (like India), middle-income countries and high-income countries. Levine and Zervos created a measure for stock market development. By this measure, a stock market is regarded as developed if it fulfills three conditions.

These conditions are:

- a) assets intermediated by the market are large
- b) the market is liquid, and,
- c) the market is well integrated with the world markets.

The study found that there is a significant positive correlation between stock market development and real per capita GDP growth. Regressions developed by Levine and Zervos even go to the extent of suggesting that individual countries (like Mexico and Brazil) can push up their growth rates by more than a percentage point with developed stock markets.

3.4 Capital Market Theory

Capital market theory is concerned with asset pricing based on optimal portfolio selection. Optimal portfolio selection factors in the risk – return profile achieved through diversification of portfolio. Resource mobilization through the primary capital market is crucially related to the performance of the secondary stock market. Empirical evidence suggests positive correlation between the secondary

market and the primary market. Therefore it is important to examine the factors influencing stock price movements and its theory.

3.4.1 Fundamental and Technical Analysis

There are two approaches to explain stock price movements. They are:

- Fundamental analysis
- Technical analysis

Fundamental analysis explains stock price movements in terms of the fundamentals of the company, the industry and the economy. When these turn favourable, the stock prices move up. Important company (stock) specific fundamentals are: EPS, GPM, NPM, RoNW, PE Ratio, Pay out Ratio etc. The important industry specific indicators are whether the industry concerned is a sunrise industry or a sunset industry, whether the industry is on a cyclical down turn or up turn etc. The crucial fundamentals of the economy are the growth rate of G D P, the growth rates of the specific sectors, inflation rate, interest rate, fiscal and current account status, exchange rate, foreign exchange reserves etc. and the market expectations regarding these indicators.

If Fundamental analysis is about economic and financial information and expectations, Technical analysis is about price and trade volume movement in the market. Technical analysts called chartists believe that fundamentals manifest in the market. According to technical analysis, price and volume movements reflect the decisions of thousands of investors and speculators who play with fundamental information. Chartists do not go by fundamental information; they allow others to do it. Chartists study the price and volume

movements in the market and try to find patterns in them. Based on these trends future trends are predicted.

3.4.2 Dow Theory

Much of Technical analysis has been developed from the writings of Charles H Dow⁷. Dow wrote a series of articles for the Wall Street Journal. When Dow died in 1902 these principles formulated by him in his writings were compiled into the Dow theory. The essence of the Dow theory is that the Stock market does not move on a random basis. It is influenced by distinct trends that shape its general direction. By following these trends the general market direction can be predicted.

Basic Tenets of the Dow theory

Basic tenets of the Dow theory are the following:

i. Averages Discount Everything

All averages like the prices and volumes are the result of the actions of thousands of market players, including experts, who know everything about fundamentals. Therefore, averages discount every known and foreseeable factor.

ii. The Market Swings in Trends

The market moves in three trends, which have a general direction. These trends are: Primary trends, Secondary trends and Minor trends. Primary trends are extensive up or down movements. They are long- range cycles that move the market up or down. They normally last for a year and bring about appreciation or depreciation of about 20 percent in prices. Secondary trends are interruptions

in the primary trend, which bring about opposite movements. They take the form of reactions from an upward movement during a bull phase or recovery from downward movement during a bear phase. Secondary trends normally last for 3 weeks to 3 months retracing one third, to two third of the gains or losses. Minor trends are day-to-day fluctuations lasting for a few days. A series of minor trends make up a short- term trend.

iii. Volume goes with the Trend

According to the Dow theory, the trading volume moves with the trend. This means volumes increase with price increases and decrease with price decreases.

iv. Lines

Lines sometimes substitute for secondary trends. Lines are sideward movements that last for 2 or 3 weeks or months. In the course of a line, price fluctuates within a range of, say, 5 percent.

3.4.3 Portfolio Theory

A portfolio is a package of securities. The idea behind building a portfolio of securities is the principle of risk diversification. It is a fundamental principle of investment that spreading risk is better than 'putting all the eggs in one basket'. The traditional approach to diversification emphasized diversifying investment in such a way as to build a portfolio of securities of diverse industries. For instance, it is less risky to have a portfolio of one stock each of mining, utility and manufacturing rather than having three utility stocks.

3.4.4 The Markovitz Model

The modern approach to portfolio theory was developed by Harry Markovitz (1951)⁸. Markovitz came up with the idea of Optimal Portfolios based on risk-return relationship. Markovitz made the important observation that incorporating into the portfolio a security with greater risk than those already held could reduce risk. An investor can have any number of portfolios with various risk-return mixes. Each portfolio can be described in terms of its expected rate of return and standard deviation of the expected rate of return. If plotted in a two-dimensional graph the collection of all portfolios represent the feasible region. Feasible portfolios are those that can be created from the list of securities. Efficient portfolios are those that can give the highest return for a given level of risk or lowest risk for a given level of returns. A portfolio is efficient when:

- a. One cannot have a higher portfolio return with the same risk
- b. One cannot have a lower risk with the same return
- c. One cannot have a higher portfolio return with a lower risk

3.4.5 The Sharp Index Model

Sharp (1963)⁹, developed a simplified variant of the Markovitz Model. Sharp tried to simplify the process of data inputs and data tabulation. The Sharp Model assumes that fluctuations in the value of a stock relative to that of another do not depend on the characteristics of those two securities alone. The two securities might reflect general business conditions. Relationship between securities occurs through their individual relationships with some index of

business activity. The reduction in the number of covariance estimates needed, reduces substantially, the job of security analysis.

Sharp suggested that a satisfactory simplification would be to abandon the covariances of each security with each other security. This should be substituted with information on the relationship of each security to the market. Thus, it would be possible to consider the return for each security to be represented by the following equation:

$$R_i = a_i + B_i I + e_i$$

Where:

R_i = expected return on security i

a_i = intercept of a straight line or alpha coefficient

B_i = slope of a straight line or beta coefficient

I = expected return on Index

e_i = error term with a mean of zero and a standard deviation which is constant

Thus, the return on any stock depends upon some constant (a), plus some coefficient (B), times the value of a stock (I), plus a random component (e).

3.4.6 The Efficient Market Model

The Efficient Market Hypothesis (Fama 1969)¹⁰ examines the relationship between historical stock prices and rates of return and future stock prices and rates of return. There are mainly three forms of the Efficient Market Model.

They are:

Weak Form: The Random Walk Theory

According to the Weak Form of Efficient Market Hypothesis popularly known as the Random Walk theory, the current stock prices already fully reflect all the information that is contained in the historical sequences of prices. Therefore there is no benefit in analyzing the historical sequences of prices. Thus, it repudiates technical analysis.

Semi-strong Form

According to the semi-strong form of the Efficient Market Hypothesis, current prices of stocks not only reflect all informational content of historical prices but also reflect all publicly available knowledge about the firms being studied. The theory also says that attempts to acquire and analyze public information like corporate reports, announcements relating to dividend, bonus, stock splits etc will not yield any superior returns to investors and analysts. The basic logic behind the semi-strong form is that as soon as information becomes publicly available, it is absorbed and reflected in stock prices. The adjustment in prices need not be the correct one always; there can be over adjustments and under adjustments. Also, the adjustment need not be immediate. Even then, the analysts need not get superior returns, because the incorrect adjustments will not take place consistently. In such a scenario it is difficult to develop a trading strategy based on publicly available information.

Strong form

The Strong Form of Efficient Market Hypothesis, goes beyond the weak and semi-strong forms and argue that not only is the publicly available information

useless, but all information is useless. According to the theory, no available information- public or inside- can be used to earn consistently superior returns.

The general efficient market model recognizes market imperfections caused by transactions costs, information costs, delays in getting information to all market players etc; however, the point is that these imperfections will not be adequate enough to yield superior returns to analysts who develop trading strategies to exploit these imperfections.

3.4.7 The Capital Asset Pricing Model

The Capital Asset Pricing Model (CAPM) is a relationship explaining how assets should be priced in the capital markets. The portfolio theory implied that each investor faced an efficient frontier. Since expectations of investors vary, efficient frontier will vary from investor to investor. The CAPM makes the following assumptions.

- ↯ Investors are risk averse.
- ↯ Individuals have homogeneous expectations regarding returns, variance of returns and covariance between securities.
- ↯ Individuals can borrow and lend at a risk-less return.
- ↯ The quantity of risky securities is given.
- ↯ There are no transactions costs; the market is perfect.

When we introduce the assumption that individuals can lend and borrow at risk-less rate, the efficient frontier is transformed into a straight line. The return on portfolio will be given by the equation:

$$R_p = X R_m + (I-x) R_f$$

where:

R_p = expected return on portfolio

X = percentage of funds invested in risky portfolio

R_m = return from risky portfolio

$I-x$ = percentage of funds invested in risk free asset

R_f = risk free returns

3.4.8 Arbitrage Pricing Theory

The Arbitrage pricing theory of Ross (1976)¹¹ recognizes the fact that security returns are affected by several systematic factors. According to Ross the returns on an individual stock will depend on a variety of anticipated and unanticipated events. Investors factor the anticipated events into their expectations of returns. Therefore, they will be incorporated in the market prices. Most of the realized returns, however, come from unanticipated events. Even though change itself is anticipated, we do not know the direction or magnitude of changes; we only know the sensitivity of returns to changes. Major sources of risk in portfolio returns are systematic factors. Since different portfolios have different sensitivity to systematic risks, their market performance also varies. Since the systematic factors are primary sources of risk, they primarily determine the expected as well as the real return on portfolios. The actual return (R) of a security or portfolio may be broken down into three constituents and expressed as follows:

$$R = E + bf + e$$

Where:

E = expected return on security

b = security's sensitivity to change in the systematic factor

f = the actual return on the systematic factor

e = returns on the unsystematic, idiosyncratic factors

The essence of the equation is that the actual return equals the expected return, plus factor sensitivity times factor movement, plus residual risk.

In the backdrop of the above observations on the role of the stock market in resource mobilization and capital market theory, it would be meaningful to examine the Indian experiences in resource mobilization.

3.5 Resource allocation – the Indian experience

In India, the banking system has been dominant for nearly four decades since independence. The 'commanding heights principle' of economic growth, the socialist bias in economic policy, low savings rate and resource constraints experienced by the private corporate sector in the early years following independence, created an environment in which the government owned and controlled banking system dominated over the market. Resource mobilization for industrialization came mainly from financial institutions. See table 3.1.

TABLE 3.1**ASSISTANCE SANCTIONED BY ALL FINANCIAL INSTITUTIONS**

Year	Amount disbursed Rs. crores	Growth(in %)	Year	Amount disbursed Rs. crores	Growth (in %)	Year	Amount disbursed Rs. crores	Growth (in %)
1970-71	159.9		1980-81	1847.9	36.66	1990-91	12810.1	32.89
1971-72	191.4	19.69	1981-82	2352.0	27.28	1991-92	16260.0	26.93
1972-73	218.8	14.31	1982-83	2468.5	4.95	1992-93	23150.3	42.38
1973-74	301.6	37.84	1983-84	3138.4	27.13	1993-94	26624.3	15.01
1974-75	425.0	40.91	1984-85	3627.9	15.6	1994-95	33568.1	26.08
1975-76	435.2	2.4	1985-86	4940.0	36.17	1995-96	38649.5	15.14
1976-77	602.0	38.32	1986-87	5709.1	15.57	1996-97	42656.5	10.37
1977-78	713.0	18.43	1987-88	7061.1	23.68	1997-98	53647.9	25.77
1978-79	947.5	32.89	1988-89	7700.8	9.06	1998-99	57190.7	6.6
1979-80	1352.2	42.71	1989-90	9639.7	25.17	1999-00	68478.8	19.74
1977-78	713.0	18.43	1987-88	7061.1	23.68	1997-98	53647.9	25.77
1978-79	947.5	32.89	1988-89	7700.8	9.06	1998-99	57190.7	6.6
1979-80	1352.2	42.71	1989-90	9639.7	25.17	1999-00	68478.8	19.74

Source: RBI Handbook 2000

The liberalization era beginning with the eighties and gathering momentum in the nineties, transformed the resource mobilization environment. Even though the banking system grew fast during this period, the capital market started growing by leaps and bounds and became a preferred source for corporate capital mobilization. This is evident from table 3.2

TABLE 3.2

CAPITAL ISSUES BY PUBLIC LIMITED COMPANIES

Year	No. Of Issues	Amount raised (in Rs. crores)	Year	No. Of Issues	Amount raised (in Rs. crores)	Year	No. Of Issues	Amount raised (in Rs. crores)
1970	113	66.4	1980	237	163.9	1990-91	364	4312.2
1971	100	43.4	1981-82	435	598.4	1991-92	514	6193.1
1972	141	92.9	1982-83	644	706.0	1992-93	1040	19803.4
1973	190	74.4	1983-84	794	837.5	1993-94	1133	19330.3
1974	173	56.3	1984-85	471	1056.4	1994-95	1678	26416.7
1975	170	97.9	1985-86	850	1745.3	1995-96	1663	15997.6
1976	140	68.6	1986-87	521	2581.4	1996-97	838	10409.5
1977	152	103.4	1987-88	225	1787.7	1997-98	102	3138.3
1978	165	100.5	1988-89	341	3224.8	1998-99	48	5013.1
1979	189	180.0	1989-90	407	6509.9	1999-00	79	5153.3

Source: R.B.I.Handbook 2000

It can be seen from the table that resource mobilization by public limited companies entered an era of fast growth during the eighties and reached a peak

during the mid-nineties. During the period 1995 –2000, resource mobilization through capital issues declined: it fell from a peak of Rs. 26416.7 crores in 1994-95 to Rs. 5153.3 in 1999 –2000. However during this period, resource mobilization through the primary market continued to increase; it rose from Rs. 36689 crores in 1995-96 to Rs. 72450 crores in 1999-2000. The reason for this apparent paradox is that this period witnessed a structural change in the mode of resource mobilization; public issues declining and private placement becoming increasingly popular. This is evident from table 3.3

TABLE 3.3
RESOURCE MOBILIZATION FROM THE PRIMARY MARKET
(RS CRORES)

Issues	1990-91	1991-92	1992-93	1993-94	1994-95	1995-96	1996-97	1997-98	1998-99	1999-00
Corporate securities	14,219	16,366	23,537	44,498	48,084	36,689	37,147	42,125	60,192	72,450
Domestic issues	14,219	16,366	23,286	37,044	41,974	36,193	33,872	37,783	59,044	68,963
Non-Govt. Public companies	4312	6,193	19,830	19,330	26,417	16,075	10,410	3,138	5,013	5,153
Private Placement	4,244	4,463	1,635	7,466	11,174	13,361	15,066	30,099	49,679	61,259

Source: Indian Securities Market: A Review, NSE 2002

3.5.1. Efficiency in resource allocation in India

As stated earlier, the efficiency of resource allocation depends on transactions costs and the quality of information processing. How have the banking system and the capital market performed vis-à-vis these parameters of efficiency?

The transactions costs of the banking system in the pre-reform (pre 1991) period have been very high. This has been largely due to government control over the banking system, which pre-empted competition and discouraged attempts to reduce administrative expenses through trimming labour force and adoption of modern technology (Shah and Thomas 1996)¹².

The transactions costs of the capital market, as stated earlier, are determined by factors such as brokerage, market impact cost, counter-party risk and back office expenses relating to transfer of shares etc. These were very high in the pre-reform period. The near monopoly of the Bombay Stock Exchange, poor liquidity for securities, archaic systems of share transfer and absence of institutions that guarantee trades avoiding counter party risk etc meant very high transitions costs. Capital market reforms initiated since 1991 have subsequently, substantially reduced the transactions costs. This aspect is treated in detail in section 4.4.ahead.

Regarding the quality of information processing, the performance of the banking system was highly inadequate, in the pre-reform period. The hallmarks of the pre-reform banking system, like government ownership/control, branch licensing and entry barriers, pre-emption of a major part of bank funds through very high SLR and CRR and directed lending policies through priority sector lending and discriminatory interest rates, substantially limited the banking system's ability to process information. The replacement of commercial banking with social banking, starting with the bank nationalization of 1969, adversely affected the ability of the banking system to process information based on economic criteria. The financial sector reforms of the nineties have reformed the banking system substantially, and, consequently,

the quality of its information processing has improved markedly. Removal of entry barriers, increasing competition, low SLR and CRR and technological modernization etc have improved the ability of the banking system to process information.

The capital market also, in the pre-reform period, was influenced and regulated by the government. The need to get permission from the Controller of Capital Issues for raising capital, regulations of pricing of issues and capitalization of reserves etc, constrained the efficiency of the capital market, to a large extent. But, this was limited, compared to the constraints under which the banking system operated. There are limits beyond which government cannot influence, regulate and control the market. This is because of the freedom that the market enjoys. For instance, the government can instruct the banking system to provide a particular percentage of their funds for the priority sector or direct the banking system to lend funds for particular programmes at low subsidized interest rates. But the government cannot direct or make the markets to lend money (through a debenture issue for instance) at a lower rate of interest to a particular firm, or, direct investors to subscribe to the IPO of a particular firm.

Thus, it becomes clear that the efficiencies of both the banking system and the capital market were constrained in the pre-reform period. Yet, the banking system dominated over the capital market in playing the allocative role. This was due to the following reasons:

- The socialist bias in economic policy and emphasis on 'government-led' growth and development.

- Lack of trust in markets in general, which led to a plethora of controls on markets, including the capital market.
- Reliance on deficit financing for financing many programmes of economic development.
- Nationalization of banks and the pro-active role played by banks disregarding economic principles and criteria.
- Restrictive industrial policies like the reservation for the public sector, MRTP Act etc which stifled private initiative and enterprise and constrained the private sector. This precluded the need for massive capital mobilization by the private sector.
- The leadership role given to financial institutions like the IDBI, IFCI etc.

Conclusion

There is empirical evidence pointing to a positive correlation between stock market development and economic growth. Arguably, the capital market is a more efficient allocator of resources than the banking system, particularly in developing economies. In India, the efficiencies of both the banking system and the capital market have been constrained during the pre-reform period. The efficiency of the banking system was lower due to its high transactions costs imposed by obsolete technology and pre-emption of funds by the government via high SLR and CRR requirements; and poor quality of information processing caused by directed credit programmes. The efficiency of the capital market was constrained by government controls on primary and seasoned issues, dividend control etc. However the controls on the banking system was far more pervasive and restrictive than the controls on the capital market. This

was due to the relative freedom that the capital market enjoyed vis-à-vis the banking system. In spite of the relative inefficiency of the banking system, it dominated the financial system of the economy and its resource mobilization because of government's socialist policies, which emphasized state-led programmes and subordinated markets.

* * *

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⁷Much of Technical analysis has been developed from the writings of Charles. H .Dow in the Wall Street Journal. When Dow died in 1902, his successor and friend compiled his writings to form the now famous Dow Theory.

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¹¹Stephen Ross (1976):"The Arbitrage Theory of Capital Asset Pricing," *Journal of Economic Theory*, 13, pp. 341-60.

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CHAPTER 4

INDIAN CAPITAL MARKET:

GROWTH AND EMERGING TRENDS

4.1 SECURITIES MARKET IN INDIA: A PROFILE

4.2 RESOURCE ALLOCATION IN THE PRE-REFORM PERIOD

4.3 RESOURCE ALLOCATION IN THE POST-REFORM PERIOD:

STRUCURAL CHANGES

4.4 REFORMS IN THE INDIAN CAPITAL MARKET: POST 1991

4.5 IMPACT OF REFORMS AND EMERGING TRENDS

CHAPTER 4

INDIAN CAPITAL MARKET: GROWTH AND EMERGING TRENDS

This chapter examines the growth and emerging trends in the Indian capital market. It begins with a historical profile of the securities market and then goes on to examine the trends in the evolution of the market, focusing on the reforms and their impact, particularly on the efficiencies of the banking system and the capital market in resource allocation.

4.1 Securities Market in India: A Profile

The securities market in India has a long history. It made its humble beginnings with trading in the securities of East India Company in Mumbai and Calcutta in the 18th century. It is said that brokers used to gather under a banyan tree in Mumbai and under a neem tree in Calcutta for trading. The major breakthrough for the securities market was the introduction of joint stock companies with limited liability in the 1850s. The 1860s witnessed brisk trading and speculation in securities. This paved the way for the formation of the first formal and organised stock exchange in the country – The Bombay Stock Exchange in July 1875. Ahmedabad and Calcutta Stock Exchanges were formed in 1894 and 1908 respectively and 21 other stock exchanges were formed in the 20th century.

Even though the stock market in India has a history of more than a century, it remained in a state of insignificant low profile, in the first three decades following independence. The adoption of the principle of ‘commanding heights’, the socialist bias in economic policy and planning, lack of trust in markets and the strategy of ‘state-led growth’ created an economic and financial environment, where, the capital market was secondary, if not insignificant. The lengthening shadow of the ‘Control Raj’ in the early

seventies had its repercussions in the stock market, too. The dividend freeze of 1974 sent the market into a limbo culminating in its closure for three months. The total amount raised from the capital market by non-government public limited companies during the decade of seventies was a mere Rs.883 crores, the annual average being Rs.88.3 crores only [RBI Handbook 2000]¹.

4.2 Resource allocation in the pre-reform period

Consequent to the cumulative effect of the factors elaborated in section 3.4.1, the banking system, particularly the Term-Lending Financial Institutions like the IDBI, IFCI and ICICI dominated the capital market in capital mobilization. While the total amount mobilized by non-government public companies, through initial public offerings (primary market) rose only modestly from Rs.66.4 crores in 1970 to Rs.163.9 crores in 1980 (147 percent increase), the financial assistance disbursed by all financial institutions (banking system) rose from Rs.159.9 crores in 1970-71 to Rs 1847.9 crores in 1980-81. This is a phenomenal increase of 1056 percent (Ibid)².

Meanwhile, the sector-wise savings and intra-sectoral savings in the economy were undergoing major secular shifts. The share of household savings and corporate savings as percentage of gross domestic savings steadily increased, while that of public sector savings showed a declining trend. This is evident from table 4.1

TABLE 4.1**SECTOR-WISE DOMESTIC SAVINGS (AT CURRENT PRICES)**

Year	Household Sector			Private Corporate sector	Public sector	Gross Domestic savings
	Financial Savings	Physical Savings	Total (2+3)			
1	2	3	4	5	6	7
1970-71	1,371 (28.13)	3,502 (71.88)	4,873 (71.84)	657 (9.69)	1,253 (18.47)	6,783
1975-76	3,918 [185.78]	6,616 [88.92]	10,534 [116.17]	1,055	3,339 [166.48]	14,928 [120.08]
1980-81	8,610 (39.41) [119.75]	13,238 (60.59) [100.1]	21,848 (75.90) [107.40]	2,284 (7.93) [116.49]	4,654 (16.17) [39.38]	28,786 [92.83]
1985-86	18,538 [115.31]	19,620 [48.21]	38,158 [74.65]	5,318 [133.07]	8,457 [81.71]	51,933 [80.41]
1990-91	49,700 (45.34) [168.1]	59,923 (54.66) [205.42]	1,09,623 (84.33) [187.29]	14,940 (11.49) [180.93]	5,436 (4.18) [-35.72]	1,29,999 [150.32]
1995-96	95,715 [92.59]	1,14,702 [91.42]	2,10,417 [91.95]	47,391 [217.21]	25,195 [363.48]	2,83,003 [117.70]
1998-99	1,92,621 (59.07) [101.24]	1,33,195 (40.93) [16.12]	3,25,456 (82.68) [54.67]	67,573 (17.16) [42.59]	572 (0.15) [-97.73]	3,93,601 [39.08]

Source: Central Statistical Organization

1998-99 figures are from new series (Base: 1993-94). Others are from old series (Base: 1980-81). Figures in parenthesis indicate percentages and in square parenthesis show growth rates.

The table reveals major structural changes in the composition of gross domestic savings. The share of the household sector in GDS has been showing

a secular upward trend, rising from 71.84 percent in 1970-71 to 82.68 percent in 1998-99. It can be seen that within the household sector the share of physical savings declined from 71.87 percent in 1970-71 to 40.93 percent in 1998-99 and correspondingly the share of financial savings increased from 28.13 percent to 59.07 percent during the same period. The growth rate of the savings share of private corporate sector has been much more impressive: rising from 9.69 percent in 1970-71 to 17.16 percent in 1998-99. A reverse trend can be seen in the share of public sector savings, which crashed from 18.47 percent in 1970-71 to 0.15 percent in 1998-99. The notable feature of the trends and structural changes in gross domestic savings is the steady increase in the household and private corporate savings and the steady deterioration in public savings. These structural shifts in the composition of GDS were reflected in the composition of gross domestic capital formation also. This is evident from table 4.2.

TABLE 4.2
SECTOR-WISE GROSS CAPITAL FORMATION

YEAR	Household sector	Private corporate sector	Public sector	Gross capital formation
1970-71	3,541 (47.99)	1,030 (13.96)	2,808 (38.05)	7,379
1975-76	6,684 (40.74) [88.76]	2,139 (13.03) [107.67]	7,583 (46.22) [170.05]	16,406 [122.33]
1980-81	13,238 (46.53) [98.06]	3,448 (12.12) [61.20]	11,767 (41.36) [55.18]	28,453 [73.43]
1985-86	19,620 (30.92) [48.21]	14,405 (22.70) [317.78]	29,417 (46.36) [150]	63,442 [122.97]
1990-91	59,923 (44.34) [205.42]	23,082 (17.08) [60.24]	52,151 (38.59) [77.28]	1,35,156 [113.04]
1995-96	1,14,702 (37.60) [91.42]	1,01,801 (33.37) [341.04]	88,477 (29.01) [69.66]	3,04,980 [125.65]
1998-99	1,33,195 (34.64) [16.12]	1,35,161 (35.15) [32.77]	1,16,162 (30.21) [31.29]	3,84,518 [26.08]

Source: Central Statistical Organisation. Figures in parenthesis show percentage share and in square parenthesis show growth rates.

With the partial liberalization of the economy witnessed in the eighties, coupled with pro-capital market policies, the structure and composition of resource mobilization started to change. The eighties witnessed many policy initiatives aimed at reducing many restrictions on the private sector; such as

amendment to the MRTP Act, reduction of corporate tax, removal of price controls in certain industries like steel, partial delicensing etc. This gave a big boost to investment and consequently corporate gross capital formation increased markedly. This is evident from table 4.3.

TABLE 4.3
CORPORATE GROSS FIXED CAPITAL FORMATION

(1955-56 to 1993-94)

Corporate Gross Fixed Capital Formation (1955-56 to 1993-94)		
Years	Corporate G F C F as % of	
	G D P (m p)	Total G F C F
1955-56 to 1959-60	1.6	12.3
1960-61 to 1964-65	2.5	17.6
1965-66 to 1969-70	1.4	9.5
1970-71 to 1974-75	1.6	10.6
1975-76 to 1979-80	1.6	8.8
1980-81 to 1984-85	3.4	17.5
1985-86 to 1989-90	3.5	16.3

Source. National Accounts Statistics- Various issues

The higher level of capital formation enabled the economy to take off to a higher growth path. The Hindu Growth Rate of 3.5 percent achieved during the first three decades since planning gave way to a respectable growth rate of 5.6 percent in the eighties. The new environment gave a fillip to the capital market. The total capital issues by non –government public companies rose from Rs.163.9 crores in 1980 to Rs.4312.2 crores in 1990-91 (growth of more than 25 times). During this period the financial assistance disbursed by all financial institutions rose from Rs.1847.9 crores to Rs.16260 crores (Ibid)³.

This marks a growth of less than 8 times only. Clearly, the structure and composition of resource mobilization started to change.

4.3 Resource mobilization in the post-reform period: Structural changes

The reforms of the eighties were half-hearted; they addressed mainly the constraints experienced by domestic entrepreneurs. Compared to the half-hearted reforms of the eighties, the Structural Adjustment Programme of the nineties was 'Big Bang'. Major policy initiatives encompassing all major segments of the economy, transformed the economic environment. Along with internal liberalization, external liberalization and competition were also ushered in, through drastic reduction in import tariffs and liberalization of imports. The dramatic change in the economic environment and great expectations about future potential led to a boom in capital markets. Even though the decade of the nineties witnessed a major stock market scam and high volatility in stock prices, the capital market as a whole experienced a steady secular growth trend. For the first time in Indian economic experience, the resource mobilization from the primary market exceeded the assistance disbursed by all financial institutions. Resource mobilization through the issue of corporate securities in the primary market rose to Rs.68963/ crores (excluding Euro issues) during 1990-2000 while the assistance disbursed by all financial institutions rose to Rs.68478 crores during the same period (I S M. A Review 2002 & RBI Handbook)⁴. Clearly, the capital market had arrived.

4.4 Reforms in the Indian Capital Market: Post 1991

The year 1991 marks a watershed in Indian economic history. The reforms initiated in 1991 as a response to the Balance of Payments crisis of 1991, were sweeping in their scope and revolutionary in content. The Structural Adjustment Programme initiated in 1991 transformed many segments and

markets in the economy, beyond recognition. One market that was subjected to sweeping reforms has been the capital market. These reforms, led to a spectacular growth in the Indian capital market, two scams notwithstanding.

Consequent to the reforms, the market has grown in size and improved in efficiency. As measured in terms of capital raised from market, number of stock exchanges and other intermediaries, the number of listed stocks, market capitalization, investor population, trading ratios and trading volumes, turnover in stock exchanges and technological sophistication, the growth of the capital market has been truly remarkable. Fundamental institutional changes brought about drastic reduction in transactions costs and considerable improvements in market efficiency, safety and transparency. Particularly, the setting up of institutions like the SEBI, the NSE and the Clearing House Corporation, market pricing of issues, country-wide screen based trading, dematerialization of securities, rolling settlement, modern risk-management systems, derivatives trading, foreign portfolio investment and disclosure and investor protection measures, transformed the Indian capital market from an oligopolistic broker controlled, technologically backward, inefficient market, to a sophisticated, transparent market with a high level of market efficiency. It would be meaningful to revisit these reforms and examine their impact on market efficiency.

4.4.1 Market pricing of issues

Abolition of the office of the Controller of Capital Issues (CCI) and the decision to leave pricing of issues to the market were major steps taken in 1991. This reform, replaced the bureaucratic price administration with market pricing, thereby, facilitating price discovery.

4.4.2 Empowering the Regulatory Body, SEBI

The regulatory body Securities and Exchange Board of India (SEBI), set up in 1989, was empowered in 1992 with the responsibility of protecting the interests of investors and promoting and regulating the development of securities market. All market intermediaries are registered and regulated by SEBI. SEBI lays down the rules of the game for all market intermediaries and participants. Disclosure and Investor Protection (DIP) guidelines are issued by the SEBI to protect the interests of investors.

4.4.3 Open electronic limit order book market and screen based trading

A major reform was the replacement of the 'open outcry' system with the modern open electronic order book market. The open outcry system is similar to auctioning vegetables in a local market. Brokers assemble in a trading floor and trade through shouting and hand signaling. The deficiency of this system is that its liquidity is limited to the ability of market intermediaries to hold inventory of securities. Also the price signals emanating from such a market reflect the information set of market intermediaries confined to that market.

The open Electronic Limit Order Book (ELOB) system is a countrywide computer based matching system. The advantage of this system is that it facilitates discovery of prices that reflect the combined resources and information of all traders. This boosts liquidity substantially. Further more, it facilitates transparent screen based trading. The exchange that started ELOB and screen based trading was the newly set up -1994- National Stock Exchange (NSE). NSE started trading equity and debt instruments in 1994. BSE followed suit in 1995.

4.4.4 Extension of markets: Countrywide integrated markets

Under the open outcry system that was dominated by the BSE, traders including investors had to route their orders to Bombay through intermediaries. Multiplication of intermediaries pushed up transactions costs. Also, variations in prices between Bombay and other markets were common. The system did not provide scope for exploiting arbitrage opportunities.

This major deficiency was removed when NSE established satellite communications system, paving way for nationwide connectivity. This led to the emergence of an integrated national market. An order placed from any part of the country through computers, can be matched with any order from any part of the country. Consequently, price variations are removed by arbitrageurs, who exploit pricing discrepancies.

The ELOB system and the consequent country-wide integration of markets, succeeded in substantially reducing the number of intermediaries, thus reducing transactions costs; this removed price discrepancies between markets, thereby contributing to market efficiency.

4.4.5 Clearing House System

Another major deficiency of the Indian capital market has been the possibility of counter – party risk implied in the earlier system. Counter – party risk arises when one of the parties to a contract declares bankruptcy, and reneges the contract. High volatility in stock prices adds to the possibility of counter–party risk. The danger of counter- party risk is that a default at the level of one or a few traders can lead to default at the entire market level, and a systemic collapse through cascading effects. This happened in April 1995, when the BSE had to be closed down for three days due to cascading defaults in connection with the ‘M.S.Shoes’⁵ stock trading.

The problem of counter – party risk has been removed through a major reform: the establishment of the Clearing House Corporation that guarantees each trade. From July 1996 onwards, the National Securities Clearing House Corporation (NSCC) guarantees each trade, thereby, removing the risk of counter –party risk and its cascading consequences.

4.4.6 Depository Services

Till 1996, share transfers in the market required physical movement of shares. Physical shares are beset with problems like bad delivery (arising from non – compliance of rules, signature differences etc). This resulted in lot of back office work arising from filling in the Transfer Deeds, affixing share transfer stamps, sending certificates to the company through post offices etc. This led to high transactions costs. Further, the delay in getting a share transferred to the buyers name (it used to take around 45 days on an average), adversely affected the liquidity of the stock.

Problems arising from physical certificates have been solved through the system of depositories (Depository Act 1996). Depositories are institutions that dematerialize securities. Dematerialization is the process of converting securities from physical form into electronic form. Depositories maintain an electronic record of ownership of shares, thereby, eliminating the need for storage and handling of securities. This reduces costs, substantially. Further more, possibilities of forgery, counterfeiting and theft of securities are eliminated. The significance of depositories is that they reduce transactions costs, improve liquidity and help in better price realization (demat securities always command a premium over physical securities), thereby, contributing to market efficiency. India now has two depositories, viz., National Securities Depository Limited (NSDL) – promoted by the NSE, and Central Depository Services Limited (CDSL) –promoted by the BSE.

4.4.7 Rolling Settlement

In the pre-reform period, settlement cycles on the stock exchanges were long resulting in long open positions with their inherent volatility risk. The trading cycle varied from 14 days for specified securities, to 30 days for others, with carry over facilities under badla system. Actual delivery of securities, and payment of cash after settlement date, took another 10 days or more. Such long periods between entering into a contract, and final settlement, often caused defaults and settlement problems. To overcome these problems, the settlement cycle was later reduced to one week. However, this could not solve the problem, since, different exchanges had different settlement periods resulting in transfer of positions from one exchange to the other.

Reform of the trading cycle and settlement system was effected through the introduction of the T + n Rolling Settlement. Here, T refers to the trading day and n refers to the number of days after the trading day, when actual settlement takes place. Rolling settlement on T +5 basis was introduced, reducing the trading cycle to just one day. Under T+5 rolling settlement, all trades outstanding at the end of day T will be settled on the 5th day. All shares were compulsorily moved to rolling settlement from December 2001. All exchanges were moved to the same settlement day. Later T +5 was replaced with T +3 and T +2. The most advanced T +1 mode is proposed to be introduced in 2004.

The rolling settlement substantially reduces the risk of large open positions with their high volatility potential. The stock market booms and crashes of 1992 and 2000-01, were to a large extent, caused by the huge open positions

built by speculators exploiting the lengthy settlement periods and carry – forward mechanisms.

4.4.8 Derivatives trading

An important reform in recent times has been the introduction of derivatives trading. Derivatives like futures and options are financial contracts, which derive their value from ‘the underlying.’ The ‘underlying,’ refers to the spot market price of the product concerned. Trading in derivatives was introduced in June 2000. The market, presently offers index futures and options, and stock futures and options in securities. The Clearing Corporation guarantees all trades in the derivatives market. The advantage of derivatives is that they allow better risk management. Trading in derivatives enables risk minimization through hedging and arbitrage.

4.4.9 Capital from abroad: GDRs and ADRs

Till 1994, Indian corporate sector could raise resources only from within the domestic market. Gross domestic corporate capital formation was thus constrained by the availability of domestic savings. This situation changed in 1994 when Indian companies were allowed to raise capital abroad through the issue of Global Depository Receipts (GDRs) and American Depository Receipts (ADRs). This enabled the Indian corporate sector to mobilize foreign savings for capital formation in India.

4.4.10 Foreign Portfolio investment (FPI)

Yet another landmark reform was the opening up of the Indian stock market for foreign portfolio investment in 1993. Foreign Institutional Investors (FIIs) were allowed to invest in the Indian stock market. This gave a big boost to the secondary market.

FPI played a significant role in boosting India's foreign exchange reserves at a time when the country's reserves position was precarious, after the BoP crisis of 1991. FPI boosted the sagging morale of the market that was dented by the crash of 1992. FPI also has a positive effect from the macro economic perspective. Increase in capital flows through FPI reduces the interest rate (via increase in money supply). Reduction in the cost of capital (interest rate) has a favorable impact on investment and growth. On the flip side, FPI is hot money. During times of disturbances and instability, FPI flows out quickly causing major macro economic crisis.

4.4.11 Book Building

Yet another important reform (1995) has been the introduction of the modern book building system of securities issue. Under the normal system, securities are issued at a fixed price. Book building is a process of offering securities based on bids received from investors. Bidding facilitates demand assessment and price discovery.

4.4.12 Corporatisation of Stock Exchanges

It used be said of the Indian Stock Exchanges that they were 'institutions of the brokers, for the brokers, by the brokers.' Brokers owned, controlled and managed stock exchanges; naturally, their interests got precedence over that of investors. The way out of the impasse was corporatization and demutualization of stock exchanges. This reform was introduced in 2001. Under corporatization, ownership, management and trading membership are segregated from one another. NSE has a demutualized governance structure. For other exchanges, government offered many concessions and tax incentives to facilitate corporatization.

4.4.13 Risk management

Stock markets are notorious for their volatility. To prevent volatility from degenerating into crisis, market failures and systemic collapse, market integrity is essential. This requires comprehensive risk management system. Learning lessons from scams and market crashes; a comprehensive risk management system has been introduced. This includes capital adequacy of members, adequate margin requirements, limits on exposure and turnover, indemnity insurance, on-line position monitoring and automatic disablement etc. Also, there are systems for efficient market surveillance to curb excessive volatility and prevent price manipulations.

4.4.14 Other reforms

Other reforms introduced include the following:

- Opening of the mutual fund industry to the private sector
- Code for take overs/acquisitions and mergers
- Stock buy back facility for companies
- Stock lending
- Disclosure and Investor Protection Guidelines

4.5 Impact of reforms

The cumulative impact of the above-discussed reforms has been that the Indian capital market got transformed dramatically. The contrast between the market designs at the beginning of reforms (1991), and at the end of a decade of reforms (2002) brings this into perspective. This is shown in table 4.4

TABLE 4.4
MARKET DESIGN IN INDIAN SECURITIES MARKET
1992 AND 2002

Feature	1992	2002
Regulator	No specific Regulator but Central Govt. oversight	A specialized regulator for securities market (SEBI) vested with powers to protect investors' interest and to develop and regulate securities market. SROs strengthened
Intermediaries	Some of the intermediaries like stock brokers, authorized clerks etc regulated by the SROs	A variety of specialized intermediaries emerged. They are registered and regulated by SEBI (also by SROs) They as well as their employees are required to follow a code of conduct and are subject to a number of compliances
Access to Market	Granted by Central Government	Eligible issuers access the market after complying with the issue requirements
Pricing of securities	Determined by Central Government	Determined by market, either by the issuer through fixed price or by the investors through book building
Integration with International Market	No Access	Corporates allowed to issue ADRs/GDRs and raise ECBs. ADRs/GDRs have two-way fungibility. FIIs allowed to trade in Indian Market. MFs also allowed to invest overseas
Trading Mechanism	Open outcry. Available at the trading rings of the exchanges. Opaque, Auction/negotiated deals	Screen based trading system, Orders are matched on price-time priority, Transparent, Trading platform accessible from all over the country
Aggregation order flow	Fragmented market through geographical distance. Order flow unobserved	Order flow observed. Exchanges have open electronic consolidated limit order book.
Anonymity in Trading	Absent	Complete
Settlement System	Bilateral	Clearing House of the Exchange or the Clearing Corporation is the central counter-party
Settlement Cycle	14 day account period settlement, but not adhered to always	Rolling settlement on T+3 basis
Counter party risk	Present	Absent

Form of Settlement	Physical	Mostly Electronic
Basis of Settlement	Bilateral Netting	Multilateral Netting
Transfer of Securities	Cumbersome. Transfer by endorsement on security and registration by issuer	Securities are freely transferable. Transfers are recorded electronically by Depositories
Risk Management	No focus on risk management	Comprehensive risk management system encompassing capital adequacy, limits on exposure and turnover, margining, on-line position monitoring etc

Source. Indian Securities Markets, A Review (2000)

The impact of reforms may be summarized as follows:

- Reduction in transactions costs
- Improved price discovery; market determined pricing
- Efficient electronic settlement
- Better risk management; elimination of counter-party risk, possibilities of hedging
- Integration of markets within the country; removal of price discrepancies through arbitrage operations
- Global integration of markets: Euro issues and FPI, and,
- Substantial improvement in liquidity.

Clearly, the reforms have transformed the Indian Capital market from an oligopolistic, broker controlled, technologically backward, inefficient market, to a sophisticated, technologically advanced, transparent market, with high levels of market efficiency.

4.5.1 Market Reforms and Market Development

According to Levine and Zervos (2000)⁶, the level of development of a country's stock market can be assessed by three parameters, viz.,

- i. assets intermediated by the market
- ii. liquidity of the market, and
- iii. the level of global integration of the market

If a market is characterized by a higher level of asset intermediation relative to that of banks, good liquidity, and sufficient integration with global markets, then, that market can be regarded as a developed market. Now, let us look at the Indian capital market from the perspective of these three parameters.

4.5.1.1 Assets intermediated by banks and the market

The improved efficiency of the market, naturally, benefits the households. Better returns from the financial market quicken the process of disintermediation, leading to an increasing share of resource mobilization by the capital market relative to banks. This transformation that happened in the nineties is clear from the table 4.5. **TABLE 4.5**

ASSETS INTERMEDIATED BY BANKS AND MARKETS 1990 & 2000

(IN RUPEES BILLION)

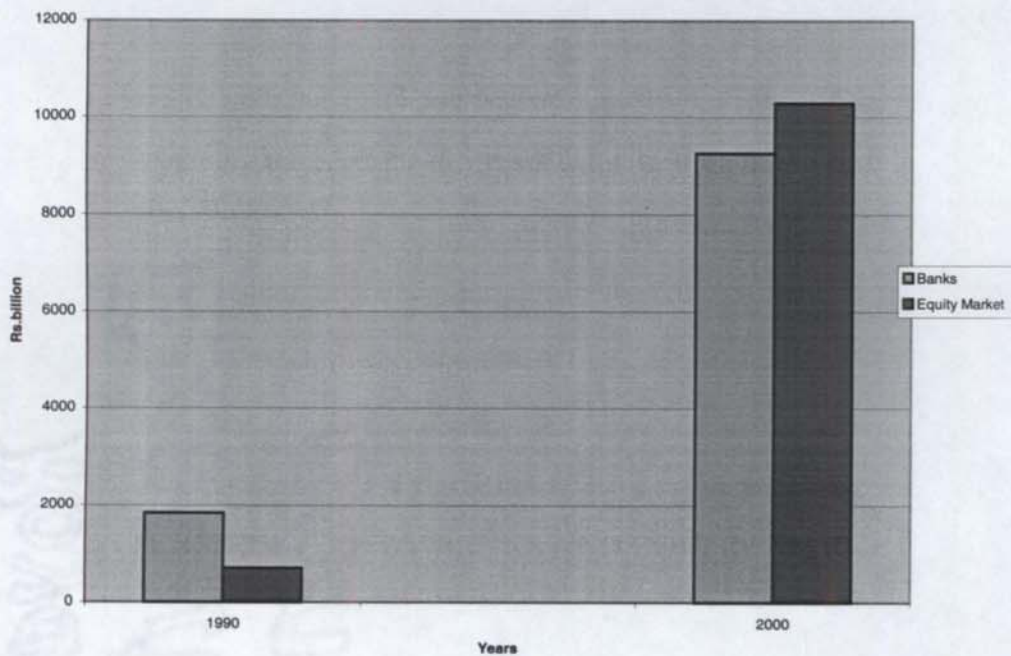
Year	Banks	Equity Market
1990	1841	705.21
2000	9254	10293

Sources: Calculated from R.B.I. Handbook 2000 and Capital Market April 1990 and April 2000

This table uses the aggregate bank deposits as a measure of the assets given to the banking system by the economy. Market capitalization of the BSE is taken as the measure of the assets held through the equity market. The shifting preference of the Indian financial sector from banking system to financial markets is evident from table 4.5 and figure 4.1.

FIGURE 4.1

ASSETS INTERMEDIATED BY BANKS AND EQUITY MARKETS



The asset intermediation through the capital market which was less than half of the asset intermediation by the Banking system in 1990, shot up in the nineties overtaking it by 2000. While the asset intermediation by the banking system rose from Rs.1841 crores in 1990 to Rs.9254 in 2000, the asset intermediation by the capital market shot up from Rs.705.21 in 1990 to Rs.10293 crores in 2000.

4.5.1.2 Market liquidity

Market liquidity is measured by the turnover. Turnover in the Indian market, as a percentage of the global market turnover more than doubled in 2000 compared to 1990. This is clear from table 4.6.

TABLE 4.6.
TURNOVER FOR MAJOR MARKETS (in \$ million)

Country/Region	1990	2000
Developed Markets	4,616,473	43,912,999
Australia	40,113	226,325
Japan	1,602,388	2,693,856
UK	278,740	1,835,278
USA	1,751,252	31,862,485
All Emerging Markets	898,233	3,956,869
China	-	721,538
India	21,918	509,812
Indonesia	3,992	14,311
Korea	75,949	1,067,669
Malaysia	10,871	58,500
Philippines	1,216	8,196
Taiwan	715,005	983,491
World Total	5,514,706	47,869,867
US as % of World	31.76	66.56
India as % of World	0.40	1.06

Source: S&P Emerging Markets Fact book, 2002.

It can be seen that Indian market's turnover as a percentage of world turnover more than doubled from 0.40 in 1990 to 1.06 in 2000. This is a reflection of substantial improvement in liquidity.

4.5.1.3 Global integration

Before the reforms, Indian markets were not integrated with the global markets; in fact, the level of integration was zero. Global integration began in 1992 when Indian companies were allowed to raise capital abroad through the issue of GDRs, ADRs and Euro Bonds; and took a major step forward in 1994 when Foreign Institutional Investors (FIIs) were allowed to make Portfolio Investment in India. Taking capital mobilized from abroad and Foreign Portfolio Investment as proxies for global integration, the situations in the pre-reform and post-reform periods can be summarized as shown in table 4.7.

TABLE 4.7

GLOBAL INTEGRATION OF THE INDIAN STOCK MARKET

Parameters of integration	1990	2000
Access to foreign capital markets	No access	Access through ADRs, GDRs and Euro Bonds
Amount mobilized abroad (in Rs.crores)	Nil	30868
Foreign Portfolio Investment	Non-existent	Exists
FPI value (in Rs.crores)	Nil	39331

Source: RBI Handbook 2000 & Indian Securities Market A Review 2002

4.5.2 Stock Market Efficiency – Reduction in transactions costs

Efficiency of the stock market is measured by transactions costs. Post-1991 reform initiatives have drastically reduced transactions costs in the Indian capital market. Now, India's transactions costs are almost at par with the best in the world. This is evident from table 4.8 and figure 4.2.

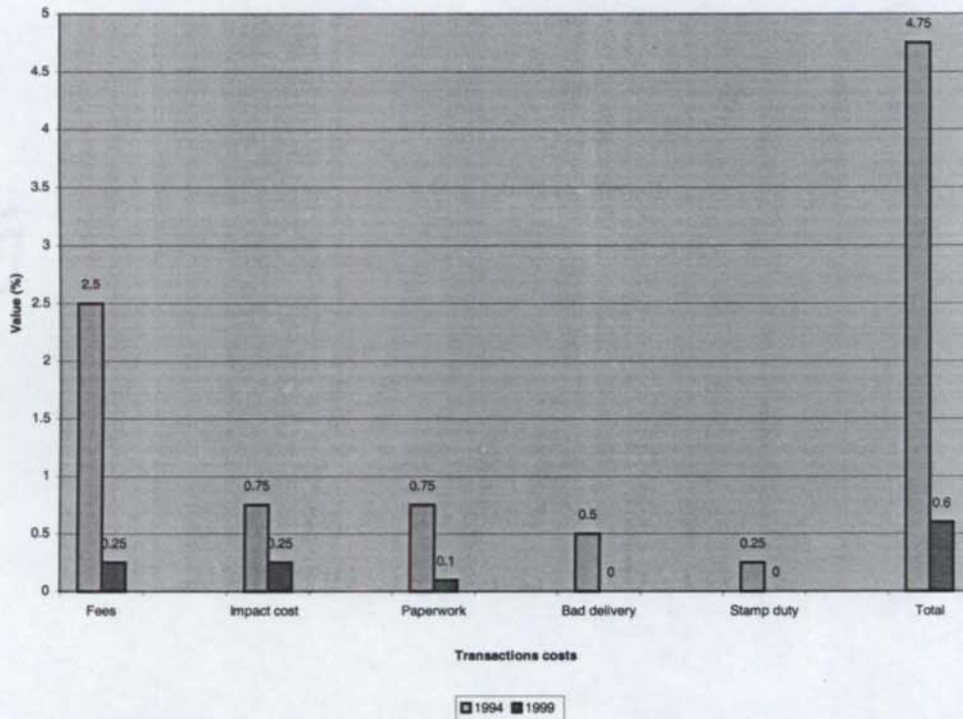
TABLE 4.8
REDUCTION IN TRANSACTIONS COSTS IN INDIA
{1994 & 1999}

Transaction Cost	1994	1999	Global Best
Trading (%)			
Fees	2.5	0.25	0.25
Impact Cost	0.75	0.25	0.2
Clearing			
Counter Party Risk	Present	Nil	Nil
Settlement (%)			
Paper work	0.75	0.1	0
Bad Delivery	0.5	0	0
Stamp Duty	0.25	0	0
Total (%)	>4.75	0.6	0.45

Source: National Stock Exchange

It can be seen that with regard to transactions costs such as trading fee, bad delivery, counter-party risk and stamp duty, Indian capital market is at par with the best in the world. In market impact cost, India slightly lags the global best parameters. When the total transactions costs are taken, it can be seen that there has been a drastic reduction: from around 4.75 percent in 1994 to 0.6 percent in 1999. This is a reflection of substantial improvement in market efficiency. Figure 4.2 shows the reduction in transactions costs.

FIGURE 4.2
REDUCTION IN TRANSACTION COSTS



4.5.3 Market efficiency of Banks

The single most important indicator of market efficiency, as already discussed, is transactions costs. The lower the transactions costs imposed on the households, the higher is the market efficiency. Lower transactions costs enable markets to give better returns to households.

The transactions costs of banks are determined by their administrative costs, technological sophistication, government policies regarding entry into the industry, policies relating to directed credit like priority sector lending, pre-emption of funds via CRR and SLR etc. During the pre-reform period, transactions costs of banks were very high due to factors such as:

- Trade union opposition to computerization and automation
- Government control/ownership over the banking sector

- Restrictions on entry/expansion etc imposed on private and foreign banks
- Directed credit through priority sector lending, leading to inefficient resource allocation
- Pre-emption of large chunks of funds via high CRR and SLR at below market rates of interest

These factors cumulatively caused high transactions costs for banks; consequently, the returns they could offer to households were poor. The best indicator of the high transactions costs, is the interest rate spread, i.e., the difference between the deposit rate and the lending rate. The lower the spread, the higher is the efficiency. Reforms in the banking sector in the post-reform period, consequent to the implementation of the Narasimham Committee recommendations, certainly led to reduction in transactions costs of banks. Removal of entry barriers in the industry, permission to foreign banks to increase the number of branches, removal of branch licensing, the emergence of the New Generation Hi-Tech Banks, the technological sophistication introduced into the industry (ATMs, electronic clearing etc.) in the new competitive environment, market related returns for CRR and SLR etc, led to reduction in transactions costs. This, in turn, reduced the interest rate spread, giving relatively better returns to investors.

The decline in interest rate spread is evident from the table 4.9

TABLE 4.9
TRENDS IN THE INTEREST RATE SPREAD

Year	Average Deposit rate (1 to 3 years-in %)	Minimum lending rate (in %)	Interest rate spread (in %)
1990-91	9.5	16	6.5
1991-92	12	19	7
1992-93	11	17	6
1993-94	10	14	4
1994-95	11	15	4
1995-96	12	16.5	4.5
1996-97	11.5	14.75	3.25
1997-98	10.75	14	3.25
1998-99	10	12.5	2.5

Source: Calculated from RBI Handbook 2000 data.

It can be seen that the transactions costs, and consequently the interest rate spread, had fallen steeply during the post-reform period. The interest rate spread fell from 6.5% in 1991 to 2.5% in 1999. It is interesting to note that the fall in interest rate spread was caused mainly by the reduction in lending rates. The drastic reduction in SLR and CRR and the unprecedented technological sophistication that was ushered in, played crucial roles in the reduction in transactions costs during the reform period.

4.5.4 Efficiency of Stock Markets and Banks – a comparison

It is clear from the analysis that the efficiencies of both the competing systems of resource mobilization- the capital market and the banking system- have improved during the post-reform period. However, the improvement in efficiency, as reflected by the reduction in transactions costs, is far greater in

the stock market than in the banking system. This is clear from table 4.10 and figure 4.3.

TABLE 4.10

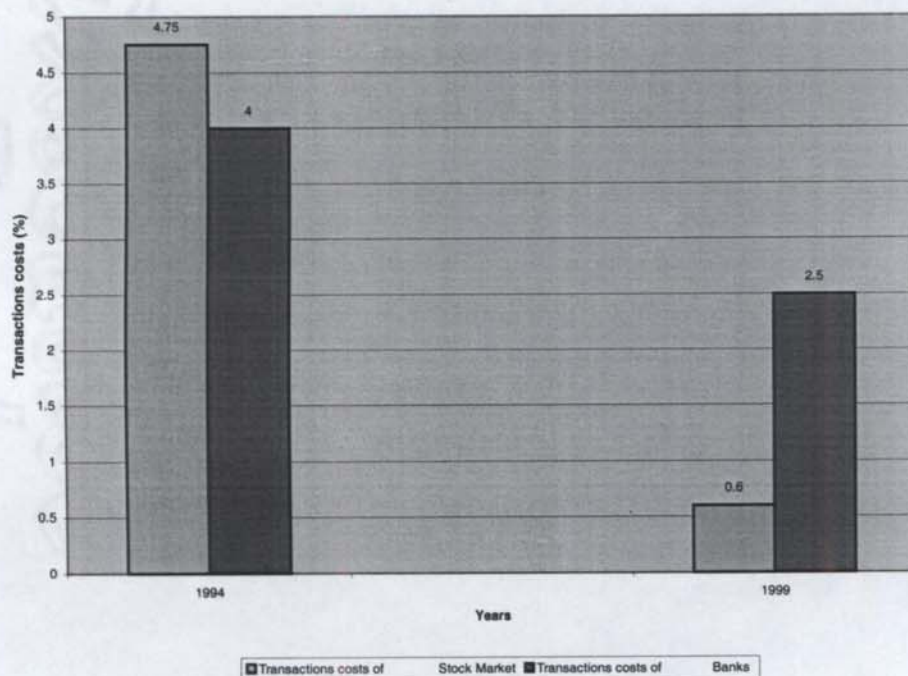
TRANSACTIONS COSTS OF STOCK MARKET AND THE BANKS

Year	Transactions costs of Stock Market [in %]	Transactions costs of Banks [in %]
1994	4.75	4
1999	0.6	2.5

Source: Calculated from National Stock Exchange and RBI Handbook 2000 data

FIGURE 4.3

REDUCTION IN TRANSACTIONS COSTS OF STOCK MARKET AND BANKS



The stock market had higher transactions costs relative to Banks in 1994. But, consequent upon the implementation of reforms, transaction costs of the stock market has declined drastically; it is now lower than that of banks. The fact that this achievement is, in spite of a steep decline in the transactions costs of banks, is noteworthy.

The capital market reforms and the consequent improvement in market efficiency have led to unprecedented capital market development. See table.4.11.

It can be seen that there are substantial improvements in the important attributes of market development such as, the number of listed companies, market capitalization, market capitalization ratio, market turnover and turn over ratio etc. These parameters have vastly improved in the Indian market. This puts Indian capital market in the same league as the markets in the developed countries. This is evident from table 4.11

TABLE 4.11**STOCK MARKETS: INTERNATIONAL COMPARISON [2001]**

	USA	U.K	Japan	Germany	Singapore	Hong Kong	China	India
No.of listed companies	6,355	1,923	2,471	988	386	857	1,160	5795
Market Capitalization (\$ Bn.)	13,810	2,217	2,252	1,072	117	506	524	110
Market Capitalization Ratio (%)	143.8	151.9	49.8	51.9	118.0	287.3	49.3	24.3
Turnover (\$ Mn.)	29,041	1,872	1,826	1,420	63	196	449	249
Turnover Ratio (%)	201.3	78.4	67.9	124.7	46.9	34.8	81.3	191.4

Source: ISM A Review 2002

It can be seen from the table that India is second only to the U.S.A. in terms of the number of listed companies and turn – over ratio. However, in terms of market capitalization and market capitalization ratio, India’s position is not among the top performers. Among emerging markets, India is the leader in the value of equity issues. This is clear from the table 4.12.

TABLE 4.12
VALUE OF NEW EQUITY ISSUES IN SELECTED ASIAN
COUNTRIES [U S \$MILLION]

	1990	1991	1992	1993	1994	1995	1996	Total
China	8,04.5	5,50.6	1,355.1
India	1,796.5	2,849.8	4,267.8	7,421.4	12,242.3	10,516.3	3,691.5	42785.6
Indonesia	...	1,78.2	7,34.8	3,509.8	11,225.5	9,284.8	1,584.7	26547.8
Korea	4,039.5	3,648.3	2,269.5	3,512.3	6,805.7	7,323.3	4,285.4	31,884.0
Malaysia	3,488.5	1,896.2	2,378.8	2,738.9	2,684.0	4,572.7	4,824.8	22,583.9
Philippines	3,39.4	3,81.1	1,24.5	4,13.7	1,387.7	1,493.3	1,198.0	5,337.7
Taiwan	7,444.6	1,688.0	1,044.6	2,526.9	3,676.9	3,878.0	3,983.1	24,244.2
Thailand	1,748.2	2,536.3	2,157.7	1,160.8	3,157.0	3,167.0	3,604.6	17,531.6

Source: International Capital Markets: Developments Prospects And Key-Policy Issues; IMF, Washington D. C. November 1997

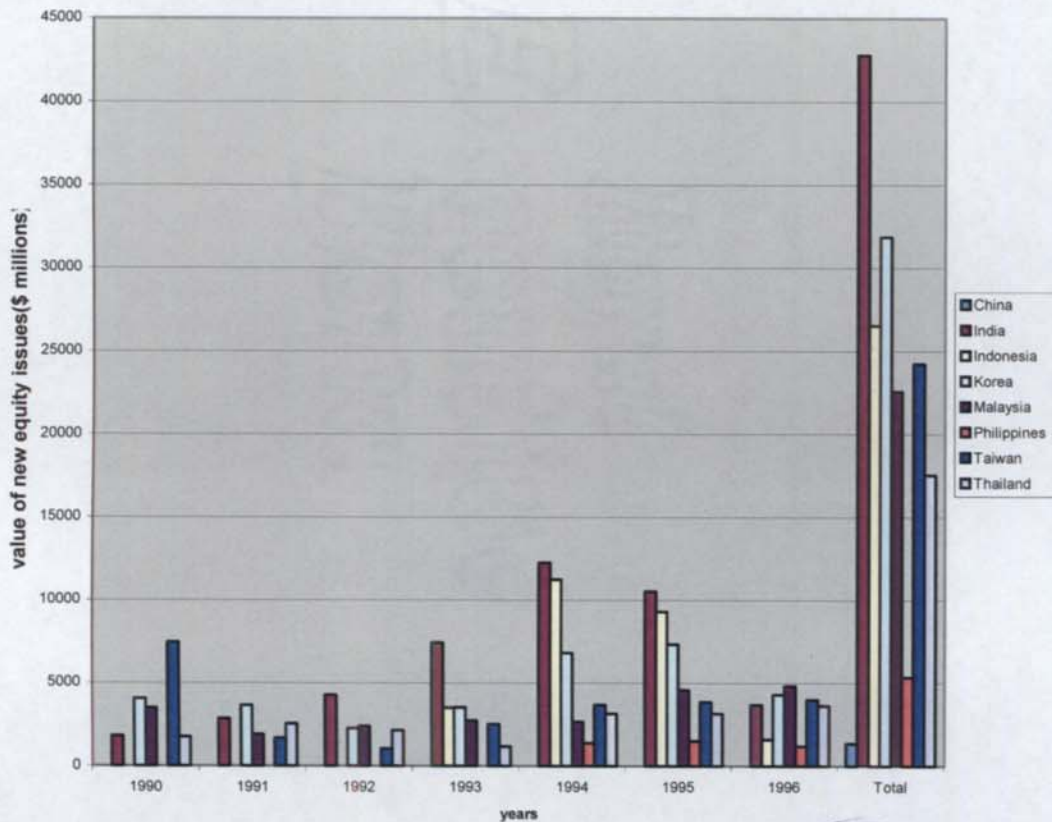
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FIGURE 4.4

VALUE OF NEW EQUITY ISSUES IN SELECT ASIAN COUNTRIES



The nineties saw tremendous growth in stock markets worldwide. It is a fact that markets in the developed world has grown faster than those in developing countries. It is amazing to note that the U.S alone accounted for 70 percent of worldwide turnover in 2001. Though the markets in India witnessed good growth in the nineties, its performance relating to market capitalization and turnover has not been impressive relative to other countries. This is evident from table 4.13

TABLE 4.13

**MARKET CAPITALIZATION AND TURNOVER FOR MAJOR
MARKETS [US \$ MILLION]**

Country/Region	Market capitalization (end of period)			Turnover		
	1990	2000	2001	1990	2000	2001
Developed Markets	8,795,239	29,614,264	25,246,554	4,616,473	43,912,999	39,676,018
Australia	108,879	372,794	374,269	40,113	226,325	240,667
Japan	2,917,679	3,157,222	2,251,814	1,602,388	2,693,856	1,826,230
UK	848,866	2,576,992	2,217,324	278,740	1,835,278	1,871,894
USA	3,059,434	15,104,037	13,810,429	1,751,252	31,862,485	29,040,739
Emerging Markets	604,420	2,608,486	2,572,064	898,233	3,956,869	2,400,844
China	-	580,991	523,952	-	721,538	448,928
India	38,567	148,064	110,396	21,918	509,812	249,298
Indonesia	8,081	26,834	23,006	3,992	14,311	9,667
Korea	110,594	148,649	220,046	75,949	1,067,669	703,960
Malaysia	48,611	116,935	120,007	10,871	58,500	20,772
Philippines	5,927	51,554	41,523	1,216	8,196	3,148
Taiwan	100,710	247,602	292,621	715,005	983,491	544,808
World Total	9,399,659	32,222,750	27,818,618	5,514,706	47,869,867	42,076,862
US as % of World	32.55	46.87	49.64	31.76	66.56	69.02
India as % of World	0.41	0.46	0.40	0.40	1.06	0.59

Source: S&P Emerging Markets Fact book, 2002.

Even though in international comparisons, the Indian Capital market is deficient in certain parameters, the overall growth of the market in the nineties is indisputable. The nineties witnessed many structural changes in the Indian Market.

4.4 Resource mobilization through the primary market in the nineties:

The decade of explosive growth.

As already mentioned, the Development Financial Institutions (DFIs), insurance companies and the U.T.I. were the major sources of capital for the corporate sector in the early decades after independence. With the nineties, the situation started to change dramatically. The nineties witnessed, as we have already seen, spectacular growth of the capital market, two scams notwithstanding. The sweeping capital market reforms, along with the

liberalized economic environment, created a favorable ambience for capital market growth. Consequently, capital mobilization by non-government public companies through the primary market witnessed a veritable explosion. See table 4.14

TABLE 4.14
RESOURCE MOBILIZATION FROM THE PRIMARY MARKET
[RS CRORES]

Issues	1990-91	1991-92	1992-93	1993-94	1994-95	1995-96	1996-97	1997-98	1998-99	1999-00
Corporate securities	14,219	16,366 (15.1)	23,537 (43.82)	44,498 (89.06)	48,084 (6.98)	36,689 (-23.7)	37,147 (1.25)	42,125 (13.4)	60,192 (35.77)	72,450 (20.36)
Domestic issues	14,219	16,366 (15.1)	23,286 (42.28)	37,044 (59.08)	41,974 (13.30)	36,193 (-9.01)	33,872 (-6.41)	37,783 (11.56)	59,044 (56.27)	68,963 (16.8)
Non-Govt. Public companies	4312	6,193 (43.62)	19,830 (220.2)	19,330 (-2.52)	26,417 (36.66)	16,075 (-39.15)	10,410 (-35.24)	3,138 (-69.86)	5,013 (59.75)	5,153 (.80)
PSU Bonds	5,663	5,710 (.82)	1,062 (-81.4)	5,586 (426)	3,070 (-45.04)	2,292 (-25.34)	3,394 (48.08)	2,982 (-12.14)	-	-
Government Companies	-	-	430	819 (90.47)	888 (8.42)	1,000 (12.61)	650 (-35)	43 (-93.38)	-	-
Banks & FIs			356	3,843 (979.49)	425 (-88.94)	3,465 (715.29)	4,352 (25.6)	1,476 (-66.08)	4,352 (194.85)	2,551 (-41.38)
Private Placement	4,244	4,463 (5.16)	1,635 (-63.36)	7,466 (356.64)	11,174 (49.67)	13,361 (19.57)	15,066 (12.76)	30,099 (99.78)	49,679 (65.05)	61,259 (23.30)
Euro Issues	-	-	702	7,898 (1025.07)	6,743 (-14.62)	1,287 (-80.91)	5,594 (334.65)	4,009 (-28.33)	1,148 (-71.36)	3,487 (203.75)

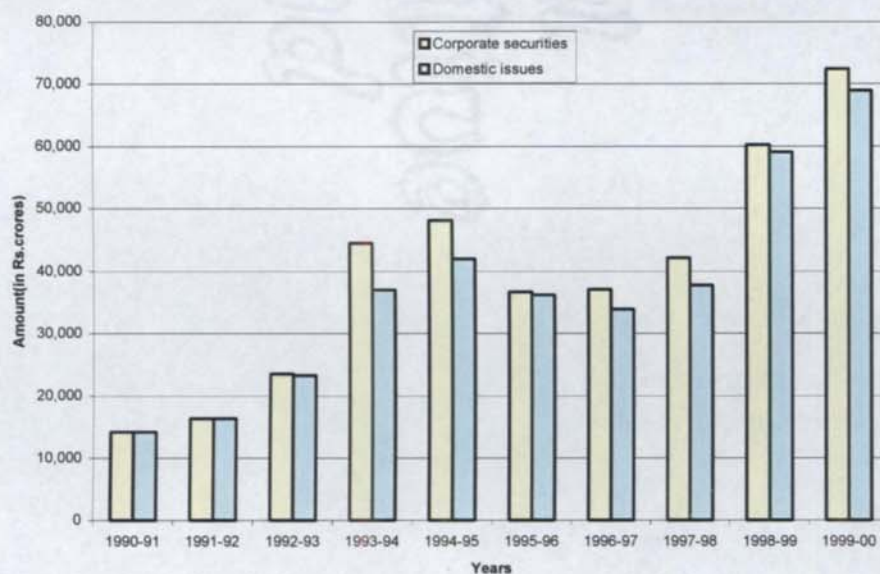
Source: Indian Securities Market, A Review, NSE , 2002

It can be seen from the table that capital mobilization through the primary market by non-government public companies rose from Rs.4312 crores in 1990-91 to Rs.26417 crores in 1994-95. The massive volatility in stock price movements during the nineties caused spectacular ebbs and flows in the public issue market also. This led to certain structural changes in the primary market. The public issue market slowed down substantially, but the private placement market leap frogged. The public issues by non-government companies declined from a peak of Rs.26417 crores in 1994-95 to Rs.5153 crores in

1999-2000. But, as can be seen from the table, resource mobilization through the private placement route, shot up from Rs.11174 crores in 1994-95 to Rs.61259 crores in 1999-2000. These structural changes apart, the primary market as a whole witnessed substantial growth in the nineties, with the total resource mobilization through domestic issues rising from Rs.14219 crores in 1990-91 to Rs.68963 crores in 1999-2000, a growth of 385 percent. Figure 4.5 brings this out, vividly.

FIGURE 4.5

RESOURCE MOBILIZATION THROUGH THE PRIMARY MARKET



4.5 Increasing preference of the corporate sector for the primary market.

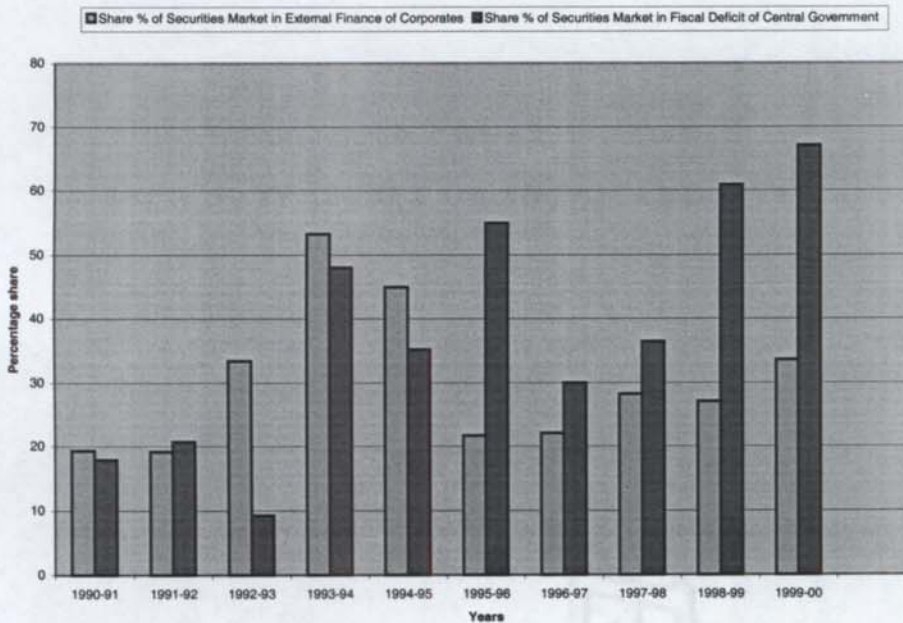
The nineties also witnessed an increasing dependence of the corporate sector on the primary market, for resources. A marked preference for direct financing through equity and debt emerged in lieu of indirect financing through bank intermediated debt. This is clear from table 4.15

TABLE 4.15
DEPENDENCE ON SECURITIES MARKETS

Years	Share % of Securities Market in	
	External Finance of Corporate	Fiscal Deficit of Central Government
1990-91	19.35	17.9
1991-92	19.17	20.7
1992-93	33.38	9.2
1993-94	53.23	48.0
1994-95	44.99	35.2
1995-96	21.67	54.9
1996-97	22.12	30.0
1997-98	28.16	36.5
1998-99	27.05	60.9
1999-00	33.58	67.1

Source: Indian Securities Market, A Review, NSE 2002.

FIGURE 4.6
INCREASING DEPENDENCE ON THE SECURITIES MARKET



As can be seen from the table and the figure, the corporate sector's dependence on, and preference for the securities market, increased in the nineties. The share of the securities market in external corporate finance increased from 19.35% in 1990-91 to 31.39% in 2000-01. However, the peak level of 53.28% share reached in 1993-94 could not be sustained. Nevertheless, for the decade as a whole, there was a big increase in the share of the primary market in external corporate finance.

Conclusion

The Study reveals tremendous growth of the Indian capital market. The nineties witnessed a big leap in the quantity as well as in efficiency of resource mobilization. Particularly, the capital market reforms ushered in as part of the Structural Adjustment Programme of 1991, substantially improved the efficiency of the Indian capital market through drastic reduction in transactions costs. It was found that the efficiency improvement as measured by transactions costs has been relatively better in the stock market than the banking system. The Indian capital market compares well with other emerging markets of the world, judging by the accepted parameters of market development.

Notes and References

¹ R B I Handbook, Op. Cit.,p.95

² Ibid.,pp.87 and 95

³ Ibid.,p.87

⁴ ISM A Review,Op.Cit.,p.16 and RBI Handbook Op.Cit.,p.85

⁵ The bull syndicate which cornered the M.S.Shoes shares and artificially boosted the share price to help the promoter Pawan Sachdewa mobilize funds through a rights convertible issue, could not meet the commitments of the BSE. The bull syndicate collapsed; and the cascading effects of default caused a systemic collapse leading to the closure of the BSE for three days.

⁶ Ross Levine and Sara Zervos (1996): “ Stock Market Development and Long Run Economic Growth”, *World Bank Economic Review*, vol.10, no. 3, pp. 323-39

CHAPTER 5
KERALA'S INDUSTRIALIZATION
THROUGH
THE PRIMARY CAPITAL MARKET ROUTE

5.1. HISTORY OF KERALA'S INDUSTRIALIZATION: A BRIEF NOTE

5.2. INDUSTRIAL DEVELOPMENT AFTER 1956

5.3. KERALA'S SDP GROWTH IN THE EIGHTIES AND NINETIES

5.4. INDUSTRIALIZATION IN THE NINETIES

5.5. SECTORAL COMPOSITION OF KERALA'S NSDP

5.6. RELATIVE PERFORMANCE OF INDUSTRIAL SUB-SECTORS

5.7. KERALA'S INDUSTRIALIZATION THROUGH THE PRIMARY
CAPITAL MARKET ROUTE

5.8. FINDINGS

CHAPTER 5
KERALA'S INDUSTRIALIZATION
THROUGH
THE PRIMARY CAPITAL MARKET ROUTE

This chapter examines Kerala's industrialization through the capital market route. It begins with a peep into the historical roots of Kerala's industrialization; then makes a *tour-de-force* of the trends in Kerala's industrialization after independence and finally focuses on Kerala's industrialization through the capital market route.

5.1 History of Kerala's industrialization – a brief note

An economy's industrial structure and its level of development are shaped and determined primarily by historical forces, its resource endowments and policy initiatives. Viewed from this perspective, Kerala was not unfavorably placed in terms of industrial development, vis-à-vis other states, at the time of its formation in 1956.

The state of Kerala was formed, consequent to the linguistic reorganization of States of the Indian Union in 1956, bringing together the erstwhile Princely States of Travancore and Cochin and British Malabar. Even on the eve of the birth of the State, there were glaring inequalities in the level of its industrial development, Travancore being highly industrialized and Malabar, very backward. It would be worthwhile to briefly examine the historical roots of this industrial advancement (Travancore) and backwardness (Malabar).

The process of integration of the Travancore economy with the global economy began around the mid 19th century. Colonial rule paved way for

foreign private investment in plantations like tea and coffee and agro processing industries, particularly coir mat weaving. British and Scottish trading firms accounted for major part of these investments. Thus, early investment in plantations and agro processing industries were made by mercantile capital and not industrial capital proper. The plantation sector dominated the economy for a long period. This is clear from the data relating to composition of exports, capital invested and workforce. In 1870-71, 80.4 percent of Travancore's exports came from coconuts and its products, plantation crops like tea, coffee and rubber and other hill produce. Seventy-five years later, in 1945, the share of these products in exports was more or less the same; in fact it marginally increased to 85.5 percent (Pillai and Santha 1997)¹. Similarly, the plantation sector accounted for 56.2 percent of the total capital invested in 1940-41. Also, the plantation sector and agro-processing industries accounted for over 84 percent of the total workforce in organized industry (Ibid). Within this segment, cashew nut processing industry became a major provider of jobs. By 1947, Cashew workers accounted for about 60 percent of the factory workforce in the state (Ram Mohan 1988)².

The nature and composition of Travancore's industrialization began to change from 1930s onwards. The industrial policy of the Travancore Government in the thirties gave importance to modern large capital-intensive industries using modern technology. Major players in this new industrialization drive were the immigrant capital and the Travancore State. Local capital hardly played a role. Western and South Indian capital made huge investments in industries like cotton spinning, textile weaving, rubber processing, chemicals, rayon, cement, aluminum, glass making etc. The Travancore Government also made substantial capital investment. By late 1940s, the Government of Travancore had subscribed to Rs.984.57 lakhs worth of shares in 16 large industrial units. Also, it had advanced loan worth Rs.159.64 lakhs. In four units out of these 16, the Travancore Government

held more than 50 percent of share capital (Ibid). The leadership role of the Travancore Government is evident from this.

Ram Mohan (1996)³ identified 3 distinct layers in the industrial evolution of Travancore region. These layers are:

- a) Pre-1914 industries like cashew nut processing and mineral sand mining; built primarily on cheap labour of low caste workers.
- b) Cottage and small industries using local resources; producing primarily for the local market.
- c) Modern industries initiated and sustained by the Travancore government and immigrant capital using modern (imported) technology and skilled workforce.

Massive investment in modern industries during 1930s and 1940s made Travancore one of the most industrially advanced among the princely states of India. In fact, many industries like FACT, Travancore Rayon and Travancore Titanium were the first of their kind in the country. All major companies started during this period like Trivandrum Rubber Works (1936), INDAL (1942), FACT (1943), Travancore Rayons (1945), Travancore Titanium (1946) and Aluminum Industries (1946) had imported technology and foreign collaborations. The industrialization of Travancore during 1930s and 40s was initiated mainly by the progressive industrial policy of the Travancore State conceived by the then Dewan Sir, C.P. Ramaswamy Iyer and facilitated by the availability of plenty of water, power, land and most importantly, cheap labour. Malabar under British rule did not have most of these advantages. It is a fact that the labour policy practiced in Malabar was more progressive than that of Travancore. For instance, while the Workmen's Compensation Act, Trade Unions Act and Payment of Wages Act were implemented in British India in 1923, 1926 and 1936 respectively; these laws were implemented in Travancore only in 1939, 1938 and 1941 respectively.

Thus, while the availability of cheap labour in Travancore led to exploitation of labour, one has to concede the fact that it also facilitated the industrialization of the State (Similar conditions prevailed in England in the early years of the Industrial Revolution). The pro-labour legislation in British Malabar did not improve the conditions of labour on the ground since no worthwhile industrial investment happened there.

5.2 Industrial Development after 1956

In independent India, ambitious programmes for industrialization began with the Second Five-year Plan. However, in Kerala, serious attempts at industrialization under State leadership began only with the Third Plan. The First Plan (before the formation of the State) focused mainly on traditional industries and formation of co-operatives for industries like coir. The Second Plan also did not make much headway, other than effecting expansion of some existing units and extending the co-operative sector further, in coir and Handloom industries. Plan expenditure for industrial development during the First and Second Five year Plans accounted for only 6.7 percent of total plan expenditure (Pillai 1994)⁴. During the Third Plan and the Three Annual Plans (1966-69), the percentage of plan expenditure on industrial development rose to 7.9 percent and 9.2 percent respectively. Increasing focus on industrial development, during this period, is evident from this. During the sixties, the setting up of the Kerala State Industrial Development Corporation (KSIDC), initiation of the Industrial Estate programme and expansion of many existing large and medium industries gave a boost to the industrial sector.

The real big push to industrialization of the State came in the seventies with big investment in modern industries and stabilization of traditional industries. Expenditure on industrial development as a percentage of plan expenditure rose to 11 percent during the Fourth Plan (1974-78) and 15 percent during the two Annual Plans of 1978-80. Consequently, the index of

industrial production rose smartly from 100 in 1970-71 to 187.10 in 1980-81. In the eighties, the pace of industrial development slowed down. Decline in the Central investment, and the inability of the State government to allocate increasing amounts for industrial development due to fiscal constraints, were responsible for this. More importantly, the performance of State Public Sector Enterprises, which consistently performed poorly and increasingly accumulated losses, created a situation in which industrial development financed from surpluses generated by existing enterprises, became impossible. During this period, there was no marked improvement in private sector investment, as the state failed to attract private entrepreneurs. The eighties was the decade of industrial stagnation.

The nineties witnessed a paradigm shift in India's economic policy: the new philosophy of liberalization and privatization, set in the context of the phenomenon of globalization, radically altered the industrial policy, which, India has been following since 1956. The fiscal crisis of the Central and State governments, the unsatisfactory performance of the PSUs, the collapse of the Soviet Union and the consequent setback to communism created the right environment for abandonment of the policy of State-led industrialization. In tune with the wave of privatization sweeping across the world, India also started liberalizing its economy with de-licensing, decontrol, deregulation and de-reservation on the one hand and encouraging private investment- both domestic and foreign- on the other. Not only did the government slow down its fresh investment but also initiated a programme of disinvestment. In fact, the declining trend in government (Central) investment had started much earlier. This is revealed by the following data on Central sector investment in Kerala shown in table 5.1.

TABLE 5.1
CENRAL SECTOR INVESTMENT IN KERALA

Year (1)	Central Sector Investment in Kerala (Rs.crores)		
	Investment in Gross Block		(4) % of column3 to column2
	(2) All India	(3) Kerala	
1970	3795	116	3.06
1980	18161	423	2.33
1990	113430	1701	1.5
2000	381365	6828	1.79

Source. Economic Review 2003

The declining trend in the share of the Central investment in Kerala is evident. In percentage terms it more than halved from 3.06 percent in 1970 to 1.5 percent in 1990 and then marginally rose to 1.79 percent in 2000. The decline in central investment in the eighties along with the fiscal constraints experienced by the State had an adverse impact on Kerala's industrialization during this period. On the other hand, the impetus for industrialization of Karnataka and Andhra Pradesh, particularly of the cities of Bangalore and Hyderabad, came from central investment (Jairam Ramesh 2002).⁵

Major patterns and growth trends in Kerala's industrialization during the four decades from 1960 to 2000, are reflected in the trends in the growth of factories and average daily employment. This is shown in table 5.2

TABLE 5.2
GROWTH OF WORKING FACTORIES AND AVERAGE DAILY
EMPLOYMENT IN KERALA

Year	No. of Factories	No. of Employment (in 1000s)
1960	2400	167
1970	3040 (26.67)	20.5 (22.75)
1980	9106 (199.53)	300 (46.34)
1990	12448 (36.70)	356 (18.66)
2000	18544 (48.97)	439 (23.31)

Source: Economic Review – various issues

Figures in parenthesis show percentage growth

It is clear from table 5.2 that the fast pace of industrialization and employment generation achieved in the seventies could not be sustained in the eighties. It can be seen from the table that, while the growth in factories and employment in the seventies were 199.53 percent and 46.34 percent respectively, the same drastically declined to 36.7 percent and 18.66 percent respectively in the eighties. Eighties was the decade of industrial stagnation for Kerala. Researchers have put forward many reasons for the poor industrial performance of Kerala. These reasons have been discussed in detail in the Review of Literature. Coming to the specific issue of industrial stagnation in the eighties, there are a few explanations. One is the drastic decline in State investment caused by the fiscal crisis of the eighties; the other is the severe power crunch, which the State started to experience from early eighties onwards.⁶

5.3 Kerala's SDP growth in the eighties and nineties

The industrial stagnation of the eighties had its inevitable adverse impact on the State's economic growth. The eighties was the decade in which India broke out of its "Hindu growth rate"⁷ of around 3.5 percent achieved during the first three decades since planning and climbed up to a respectable growth rate of 5.6 percent. But Kerala did not participate in this growth, worse, Kerala became the poorest performer in SDP growth among the 14 major states of India. See table 5.3.

TABLE 5.3
SDP GROWTH OF MAJOR STATES

States	1980-1 to 1990-1 % p.a	1991-2 to 1997-8 % p.a
Bihar	4.66	2.69
Rajasthan	6.60	6.54
Uttar Pradesh	4.95	3.58
Orissa	4.29	3.25
Madhya Pradesh	4.56	6.17
Andhra Pradesh	5.65	5.03
Tamil Nadu	5.38	6.22
Kerala	3.57	5.81
Karnataka	5.29	5.29
West Bengal	4.71	6.91
Gujarat	5.08	9.57
Haryana	6.43	5.02
Maharashtra	6.02	8.01
Punjab	5.32	4.71
Combined SDP of 14 states	5.24	5.94
GDP (National Accounts)	5.55	6.89

Source: Montek Singh Ahluwalia (2002), Facets of the Indian Economy

It can be seen from the table that Kerala had the lowest growth rate in SDP among the 14 major states of India during 1980-90. Industrial stagnation of the eighties was a major factor responsible for this poor performance. Ahluwalia draws particular attention to the inter-state variations in the growth rate.⁸

5.4 Industrialization in the nineties

Nineties witnessed improvement in industrialization and employment generation. Economic stagnation of the seventies had been overcome and growth accelerated in the nineties. In fact, the nineties witnessed, the economic growth rate in Kerala exceeding the national average. This is clear from the table 5.4

TABLE 5.4
ANNUAL GROWTH RATES OF GDP & SDP

Period	Kerala	All India
1971-72 to 1980-81	3.43	3.44
1981-82 to 1990-91	4.83	5.36
1991-92 to 1997-98	6.05	5.64
1990-91 to 1999-2000	5.99	5.8

Sources: K.K Subramaniam & Abdul Azeez (2001), Kerala's Current Industrial Scene and Economic Review 2003

As a result of this high growth rate achieved in the nineties, Kerala's per capita S.D.P. overtook the national average, for the first time in 2001-02 (the per capita income at constant prices rose to Rs.10832 against the national per capita income of Rs.10754).⁹

However, it is important to note that the industrial sector has been growing at a rate lower than other sectors. Much of the growth in SDP is accounted for by the growth of the services sector. This is evident from table 5.5

TABLE 5.5

ANNUAL GROWTH RATE IN NSDP BY ECONOMIC ACTIVITY

Period	Kerala			All India		
	Agriculture	Industry	Services	Agriculture	Industry	Services
1981-82 to 1990-91	3.67	4.55	4.35	3.21	6.71	6.38
1991-92 to 1996-97	5.86	5.04	7.91	3.17	6.85	6.47

Source: K.K.Subramanian and Abdul Azeez (2001), Kerala's Current Industrial Scene.

It is clear from the table that, even though the growth rate of the industrial sector has improved in the nineties, it is still far lower than the national average. The growth rate of the services sector in the nineties has exceeded the national average; this is the reason why the SDP growth picked up in the nineties.

5.5 Sectoral Composition of Kerala's SDP

Even though the growth of the industrial sector has picked up in the nineties, the share of the industrial sector has not improved during the last twenty-five years. In fact, the share of the secondary sector has marginally declined. This is evident from the sectoral composition of the NSDP over this period shown in Table 5.6

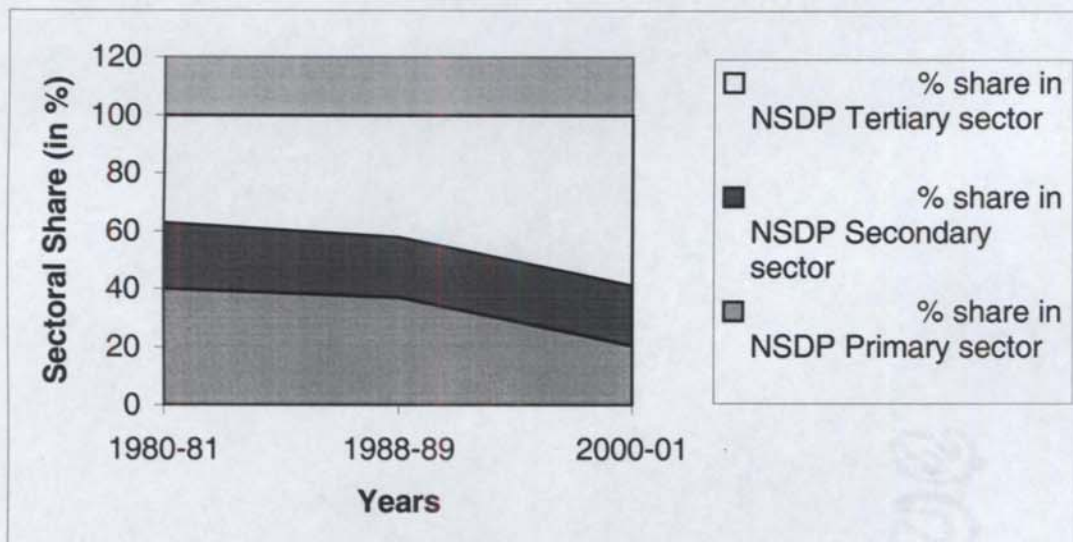
TABLE 5.6
SECTORAL COMPOSITION OF KERALA'S NSDP OVER THE
PERIOD 1980 TO 2001

Period	% share in NSDP		
	Primary sector	Secondary sector	Tertiary sector
1980-81	40	23	37
1988-89	37	21	42
2000-01	20.4	20.9	58.7

Sources: CMIE. Economic Intelligence Services, Profile of States (1997) and Economic Review 2002

The diagrammatic illustration of the sectoral composition of the NSDP vividly brings out the shifts in sectoral composition.

FIGURE 5.1.
SECTORAL COMPOSITION OF THE S.D.P.



The twenty-year period from 1980 to 2000 has witnessed drastic shifts in Kerala's sectoral composition of S.D.P. The share of the primary sector in

S.D.P. has almost halved from 40 percent in 1980-81 to 20.4 percent in 2000-01; the share of the secondary sector has almost stagnated during this period though one can discern a marginal fall in its share from 23 percent in 1980-81 to 20.9 percent in 2000-01. The major change, however, is the big increase in the share of the secondary sector from 38 percent in 1980-81 to 58.7 percent in 2000-01.

5.6 Relative performances of Industrial sub-sectors

The pick up in growth rates of industrial production and improvement in the index of industrial production do not reveal the relative performances of industrial sub-sectors. The nineties reveal interesting trends in the growth rates of particular industries. This period witnessed very good growth in industries like machinery and equipments (other than transmission and distribution), non-metallic mineral products, basic chemicals and chemicals products, and food products. The jump in the index of machinery and equipment from 346.96 to 2066.23 is, indeed, a highly positive development. Also, this period witnessed significant deceleration in cotton textiles, wool, silk and man-made fibres, paper and paper products, basic metals and alloys, and wood and wood- products. This is clear from table 5.7

TABLE 5.7**INDEX OF INDUSTRIAL PRODUCTION – 1990-91& 2000-2001**

(Base, 1980-81 =100)

Sl. No.	Item	Weight	Index for	
			1990-91	2000-01
1	2	3	4	5
1	General Index	100.00	190.45	360.20
2	Manufacture of Food Products	8.82	123.67	143.990
3	Manufacture of beverages, tobacco and related products	1.46	72.47	128.195
4	Manufacture of Cotton Textiles	8.02	167.64	135.923
5	Manufacture of wool, silk and man made fiber textiles	1.26	117.53	72.496
6	Manufacture of Textile products	3.26	88.86	17.134
7	Manufacture of wood and wood products	1.35	116.70	43.781
8	Manufacture of paper and paper products	3.16	1275.82	322.89
9	Manufacture of basic chemicals and chemical products (Except Petroleum and Coal)	19.78	165.41	308.943
10	Manufacture of rubber, plastic, petroleum and coal products and processing of unclear fuels	10.06	151.50	193.725
11	Manufacture of non-metallic mineral products	3.42	84.50	175.005
12	Basic Metals and Alloys Industries	3.43	191.28	92.422
13	Manufacture of metal products and parts except machinery and equipment	0.50	272.52	787.536
14	Manufacture of machinery and equipments other than transport equipment	9.46	346.96	2066.235
15	Manufacture of Transport equipment and parts	2.67	43.54	9.019
16	Other manufacturing Industries	1.42	12.31	39.883
17	Electricity generation, transmission and distribution	21.93	117.81	194.694

Sources: Economic Review, 1992 & 2003.

5.7 Kerala's industrialization through the Capital Market route

Economic reforms initiated in the nineties as part of the Structural Adjustment Programme, created a favorable environment for private sector-led industrialization. Capital market reforms (discussed in detail in Chapter 4) led

to a boom in the stock market and simultaneously in the primary market also. The euphoria about potential industrial growth and corporate profitability created a climate of very high expectations. Exploiting these high expectations, many reform-oriented States, succeeded in raising large amount of capital through Initial Public Offerings (IPOs) in the primary market. The decade of the nineties witnessed many Kerala companies tapping the capital market through public issues.

The new issue market was almost irrelevant for Kerala companies before the reforms, for, very few of them tapped the market during the pre-reform period. With the abolition of the office of the Controller of Capital Issues and the introduction of free pricing of issues, large number of entrepreneurs started tapping the capital market. This phenomenon, which started in the early nineties, touched a peak during 1994-96 and declined thereafter. Many Kerala companies also jumped on to this bandwagon of IPOs.

Regarding Kerala's industrialization through the primary capital market route, two important issues are sought to be studied here. They are:

- i. The quantitative dimension of capital mobilization for industrialization, i.e., the amount of capital mobilized through IPOs by Kerala companies as a proportion of the amount mobilized by the whole country.
- ii. The qualitative dimension pertaining to the efficiency with which the capital mobilized was used.

5.7.1 Capital Mobilization through IPOs – the quantitative dimension

Data on capital mobilization through IPOs during 1990-2000, with details of names of companies, year and month of issue and the amount raised are given in table 5.8.

TABLE 5.8
KERALA COMPANIES THAT RAISED CAPITAL THROUGH IPOs

Sl.no	Name of the company	Registered office	Issue-M/Y	Capital mobilized (Rs.lakhs)
1	Amison Foods Ltd.	Kochi	9/1993	506
2	Artech Power Products Ltd.	Ernakulam	8/1994	258.5
3	Bhagheeratha Engineering Ltd.	Ernakulam	10/1992	600
4	BPL Ltd.	Palakkad	3/1994	7479
5	Cochin Minerals & Rutile Ltd	Kochi	1992	180
6	Cochin Ref. Balmer Lawrie Ltd	Kochi	1994	980
7	Concert Capital Ltd.	Kochi	5/1993	300
8	Concert Spices & Exports Ltd.	Cochin	5/1992	261
9	Dhanalakshmi Bank Ltd.	Thrisoor	3/1996	3040
10	Eastern Treads Ltd.	Cochin	10/1995	320
11	Enjayes Natural Flavours Ltd.	Cochin	4/1996	345
12	Euro Marine Products Ltd.	Kochi	1/1995	450
13	Federal Bank Ltd.	Aluva	3/1994	2836
14	Federal Bank Ltd	Aluva	1/1996	1102
“	Geojit Financial Services Ltd.	Cochin	10/1995	110
15	GTN Textiles Ltd.	Alwaye	1993	1620
16	Gujarat Inject (Kerala) Ltd.	Palakkad	2/1992	208.8
17	Hendez Electronics	Palakkad	2/1990	180
18	Innovative Marine Foods	Kochi	1/1993	617
19	Integrated Rubian Export Ltd	Aroor	3/1992	180
20	Joy mat Hotels Ltd.	Kochi	1994	355
21	Kathayee Cotton	Alwaye	1/1996	80
22	Kerala Ayurveda Pharmacy Ltd.	Aluva	2/1995	300
23	Kitex Garments Ltd.	Alwaye	1/1995	280
24	Koluthara Exports Ltd.	Aroor	10/1993	300
25	KSE Ltd	Thrisoor	5/1994	162.2
26	Manappuram Fin. & Leasing Ltd.	Thrisoor	8/1995	133
27	Muthoot Capital Services Ltd.	Kochi	2/1995	162.5
28	Nedungadi Bank	Ernakulam	1/1992	238
29	Patspin India Ltd.	Kochi	9/1993	903
30	Premier Plantations	Kozhikode	1/1992	360
31	Prima Agro Ltd.	Cochin	8/1993	359.6
32	Prima Industries Ltd.	Cochin	5/1995	490
33	Profitcore Pipes	Cochin	5/1995	260
34	Rubfila International Ltd.	Palakkad	1994	1336
35	SDF Industries Ltd.	Palakkad	9/1994	650
36	South Indian Bank Ltd.	Thrisoor	10/1998	5122
37	Southern Ispat Ltd.	Palakkad	1995	315
38	State Bank of Travancore	Ernakulam	1998	6924
39	Teaktex Process. Complex Ltd.	Palakkad	5/1995	705
40	TECIL Chem & Hydro Power	Kottayam	1/1993	174.9
“	TECIL Chem& Hydro Power	Kottayam	5/1995	2400
41	Transmatic Systems Ltd.	Thiruvananthapuram	9/1994	277.5
42	Trend Designs Ltd.	Cochin	11/1993	306.8
43	Uniroyal Marine Exports Ltd.	Kozhikode	8/1993	330
44	V R Woodart Ltd (Vera T Wood)	Mumbai	10/1992	264
45	Vertex Securities Ltd.	Kochi	6/1996	532.9
46	Victory Paper & Boards Ltd.	Kunnamkulam	8/1995	600
47	Vysali Pharmaceuticals Ltd.	Kochi	7/1992	300
48	Western India Cottons Ltd.	Kannur	6/1996	701.40

Source: Official Records of the Cochin Stock Exchange & Issue Prospectus of Companies

Comparison of Kerala's performance in capital mobilization through IPOs, vis-à-vis the rest of the country, reveals very poor performance by Kerala. During the decade of the nineties (1990 to 2000), the total capital mobilization in India, by non-government companies, through IPOs was Rs.115871 crores. The corresponding figure for Kerala (capital mobilization by Kerala companies) was only Rs.468.96 crores. This is a mere 0.40 percent of the total. Considering the fact that Kerala accounts for more than 3 percent of India's population and 4.75 percent of the total deposits mobilized by the economy's banking system (RBI Handbook 2002) this figure is extremely low. This is a poor reflection of, either the deficiency of adequate number of Kerala companies with potential to raise capital, or, the inability of Kerala companies to raise adequate capital.

5.7.2 Capital mobilization through IPOs - the qualitative dimension

Now, let us look at the qualitative dimension. How did the Kerala companies that mobilized capital through public issues perform?

How efficiently was the capital mobilized utilized?

Analysis of the performance of companies was done using the tools of Financial Analysis. Important financial ratios that adequately reflect the performance of companies were calculated from the Annual Reports of Companies. Important financial ratios used in the analysis are:

- Book value
- Operating Profit Margin
- Gross Profit Margin
- Net Profit Margin
- Return on Net Worth

- Earnings Per Share and
- Cash Earnings Per Share

Besides, other indicators like dividend payout, record of bonus issues etc, also have been used in the analysis. The capital structure of the companies indicating promoter's contribution to the equity capital, also, has been calculated since promoters' stake is a crucial indicator.

The comprehensive financial analysis of 44 companies is shown in tables 5.9 to 5.14. The financial analysis is done based on annual reports for the year ending 31-03-2003 and in cases where annual reports for that year were not available, like in the case of companies that had stopped working, analysis was done based on annual reports for the previous year or the latest available year.

TABLE 5.9**KERALA COMPANIES THAT RAISED CAPITAL THROUGH IPOS:****INDUSTRY GROUPING**

Sl.No.	Company name	Registered office	Product
1	Amison Foods Ltd.	Kochi	Squid & Shrimps
2	Artech Power Products Ltd.	Ernakulam	Switch Mode Power
3	Bhagheeratha Engineering Ltd.	Ernakulam	Constuction
4	BPL Ltd.	Palakkad	Electronics
5	Cohin Minerals & Rutile Ltd	Kochi	Minerals
6	Cochin Ref. Balmer Lawrie Ltd.	Kochi	Cable Jelly & Poly Isobutene
7	Concert Capital Ltd.	Kochi	Lease Rentals
8	Concert Spices & Exports Ltd.	Cochin	Oils & Oleoresins
9	Dhanalakshmi Bank Ltd.	Thrisoor	Banking
10	Eastern Treads Ltd.	Kochi	Tread Rubber
11	Enjayes Natural Flavours Ltd.	Kochi	Chilli Oleoresins
12	Euro Marine Products Ltd.	Kochi	Frozen Marine Product
13	Federal Bank Ltd.	Aluva	Banking
14	Geojit Financial Services Ltd.	Kochi	Brokerage & Commission
15	GTN Textiles Ltd.	Alwaye	Cotton Yarn
16	Gujarat Inject (Kerala) Ltd.	Palakkad	Intravenous Solutions
17	Innovative Marine Foods Ltd.	Kochi	Marine Products
18	Integrated Rubian Exports Ltd.	Aroor	Marine Products
19	Joy mat Hotels Ltd.	Kochi	Hotel
20	Kerala Ayurveda Pharmacy Ltd.	Aluva	Ayurvedic Medicines
21	Kitex Garments Ltd.	Alwaye	Readymade Garments
22	Koluthara Exports Ltd.	Aroor	Shrimps
23	KSE Ltd	Thrisoor	Cattle Feed
24	Manappuram Gen. Finance Ltd	Thrisoor	Income From Finance
25	Muthoot Capital Services Ltd.	Kochi	Financial Services
26	Patspin India Ltd.	Kochi	Yarn
27	Prima Agro Ltd.	Kochi	Wheat & Wheat Products
28	Prima Industries Ltd.	Kochi	De-oiled cake
29	Profitcore Pipes	Kochi	PVC Pipes
30	Rubfila International Ltd.	Palakkad	Rubber Thread
31	SDF Industries Ltd.	Palakkad	Indian Made Foreign Liquor
32	South Indian Bank Ltd.	Thrisoor	Banking
33	Southern Ispat Ltd.	Palakkad	MS Ingots
34	State Bank of Travancore	Kochi	Banking
35	Teaktex Processing Ltd.	Palakkad	Processing & Dyeing
36	TECIL Chemicals & Hydro Ltd.	Kottayam	Compounds & Chemicals
37	Transmatic Systems Ltd.	Trivandrum	Electronic Items
38	Trend Designs Ltd.	Kochi	Readymade Garments
39	Uniroyal Marine Exports Ltd.	Kozhikode	Shrimps
40	V R Woodart Ltd.	Mumbai	Rubber Wood
41	Vertex Securities Ltd.	Kochi	Brokerage & Commission
42	Victory Paper & Boards Ltd.	Kunnamkulam	Paper
43	Vysali Pharmaceuticals Ltd.	Kochi	Pharmaceuticals
44	Western India Cottons Ltd.	Kannur	Cloth

Source: Compiled by the Researcher from the Annual Reports of companies

TABLE 5.10**COMPANIES': EQUITY AND PROMOTER STAKE**

Sl.No.	Company name	%Promoter	Year	Months	Equity
1	Amison Foods Ltd.	25.73	0003	12	6.79
2	Artech Power Products Ltd.	0.00	9903	12	3.77
3	Bhagheeratha Engineering Ltd.	53.71	0303	12	7.83
4	BPL Ltd.	61.83	0309	18	27.69
5	Cohin Minerals & Rutile Ltd	52.3	0303	12	7.83
6	Cochin Refineries Balmer Lawrie Ltd.	50.00	0003	12	10
7	Concert Capital Ltd.	5.49	9903	12	4.92
8	Concert Spices & Exports Ltd.	NIL	9903	12	4.43
9	Dhanalakshmi Bank Ltd.	37.01	0303	12	32.06
10	Eastern Treads Ltd.	39.97	0303	12	5.12
11	Enjayes Natural Flavours Ltd.	5.77	0003	12	4.78
12	Euro Marine Products Ltd.	33.31	0203	12	6.6
13	Federal Bank Ltd.	NIL	0303	12	21.72
14	Geojit Financial Services Ltd.	44.18	0303	12	6
15	GTN Textiles Ltd.	60.96	0303	12	10.55
16	Gujarat Inject (Kerala) Ltd.	51.42	0003	12	4.88
17	Innovative Marine Foods Ltd.	34.06	0203	12	18.5
18	Integrated Rubian Exports Ltd.	10.58	0203	12	3.79
19	Joy mat Hotels Ltd.	NIL	0103	12	14.09
20	Kerala Ayurveda Pharmacy Ltd.	36.26	0303	12	6.46
21	Kitex Garments Ltd.	42.40	0303	12	4.75
22	Koluthara Exports Ltd.	7.86	0203	12	5.31
23	KSE Ltd	33.84	0303	12	3.2
24	Manappuram General Finance Ltd	56.97	0303	12	3
25	Muthoot Capital Services Ltd.	75.00	0103	12	6.5
26	Patspin India Ltd.	65.03	0303	12	30.92
27	Prima Agro Ltd.	37.46	0203	12	5.19
28	Prima Industries Ltd.	NIL	0203	12	10.42
29	Profitcore Pipes	30	0403	12	3.71
30	Rubfila International Ltd.	44.85	0303	06	31.68
31	SDF Industries Ltd.	49.70	0303	12	11.69
32	South Indian Bank Ltd.	4.99	0303	12	35.78
33	Southern Ispat Ltd.	28.87	0103	12	4.29
34	State Bank of Travancore	75	0303	12	50
35	Teaktex Processing Complex Ltd.	NIL	0303	12	19.56
36	TECIL Chemicals & Hydro Power Ltd.	6.53	0303	12	16.61
37	Transmatic Systems Ltd.	18.73	0203	12	3.88
38	Trend Designs Ltd.	NIL	0003	12	5.33
39	Uniroyal Marine Exports Ltd.	49.84	0303	12	6.49
40	V R Woodart Ltd.	55.21	0309	12	7.73
41	Vertex Securities Ltd.	70.08	0303	12	5.18
42	Victory Paper & Boards (India) Ltd.	54.09	0303	12	9.06
43	Vysali Pharmaceuticals Ltd.	18.87	0303	18	5.43
44	Western India Cottons Ltd.	73.41	0303	12	4.49

Source: Calculated by the Researcher from the Annual Reports of companies

TABLE 5.11
COMPANIES' PERFORMANCE: OPERATING INCOME AND
PROFIT MARGINS

Sl.No.	Company name	Op.Income	GPM	NPM	OPM
1	Amison Foods Ltd.	1.42	-93.73	-345.1	-32.03
2	Artech Power Products Ltd.	3.75	7.65	-22.26	13.67
3	Bhagheeratha Engineering Ltd.	131.49	3.41	0.23	6.27
4	BPL Ltd.	963.67	-7.72	-22.02	-1.07
5	Cohin Minerals & Rutile Ltd	37.83	5.62	0.95	10.73
6	Cochin Refineries Balmer Lawrie Ltd.	0.56	-423.02	-1,284.27	-45.04
7	Concert Capital Ltd.	0.27	-408.68	-500.71	-326.35
8	Concert Spices & Exports Ltd.	0.17	-98.5	-297.2	-49.31
9	Dhanalakshmi Bank Ltd.	252.49	8.94	5.79	9.69
10	Eastern Treads Ltd.	6.7	-7.08	-11.03	-1.51
11	Enjayes Natural Flavours Ltd.	1.48	-15.76	-34.52	0.16
12	Euro Marine Products Ltd.	13.03	3.57	1.01	5.79
13	Federal Bank Ltd.	1,322.16	24.78	7.8	26.24
14	Geojit Financial Services Ltd.	17.14	0.23	1.65	9.25
15	GTN Textiles Ltd.	238.9	11.78	2.94	18.24
16	Gujarat Inject (Kerala) Ltd.	1.3	-37.49	-144.72	-0.99
17	Innovative Marine Foods Ltd.	NIL	NIL	-274.97	NIL
18	Integrated Rubian Exports Ltd.	19.26	-21.45	-36.77	-19.13
19	Joy mat Hotels Ltd.	1.00	46	NIL	54
20	Kerala Ayurveda Pharmacy Ltd.	13.02	-0.54	-10.1	3.96
21	Kitex Garments Ltd.	35.4	10.34	5.89	11.81
22	Koluthara Exports Ltd.	0	-43,425.32	-290.23	-35,699.76
23	KSE Ltd	166.15	2.39	1.02	3.45
24	Manappuram General Finance Ltd	8.93	68.04	12.59	71.97
25	Muthoot Capital Services Ltd.	2.92	60.12	17.96	68.42
26	Patspin India Ltd.	100.18	15.73	8.58	23.08
27	Prima Agro Ltd.	26.97	6.17	0.55	9.75
28	Prima Industries Ltd.	26.56	10.43	-1.88	13.83
29	Profitcore Pipes	2.54	-89.37	-99.06	
30	Rubfila International Ltd.	12.28	1.22	-43.48	11.98
31	SDF Industries Ltd.	1.36	-60.59	-178.47	-52.99
32	South Indian Bank Ltd.	816.08	15.48	8.64	24.42
33	Southern Ispat Ltd.	10.94	-1.44	-1.79	5.64
34	State Bank of Travancore	1868.85		9.11	16
35	Teaktex Processing Complex Ltd.	NIL	NIL	NIL	NIL
36	TECIL Chemicals & Hydro Power Ltd.	-0.04	NIL	NIL	NIL
37	Transmatic Systems Ltd.	5.14	-12.92	-23.43	-8.09
38	Trend Designs Ltd.	2.27	-135.93	-261.01	-124.33
39	Uniroyal Marine Exports Ltd.	28.16	1.87	1.49	4.29
40	V R Woodart Ltd.	10.97	0.92	-2.16	4.93
41	Vertex Securities Ltd.	1.06	-19.77	-8.62	3.79
42	Victory Paper & Boards (India) Ltd.	10.54	3.18	-5.07	8.8
43	Vysali Pharmaceuticals Ltd.	19.01	-0.02	-12.97	2.71
44	Western India Cottons Ltd.	27.87	2.83	-3.96	6.92

Source: Calculated by the Researcher from the Annual Reports of companies

TABLE 5.12
COMPANIES' PERFORMANCE: RONW, EARNINGS PER SHARE,
BOOK VALUE AND DIVIDEND

Sl.No.	Company name	RoNW	EPS	Cash EPS	Book value	Div.
1	Amison Foods Ltd.	NIL	-7.24	-5.96	-12.92	0
2	Artech Power Products Ltd.	NIL	-2.26	-1.66	-2.38	0
3	Bhagheeratha Engineering Ltd.	0.88	0.42	5.24	48.61	0
4	BPL Ltd.	-57.54	-78.19	-55.06	135.87	0
5	Cohin Minerals & Rutile Ltd	1.93	0.46	2.86	24	0
6	Cochin Refineries Balmer Lawrie Ltd.	NIL	-7.28	-4.76	-10.88	0
7	Concert Capital Ltd.	NIL	-1.72	-1.17	-5.67	0
8	Concert Spices & Exports Ltd.	NIL	-1.22	-0.68	0	0
9	Dhanalakshmi Bank Ltd.	12.47	4.63	6.08	37.5	1.5
10	Eastern Treads Ltd.	NIL	-1.35	-0.67	-5.34	0
11	Enjayes Natural Flavours Ltd.	-12.86	-0.99	-0.53	7.72	0
12	Euro Marine Products Ltd.	3.23	0.21	0.74	6.54	0
13	Federal Bank Ltd.	19.83	47.37	56.06	239	4
14	Geojit Financial Services Ltd.	-1.71	-0.22	2.38	13.36	0.5
15	GTN Textiles Ltd.	7.51	6.04	20.21	88.65	2
16	Gujarat Inject (Kerala) Ltd.	NIL	-3.83	-2.77	-14.77	0
17	Innovative Marine Foods Ltd.	NIL	-3.36	-2.6	-25.38	0
18	Integrated Rubian Exports Ltd.	NIL	-18.71	-17.37	-6.11	0
19	Joy mat Hotels Ltd.	NIL	0.17	0.28	9.75	0
20	Kerala Ayurveda Pharmacy Ltd.	-34.53	-2.06	-1.09	5.97	0
21	Kitex Garments Ltd.	42.91	4.42	5.57	10.30	0
22	Koluthara Exports Ltd.		-5.43	-4.9	-27.33	0
23	KSE Ltd	7.89	5.33	10.8	67.53	5
24	Manappuram General Finance Ltd	19	3.76	5	19.77	1
25	Muthoot Capital Services Ltd.	7.02	0.8	1.22	11.52	0
26	Patspin India Ltd.	17.87	2.74	5.12	15.31	0.9
27	Prima Agro Ltd.	1.65	0.28	2.37	17.38	0
28	Prima Industries Ltd.	-6.29	-0.39	0.64	6.26	0
29	Profitcore Pipes		-6.11	-6.78		0
30	Rubfila International Ltd.	-36.15	-1.76	-1.3	4.87	0
31	SDF Industries Ltd.		-4.12	-4.03	-11.56	0
32	South Indian Bank Ltd.	22.53	20.26	22.21	89.7	2.8
33	Southern Ispat Ltd.	-4.84	-0.59	1.72	12.29	0
34	State Bank of Travancore	23.66	342.08	381.84	1445.6	2.5
35	Teaktex Processing Complex Ltd.	NIL	-7.04	-6.04	-28.53	0
36	TECIL Chemicals & Hydro Power Ltd.	NIL	-9.46	-8.7	-19.57	0
37	Transmatic Systems Ltd.	-25.81	-3.2	-2.29	12.39	0
38	Trend Designs Ltd.		-12.12	-9.45	-16.86	0
39	Uniroyal Marine Exports Ltd.	17.54	0.66	1.82	3.81	0
40	V R Woodart Ltd.		-0.3	0.26	-1.39	0
41	Vertex Securities Ltd.	-2.97	-0.21	0.37	7.07	0
42	Victory Paper & Boards (India) Ltd.	-8.78	-0.56	0.12	6.45	0
43	Vysali Pharmaceuticals Ltd.	-750.21	-4.63	-3.62	0.61	0
44	Western India Cottons Ltd.	-24.5	-2.47	0.06	10.08	0

Source: Calculated by the Researcher from the Annual Reports of companies

TABLE 5.13
COMPANIES' PERFORMANCE: STOCK MARKET PRICE AND
BONUS AND RIGHTS RECORD

Sl.No.	Company name	Price	Sh.Price	Dt.	Rights	Bonus
1	Amison Foods Ltd.	1	2/14/01		NIL	NIL
2	Artech Power Products Ltd.	2	6/11/01		NIL	NIL
3	Bhagheeratha Engineering Ltd.	12.18	6/16/04		NIL	NIL
4	BPL Ltd.	25.6	6/16/04		NIL	NIL
5	Cohin Minerals & Rutile Ltd				94-2:3	Nil
6	Cochin Refineries Balmer Lawrie Ltd.	NIL	NIL		NIL	NIL
7	Concert Capital Ltd.	NIL	NIL		NIL	NIL
8	Concert Spices & Exports Ltd.	NIL	NIL		NIL	NIL
9	Dhanalakshmi Bank Ltd.	24.4	6/16/04		01-4:3	NIL
10	Eastern Treads Ltd.	NIL	NIL		NIL	NIL
11	Enjayes Natural Flavours Ltd.	NIL	NIL		NIL	NIL
12	Euro Marine Products Ltd.	NIL	NIL		NIL	NIL
13	Federal Bank Ltd.	320.4	6/16/04		95-1:2	04-2:1
14	Geojit Financial Services Ltd.	63.2	6/16/04		NIL	1:1
15	GTN Textiles Ltd.	38.05	6/16/04		NIL	NIL
16	Gujarat Inject (Kerala) Ltd.	2.99	5/13/04		NIL	NIL
17	Innovative Marine Foods Ltd.	0.81	6/16/04		NIL	NIL
18	Integrated Rubian Exports Ltd.	2.25	1/31/03		NIL	NIL
19	Joy mat Hotels Ltd.	NIL	NIL		NIL	NIL
20	Kerala Ayurveda Pharmacy Ltd.	7.58	6/16/04		NIL	NIL
21	Kitex Garments Ltd.	5	1/5/04		NIL	NIL
22	Koluthara Exports Ltd.	2.25	7/19/00		NIL	NIL
23	KSE Ltd	80.25	6/16/04		NIL	NIL
24	Manappuram General Finance Ltd	12.75	6/15/04		02-1:2	NIL
25	Muthoot Capital Services Ltd.	2.2	1/9/01		NIL	NIL
26	Patspin India Ltd.	14.05	6/16/04		96-1:3	NIL
27	Prima Agro Ltd.	1.8	12/6/01		NIL	NIL
28	Prima Industries Ltd.	0.9	12/28/00		NIL	NIL
29	Profitcore Pipes				NIL	NIL
30	Rubfila International Ltd.	1.47	6/16/04		NIL	NIL
31	SDF Industries Ltd.	2.6	7/11/02		NIL	NIL
32	South Indian Bank Ltd.	52.9	6/16/04		03-1:3	NIL
33	Southern Ispat Ltd.	4.83	6/9/04		NIL	NIL
34	State Bank of Travancore	1550	7/20/04		Nil	Nil
35	Teaktex Processing Complex Ltd.	NIL	NIL		NIL	NIL
36	TECIL Chemicals & Hydro Power Ltd.	1.6	8/23/00		80-1:3	NIL
37	Transmatic Systems Ltd.	5.55	6/15/04		NIL	NIL
38	Trend Designs Ltd.	NIL	NIL		NIL	NIL
39	Uniroyal Marine Exports Ltd.	0.25	2/4/04		NIL	NIL
40	V R Woodart Ltd.	1.25	12/3/02		96-1:10	NIL
41	Vertex Securities Ltd.	7.85	7/11/02		NIL	NIL
42	Victory Paper & Boards (India) Ltd.	3.85	4/2/04		NIL	NIL
43	Vysali Pharmaceuticals Ltd.	2.1	6/14/04		95-1:1	NIL
44	Western India Cottons Ltd.	NIL	NIL		NIL	NIL

Source: Calculated by the Researcher from the Annual Reports of companies

TABLE 5.14
COMPANIES' PERFORMANCE: DIVIDEND AND SHARE PRICE
RANGE

Sl.No.	Company name	Dividend	Year-HiLo	High	Low
1	Amison Foods Ltd.	NIL	2001	1.00	1.00
2	Artech Power Products Ltd.	NIL	2001	2.00	2.00
3	Bhagheeratha Engineering Ltd.	0103-10%	2004	34.80	11.70
4	BPL Ltd.	0103-25%	2004	61.25	25.00
5	Cohin Minerals & Rutile Ltd	0203-15%	2004	20.50	9.50
6	Cochin Refineries Balmer Lawrie Ltd.	NIL	2001	4.30	1.90
7	Concert Capital Ltd.	9503-10%	NIL	NIL	NIL
8	Concert Spices & Exports Ltd.	NIL	NIL	NIL	NIL
9	Dhanalakshmi Bank Ltd.	0203-15%	2004	33.50	21.50
10	Eastern Treads Ltd.	NIL	NIL	NIL	NIL
11	Enjayes Natural Flavours Ltd.	NIL	NIL	NIL	NIL
12	Euro Marine Products Ltd.	9603-8%	NIL	NIL	NIL
13	Federal Bank Ltd.	0203-35%	2004	404.40	215.00
14	Geojit Financial Services Ltd.	0203-5%	2004	93.40	46.05
15	GTN Textiles Ltd.	0203-17.50%	2004	57.30	30.60
16	Gujarat Inject (Kerala) Ltd.	NIL	2004	3.73	2.99
17	Innovative Marine Foods Ltd.	NIL	2004	2.10	0.45
18	Integrated Rubian Exports Ltd.	NIL	2001	1.70	1.35
19	Joy mat Hotels Ltd.	NIL	NIL	NIL	NIL
20	Kerala Ayurveda Pharmacy Ltd.	NIL	2004	15.00	5.80
21	Kitex Garments Ltd.	NIL	2004	5.00	5.00
22	Koluthara Exports Ltd.	NIL	NIL	NIL	NIL
23	KSE Ltd	0203-60%	2004	86.00	65.05
24	Manappuram General Finance Ltd	0203-10%	2004	13.00	7.50
25	Muthoot Capital Services Ltd.	9906-7%	2001	2.20	2.20
26	Patspin India Ltd.	0203-9%	2004	23.20	11.51
27	Prima Agro Ltd.	9503-12%	2001	5.65	0.85
28	Prima Industries Ltd.	NIL	NIL	NIL	NIL
29	Profitcore Pipes	NIL	Nil	Nil	Nil
30	Rubfila International Ltd.	NIL	2004	3.50	1.25
31	SDF Industries Ltd.	NIL	2001	3.00	1.80
32	South Indian Bank Ltd.	0303-25%	2004	96.00	50.45
33	Southern Ispat Ltd.	NIL	2004	20.13	8.02
34	State Bank of Travancore	0403-25%	2004	2094	706
35	Teaktex Processing Complex Ltd.	NIL	NIL	NIL	NIL
36	TECIL Chemicals & Hydro Power Ltd.	9703-2%	NIL	NIL	NIL
37	Transmatic Systems Ltd.	9504-15%	2004	20.70	6.50
38	Trend Designs Ltd.	9503-15%	NIL	NIL	NIL
39	Uniroyal Marine Exports Ltd.	NIL	2004	0.25	0.25
40	V R Woodart Ltd.	NIL	2001	2.75	1.15
41	Vertex Securities Ltd.	NIL	NIL	NIL	NIL
42	Victory Paper & Boards (India) Ltd.	NIL	2004	10.00	2.50
43	Vysali Pharmaceuticals Ltd.	9606-11%	2004	10.50	1.70
44	Western India Cottons Ltd.	9703-12%	NIL	NIL	NIL

Source: Calculated by the Researcher from the Annual Reports of companies

5.8 Findings

During the decade 1990-2000, 48 Kerala companies raised capital through IPOs. Of this, three companies have stopped working (either wound up or in the process of being wound up) and one was merged.

These companies are:

1. Hendez Electronics
2. Kathayee Cotton
3. Premier Plantations
4. Nedungadi Bank (merged with Punjab National Bank)

Analysis of the companies revealed the following facts:

TABLE 5.15
PERFORMANCE SUMMARY

Particulars	Number
Number of companies that raised capital through IPOs:	48
Number of companies closed/merged:	4
Number of companies working (as on 31-3-2000):	44
Of which,	17(38.63%)
Profit making:	
Loss making:	27 (61.36%)
Dividend paying (last 2 years [2001-03]):	9 (20.45%)
Number of companies that issued bonus shares:	2
Companies with a RoNW in excess of 8%:	6
Companies, whose share prices are quoting above issue prices: (as on 1-7-2004)	8
Companies that have wiped out their entire net worth:	14 (31.82%)

Source: Calculated by the Researcher from the financial analysis of companies

Of the 48 companies that raised capital through IPOs, three had closed down and one was merged. Out of the remaining 44, only 17 (38.63 percent) were making profits while 27 (61.36percent) incurred losses. The fact that only 9 companies (one fifth of the total) paid dividend during the last two years reflect unsatisfactory performance by companies and losses to investors. Out of the 48 companies only 8 have their share prices quoting above the issue price. The fact that 14 companies (31.82 percent) have completely wiped out their entire net worth reflects colossal losses to investors.

TABLE 5.16
AGGREGATED FINANCIAL DETAILS

Particulars	Amount (Rs.crores)
Profits of profit making companies (17):	460.03
Losses of loss making companies (27):	302.99
Net profit (all companies):	157.04
Total equity capital (all companies):	459.1
Return on equity (all companies):	34.21%
Profits of banks (4):	436.96
Equity of banks:	100.65
Return on equity of banks:	434.14%
Equity of Financial services companies:	25.6
Profits of Non-banking financial services companies:	0.99
Total Equity of the Financial sector (Banks & NBFSs companies):	126.25
Total Equity excluding the financial sector:	332.85
Total profits of the Financial sector:	437.95
Return on Equity of the Financial Sector:	346.89%
Total profits of all companies excluding the Financial sector:	-280.91
Return on equity, excluding the Financial sector:	-84.4%

Source: Calculated by the Researcher from the financial analysis of companies

Figures in brackets show the number of companies

The analysis revealed dismal performance by Kerala companies. The fact that only 17 companies (38.63 percent of the total) made profit and that 27 companies (61.36 percent of the total) incurred losses indicates very poor performance and incompetent management by entrepreneurs. The fact that 14 companies (32 percent of the total) had completely wiped out their entire net worth reflects colossal losses to investors.

Analysis of the data revealed that the 44 companies studied, made an aggregate net profit of Rs.157.04 crores. This translated into a respectable return on equity of 34.21percent. But further industry-wise analysis of the data revealed a different story: out of the total profits of Rs.460.03 crores made by all companies put together, the banking sector (4 banks) alone accounted for Rs.436.96 crores. When the entire financial sector (banks and non-banking financial services companies) was treated separately, it accounted for net profit

of Rs.437.95 crores, with a return on equity of 336.89 percent. When the profits of the financial sector were excluded, the profits (all companies) turned negative, i.e., it became losses of Rs.280.91crores.This translated into a miserable return on equity of - 84.4 percent. The conclusion is obvious: only banks and financial services did well. Performance of the manufacturing sector was very poor.

The poor record of bonus issues (only two companies issued bonus shares to share holders after their IPOs) and dividend payment (only 9 companies paid dividend during the last two years), indicate the fact that the companies in general do not have an investor-friendly attitude. Regarding the very important attribute of investment, viz., liquidity, the fact that the shares of many Kerala Companies are included in the 'poorly traded Z category' indicates very poor track record.

5.8.1 Industry-wise analysis

For a more detailed and critical study, the 44 companies were subjected to industry –wise analysis. For this, the companies were divided into eleven industry groups, viz.:

1. Banks
2. Non-Banking Financial Services
3. Pharmaceuticals
4. Yarn and Textiles
5. Processed Marine Products
6. Electrical and Electronics
7. Chemicals
8. Rubber-based industries
9. Construction, Engineering, Metals etc
10. Agro-Processing, and
11. Others.

Industry wise analysis of companies revealed interesting facts. These are summarized as follows:

5.8.1.1 Banks

The banks, which were included in this industrial group, were:

- The Federal Bank Ltd.
- The Dhanlakshmi Bank Ltd
- Nedungadi Bank Ltd
- South Indian Bank Ltd, and
- The State Bank of Travancore

All the banks that tapped the capital market were profit-making enterprises. Of the five banks, Nedungadi Bank got involved in the stock market scam of 2000-01; incurred huge liabilities and had to be merged with the Punjab National Bank. All the four other banks, continued to do well, after their IPOs. In fact, banking has been the most profitable segment in the industry groups analyzed in the present study: it made a profit of Rs.436.96 crores and had the best return on equity of 434.14 %. It is the only industry group, in which, all companies had a double digit Return on Net Worth. All the four banks are consistent dividend payers. With the exception of the Dhanalakshmi Bank, the shares of all the other three banks are quoting above their issue prices. Federal bank has a very high investor perception as reflected in its high market price of Rs.250 (January 2004). This bank holds the record for the most liberal bonus share issue ratio (2 for 1 share in 2004) among Kerala companies.

It is important to note that four major private sector banks in India – The Federal Bank, The South Indian Bank, The Dhanalakshmi Bank and The

Catholic Syrian Bank – are from Kerala. The good performance of the banking sector reflects Kerala's long-standing competence in banking and finance.

5.8.1.2 Non-Banking Financial Services

The companies, which were included in this industrial group of Non-banking financial services, were:

- Concert Capital
- Geojit Securities
- Manapuram Leasing, Hire Purchase and General Finance
- Muthoot Capital Services, and
- Vertex Securities

Though the analysis of the banking industry reflected robust performance, its sister industry- financial services - showed mixed results. Of the five companies, Geojit Securities in stock broking and related financial and investment services, and Manappuram in leasing, hire purchase and general finance, had performed well and had reasonably good track records of profitability and dividend payment. In fact, Geojit Securities Ltd is the only company other than the Federal Bank, to issue bonus shares to share holders (Geojit issued bonus shares in the ratio 1:2 in 2002). Manappuram has an uninterrupted dividend record. The other three are poor performers: Concert capital is under liquidation and Muthoot Capital Services and Vertex Securities are incurring losses.

5.8.1.3 Processed Marine Products Exports

There are six companies in this industry grouping. They are:

- Amison Foods Ltd

- Euro Marine Products Ltd
- Innovative Marine Foods Ltd
- Integrated Rubian Exports
- Koluthara Exports Ltd., and
- Uniroyal Marine Exports

Processed marine export is one industry, whose performance has been disastrous. Four out of six companies in this group have completely wiped out their net worth and accumulated huge losses making any revival almost impossible. These six companies had mobilized Rs.23.83 crores through IPOs; but five out of six companies never paid dividend. Uniroyal Marine Exports Ltd and Euro Marine Products Ltd are two better-managed companies in the group; they are still running on small profits. Euro Marine was the only company that paid dividend to share holders, that too, only once (8% in 1997).

Majority of the entrepreneurs who ventured into this industry did not have any track record of successful business management, or proven expertise in the industry. Thus, this industry became the graveyard of businessmen and entrepreneurs who jumped into a high-risk industry without a clear idea or plan of the pros and cons of this extremely risky business. Currently, the shares of three out of six companies are not traded at all; and that of the other three, are quoting far below their issue prices, which indicate colossal losses to investors.

5.8.1.4 Drugs and Pharmaceuticals

This industry group consisted of only three companies. They are:

- Gujarat Inject Kerala Ltd
- Kerala Ayurveda Pharmacy, and

- Vysali Pharma Ltd.

Indian Pharmaceutical industry has made rapid strides during the last two decades and has emerged as the world's 6th largest pharmaceutical industry with a turnover of \$ 6.5 billion and exports of \$2 billion (Shourie 2003)¹⁰. Indian companies like Ranbaxy Laboratories, Cipla, Dr.Reddy's Lab, Nicholas Piramal and Aurobindo Pharma – all five had sales turnover in excess of Rs.1000 crores for the year ending 31-3-2004 – are world class companies with global presence and huge exports. Unfortunately, pharmaceutical companies in Kerala could not even become pale shadows of these successful Indian giants.

The two pharmaceutical companies, which started operations in Kerala, viz., Vysali Pharmaceuticals and Gujarat Inject have completely wiped out their entire net worth. Vysali Pharma, paid its last dividend of 11% in 1996; Gujarat inject never paid dividend. Both company's shares are quoting substantially below their issue prices (Gujarat Inject was quoting around Rs.3 and Vysali around Rs.2 in July 2004). The other company- Kerala Ayurveda pharmacy – which is in the business of ayurvedic drugs - is running with very low profits and is yet to pay dividend. The company's share is quoting below par and liquidity is poor.

5.8.1.5 Yarn and Textiles

Yarn and Textiles industry consisted of six companies, viz.,

- GTN Textiles Ltd.,
- Kitex Garments Ltd
- Patspin India Ltd
- Teak tex Ltd
- Trend designs, and

- Western India Cottons

Like Pharmaceuticals, Indian Textile industry is doing well and is the second largest foreign exchange earner for the country after computer software. For the year ending 31-3-2003, there were 46 listed public limited companies in cotton /blended textile industry in India, with a total turnover of Rs.8972 crores and an average sales turnover of Rs.195 crores (Capital Market 2004)¹¹. Here again, Kerala companies couldn't match the performance of their counterparts in the rest of the country. However, two companies-GTN Textiles Ltd and Patspin India Ltd – of the Patodia group, did well. GTN had a GPM of more than 10%, RoNW of 7.5% and an EPS of 6.04%. GTN's dividend track record is good; it declared 20% in 2003. Its share commands a good price – Rs.40 in July 2004 – and has good liquidity. The other Patodia group company- Patspin India Ltd - had a GPM of 15% and RoNW of 17.87%. But, due to its huge equity capital base of Rs.30.92 crores, it could pay a dividend of only 9 %.

Kitex Garments, in spite of having a GPM of more than 10 % and an EPS of Rs.4 in 2003, did not pay any dividend. The attitude of the management in not rewarding shareholders is reflected in the poor stock market quote for the share at Rs.5 (July 2004). Three other companies in the textiles industry – Kathayee Cotton, Teaktex and Trend Design – are in very bad shape with huge losses and negative net worth. The other company – Western India Cotton – has a better record of profitability; but is yet to pay dividend.

5.8.1.6 Electrical and Electronics

Electrical and Electronics industry group had only 3 companies, viz.,

- Artech Power Products Ltd.

- BPL Ltd, and
- Transmatic Systems Ltd

Companies in this industry group proved to be poor performers. This group had big names like T.P.G Nambiar's BPL, but the performance was dismal. Among the 45 companies studied, BPL Ltd had the second largest operating income - next to Federal Bank - of Rs.964 crores in 2003. Even though the company still has a book value of around 136, it is undergoing difficult times with negative profit margins and no dividend. The share was quoting around Rs.26 in June 2004.

The other two companies in the group –Artech (Switch mode power supplies) and Transmatic (dot-matrix printers) – in spite of having American collaboration, have fallen into difficult times and have become loss-making companies. Regarding share price and liquidity, both companies have poor record. Artech was last quoted at Rs 2 on 11-6-2004 and transmatic was quoted at Rs5.55 on 15-6-2004. One company that raised capital through IPO in early 1990s was Hendez Electronics. Hendez, which started production of Televisions in early nineties, became one among the several companies which closed down, failing to survive the heat of intense competition that is the hallmark of this oligopolistic industry.

5.8.1.7 Chemicals, Oils and Oleoresins

The chemicals, oils, oleoresins and allied products industry had the following five companies

- Cochin Minerals and Chemicals
- Cochin Refineries Balmer Lawrie Ltd
- Concert Spices and Exports Ltd
- Enjajes Natural Flavours Ltd, and

- TECIL Chemicals & Hydro Power Ltd.

This is another industry group, which presented poor performance. All the five companies in this industry are loss making and had huge accumulated losses. 3 out of 5 companies had completely wiped out their entire net worth. None of the companies have paid dividend during the last five years and shares of all companies have stopped trading on the stock exchanges.

5.8.1.8 Rubber – based industry

Kerala being the largest producer of rubber in India, rubber-based industries are regarded ideal for the state. But practically, this is not the case. Of course, Kerala has success stories like Apollo Tyres, which is one of India's largest producer and exporter of automobile tyres. But, the rubber-based companies, which opted for the capital market route during 1990-2000, performed poorly. This industry group had the following three companies.

- Eastern Treads Ltd
- Rubfila International Ltd, and
- Veera Treatwood Ltd (later V.R. Woodart Ltd)

All the three companies are running on loss and none of the companies has paid any dividend thus far. The shares of these companies have very poor liquidity. Only Rubfila International is occasionally traded on the stock exchanges, that too at a substantial discount to the issue price; the highest quotation in 2004 (till August) being Rs.3.50.

5.8.1.9 Construction, Engineering, Metals

The industry group 'construction, engineering and metals' had only three companies, viz.,

- Bhageeratha Engineering Ltd
- Southern Ispat Ltd, and
- Profitcore Pipes

Bhageeratha Engineering Ltd is one among the few public limited companies in Kerala with a reasonable record of consistent profitability and dividend payment. This company had a book value of 48.61 in 2003; of late, its profitability has been on the decline. This is reflected in its low RoNW and EPS, which have fallen to less than one in 2003. In spite of this, the stock of the company is liquid; it is quoted almost daily on the stock exchanges. The high and low for the stock in 2004 (till August) were Rs.38.40 and 11.70 respectively. The other two companies in this industry group - Southern Ispat and Profitcore Pipes – are poor performers. Both are loss-making companies with no dividend record.

5.8.1.10 Agro-Processing

Agro-processing industry group had three companies. They are:

- Kerala Solvent Extraction Ltd
- Prima Agro Ltd and
- Prima Industries Ltd

The Study revealed mixed performance by the agro-processing industry. This industry had one of the best performing public limited companies in Kerala: the Kerala Solvent Extraction Ltd. This company had an unbroken dividend record during the last 10 years and pays very high dividend by Kerala standards: it paid 60% for the year 2002-03. KSE also had a very high book

value of 67.53. The other two companies in the industry showed poor performance. Both Prima Agro Ltd and Prima Industries Ltd are loss-making companies with the latter having no stock quotation since December 2000. The RoNW for Prima Agro was 1.65 and for Prima Industries was -6.29.

5.8.1.11 Others

In the list of companies studied, there were 3 that did not fit into any of the 10 industry groups identified. Therefore, these 3 companies – Joymat Hotels Ltd, SDF Industries, and Victory Paper & Boards – were grouped into the category ‘others’. These three companies belonged to the industry groups of star hotels, liquor and paper respectively. All the three companies are running on loss and have no dividend record. SDF has completely wiped out its net worth.

5.8.2 Some important general findings and observations

Findings from the detailed analysis of the quantitative and qualitative dimensions of Kerala’s industrialization through the capital market route were presented in the preceding sections. Based on these findings, the following observations are made:

5.8.2.1 Poor performance in capital mobilization

The Study revealed very poor performance of Kerala companies in capital mobilization. Total capital mobilized by the Kerala companies was only Rs.468.96 crores. This accounted for a mere 0.4% of the total capital mobilized by India’s corporate sector, which stood at Rs.115871 crores. Considering the fact that Kerala accounts for around 3% of India’s population and 4.75% of India’s bank deposits, this is dismal performance, indeed!

5.8.2.2 Wide disparities in financial performance among different industry groups

The Study revealed wide disparities in financial performance between various industry groups; one industry (banking) performed excellently, a few put in reasonable performance, some showed mediocre performance and others performed disastrously. This is evident from table 5.17, which shows the profitability of companies as reflected by their G.P.M.

TABLE 5.17
PROFITABILITY OF VARIOUS INDUSTRY GROUPS

Sl.No.	Industry Group	G.P.M (in %)
1	Banking	25.03
2	Non-Banking Financial Services	15.57
3	Pharmaceuticals	-10.83
4	Yarn and Textiles	8.56
5	Processed Marine Products	-22.03
6	Electrical and Electronics	- 4.33
7	Chemicals	-43.74
8	Rubber based industries	-1.6
9	Construction, Engineering, Metals etc	5.13
10	Agro-Processing	3.13
11	Others.	-30.69

Source: Calculated by the Researcher from Annual Reports of companies

It can be seen that only 5 industry groups had positive G.P.M, while 6 had negative G.P.M. Banking and N.B.F.Ss industry groupings had high G.P.M (25.03 and 15.57 respectively), followed by Yarn and Textiles (8.56) Engineering & Construction (5.13) and Agro-Processing (3.13).

5.8.2.3 Strength of the Banking and Financial Services Sector

An important finding emerging from the Study is the strength of the banking sector in particular and the financial sector in general. All banks that tapped the capital market route were profit-making, dividend paying companies. In financial services like stock broking, hire purchase and leasing etc, also, Kerala had some good companies doing reasonably well. The financial sector including banks and non-banking financial services reported an excellent

Return on Equity of 346.89 percent. This is the only industry group, whose performance is comparable to that of their counter parts, at the all India level. Thus, it can be concluded that banking and financial services are areas of core competencies for the Kerala economy.

5.8.2.4 Poor performance in manufacturing

Poor performance in manufacturing, revealed by the study, came as a stark contrast to the good performance in services (financial). With the exception of Kerala Solvent Extraction in agro-processing and GTN and Patspin in textiles, all other companies in manufacturing performed poorly; their balance sheets awash in red. The return on equity for the manufacturing sector, at – 84.4 percent, reflects disastrous capital management.

5.8.2.5 Small scale of operations

A very significant finding of the study is regarding the size of operations of the Kerala companies. It is well known that Kerala's 'medium' and 'large' companies are below optimum in size: their sales turnover/operating income being much lower than their counterparts in the rest of the country. Table 5.18 gives an indication of the relative small size of Kerala's private sector companies.

**TABLE 5.18
RELATIVE SIZE OF COMPANIES: INDIA AND KERALA**

	Companies with Market Capitalization of >Rs.1000 crores	Companies with sales of >Rs 1000 crores	Companies with sales of >Rs.500 crores
India	106	85	197
Kerala	Nil	1	1

Sources: Capital Market, March 2004 and Economic Times 28-08-2004

The popular conception about the relatively puny size of Kerala companies has been corroborated by the study. The study revealed that the Kerala companies are much smaller than their counterparts in India. Because of this reason, they are not in a position to reap the economies of scale associated with large companies. To take one instance: in the Indian Bulk Drugs and Pharmaceutical industry, there were 28 public limited companies in the private sector, with an annual average sales turnover of Rs.518 crores, for the year ended 31-03-2003 (Capital Market 2004)¹². There were 4 companies with a turnover exceeding Rs.1000 crores. In sharp contrast to this, the biggest Kerala company in this industry -Vysali Pharmaceuticals Ltd - had a turnover of only Rs.19 crores.

In the modern liberalized competitive business environment, where profit margins are coming down, sustainable profitability requires large scale of operations yielding economies of scale. Kerala companies come out poorly in this regard. Study of the 44 companies revealed that only 5 manufacturing companies had an operating income above Rs.100 crores. It is revealing to note that all these 5 companies- Bhageeratha Engineering, BPL, GTN, KSE and Patspin- are doing well. Smaller companies are finding it difficult to make profits in the competitive environment, proving the dictum, “When the going gets tough, the tough get going”, true.

5.8.2.6 Poor stock market perception of companies

An essential condition for resource mobilization through the capital market is that the companies should have a good stock market perception. There are many companies, which have tremendous stock market fancy and are much sought after by investors. These companies which are loosely referred to as ‘blue chips’ have market valuations much higher than their counter-parts in the industry. These higher valuations are reflected in P.E.Ratios, higher than the industry averages. Examples are: Infosys (P.E.Ratio, 36.4) and Wipro (P.E.Ratio, 40.5) in computer software industry, which has an industry P.E.Ratio of only 30.5; and Cipla (P.E.Ratio of 30.6) in

Pharmaceutical industry, which has a P.E.Ratio of only 23.2 (Ibid)¹³. Apart from high P.E.Ratios and very high valuations, blue chips are characterized by high levels of liquidity and selection by mutual funds for their portfolio. None of the Kerala companies analyzed in the present Study qualify as blue chips. Two companies that have reasonably high levels of market fancy are Federal Bank and K.S.E.Ltd. Of the two, K.S.E has a P.E.Ratio (15), which is double that of the industry. All other Kerala companies have comparatively low P.E.s.

5.8.2.7 “Private-profit, Public-loss syndrome”

The study gave sufficient indications about a phenomenon, which may be described as “private-profit, public-loss syndrome.” There were instances of certain business groups, whose family owned private limited companies are running very profitably, but the public limited companies managed by the very same groups were running on losses. To quote some instances: Eastern Spices (private limited) is a very profitable company, but Eastern Treads (public limited) is loss- making; Muthoot Finance (private limited) is profit-making, but Muthhot Capital Services (public limited) is loss-making; Victory Press (private limited) is profit-making, but Victory Paper & Boards (public limited) is loss making; most private concerns of the Kitex Group are profit making, but Kitex Garments (public limited) has been on loss for long, and in spite of turning profitable recently, has not paid dividend. These are sufficient indications of double standards: careful and efficient management of private concerns in which the promoter has complete stake and inefficient management of concerns in which the promoter stake is lower. Is this a case of milking the public for private gains? or a case of ‘tragedy of the commons’? or a case of taking risks with public funds while being conservative with one’s own capital? This appears to be an area for further research, with potential to yield interesting findings.

5.8.2.8 ‘Incompetent Businessmen’ masquerading as ‘Visionary Entrepreneurs’: The case of ‘sheep in wolves clothing’

Perhaps, the single most important reason for the poor performance of Kerala companies that raised capital through public issues is the lack of entrepreneurs with vision. Corporate history tells us that visionary entrepreneurs build successful companies. Kerala did not have the good fortune of having a large number of visionary entrepreneurs. One reason for the dismal performance of Kerala companies is the phenomenon of incompetent businessmen - some of whom can even be described as ‘fly by night operators’ - who, masquerading as visionary entrepreneurs, took the gullible investors, lured by the transient boom in the primary market, for a ride. The study revealed plenty of instances of businessmen without any track record of proven experience or expertise in a particular industry, venturing into businesses, only to come a cropper. The marine processing industry is a very good example. In this industry, almost the entire Rs.23 crores mobilized through public issues, have been wiped out, by incompetent businessmen, who ventured into a risky business, without a clear idea of its pros and cons, and cost and benefit. These incompetent businessmen who projected themselves (in the issue prospectus) as visionary entrepreneurs, were in fact, sheep in wolves’ clothing.

There were other instances, too, of potentially profitable ventures being messed up by incompetent management. The case of the oleoresins industry is revealing. Of the 2 companies studied in this industry- Concert Spices and Enjoy’s Natural Flavours- the former has become sick and the latter is running at a loss. But, it is interesting to note that the Synthite Group (private limited), manufacturing and exporting oleoresins is one of the most profitable enterprises in Kerala today, adequately proving that oleoresins is a potentially profitable business.

It was also found that many businessmen who had no track record or credentials cleverly used the names of persons with a track record, to woo investors. For instance, Padmasree Paul Pothen, widely regarded as the father of India's fertilizer industry, was on the Board of three companies, viz., Concert Capital, Concert Spices and Trend Designs. The presence of such big names in the Board helps to woo investors during the Public Issue. But the ethics of this business practice is indeed, questionable.

Conclusion

Study of Kerala's industrialization through the capital market initiative, revealed very poor performance, both in terms of quantitative and qualitative parameters. The State succeeded, neither in raising a good amount of capital – commensurate with its size and population – nor in utilizing the resources raised efficiently. The aggregate negative return on equity, terrible performance of the manufacturing sector, widespread erosion of net worth, poor track record of majority of companies in dividend payment, poor stock market perception of most companies, small size of operations, weak and doubtful entrepreneurial talent etc are areas of concern; but, the excellent performance of the financial services sector, particularly, the banking sector, stand out as silver lining among the dark clouds.

* * *

Notes and References

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CHAPTER 6
KERALA'S INDUSTRIALIZATION THROUGH
THE CAPITAL MARKET ROUTE: A SWOT ANALYSIS

- 6.1. STRENGTHS AND WEAKNESSES OF THE KERALA
EXPERIENCE: A BRIEF NOTE
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CHAPTER 6
KERALA'S INDUSTRIALIZATION
THROUGH
THE CAPITAL MARKET ROUTE: A SWOT ANALYSIS

SWOT Analysis is a modern management technique for self-discovery and problem solving. The essence of SWOT analysis is that every institution, be it an individual, business firm, industry or even a society, has its strengths and weaknesses; and at any given point in time, threats and opportunities emerge. An institution that understands its strengths and weaknesses, can strengthen its strengths, weaken its weaknesses and thereby avoid threats and exploit opportunities. It is even possible to convert threats into opportunities. History is replete with examples of institutions that became successful by converting threats into opportunities.

6.1 Strengths and weaknesses of the 'Kerala Experience': A brief note

Kerala's achievements in the social sector and failures on the economic front have been much debated. The 'Kerala experience' of 'social development despite economic stagnation', though a paradox, is a situation brought about by the inter-play of many factors. Kerala stands first in the country in Human Development Index (HDI); this achievement has been made possible, by the rapid strides she made in the field of education and public health. 'Public action' initiated by Christian missionaries, enlightened rulers, social organizations and social reform movements and political activism played a crucial and positive role in this achievement (Dreze and Sen1989)¹. 'Public action', therefore, has been, historically, Kerala's strength. Similarly, the improvement in living standards witnessed in the eighties and nineties, have

been primarily brought about by the massive out-migration of Malayalees to the Middle East and the huge remittances it facilitated. In fact, migration has been an area of strength for Kerala, even before the formation of the State. Actually, out-migration began, though in a small way, during the colonial period, when Keralites migrated to colonies such as Malaysia, Singapore, Burma and Sri Lanka to work as labourers, traders and contractors etc. The 1960s witnessed migration of Keralites to African countries, mainly to work as teachers there. The Seventies witnessed migration to the U.S. and Europe in response to the demand for doctors and nurses. With the Yom Kippur War of 1973 and the consequent oil boom, migration to the Middle East started. This boom is still on, though with slightly reduced intensity. The 90s witnessed migration to the U.S. again; this time the magnet pulling Kerala's human resources has been the software boom. In brief, emigration has always been Kerala's strength. This strength can also be seen as a weakness of Kerala, since, migration has been, to a large extent forced by lack of employment opportunities at home, which, in turn, has been caused by poor investment and industrial stagnation. Public action and social activism has now degenerated into too many unnecessary agitations, adversely affecting the image of Kerala as an investment destination. Nevertheless, it is an indisputable fact that public action contributed substantially to Kerala's social development, particularly in empowering the vulnerable, the voiceless and the marginalized sections of the society.

'Social development in spite of economic stagnation' becomes a paradox when one views it as 'economic stagnation despite social development'. The industrial stagnation in Kerala can be attributed to many reasons, but the fact

remains that Kerala failed in attracting investment. Kerala failed to recognize entrepreneurs as wealth creators and income generators; instead, they were looked down upon as exploiters. This attitude cost the State dear. Even though Travancore was one of the most industrialized princely states of the country at the time of independence, after the formation of Kerala State in 1956, the tempo of industrialization could not be sustained; and Kerala came to be perceived as a poor investment destination. Though Kerala did not succeed in exploiting opportunities, Keralites did. Keralites spread forth all over the world, looking for greener pastures and flourished in them. Annual remittances to Kerala currently stands at a whopping Rs.18000 crores a year. But, it has to be appreciated that keralites could exploit opportunities thrown up by the world because they could built upon the strengths provided to them by investment in education and health.

Against this backdrop, it would be appropriate to do a SWOT Analysis of Kerala from the perspective of industrialization through the capital market route.

6.2 Kerala's Strengths

Without doubt, Kerala has some areas of strengths in resource mobilization for industrialization. These strengths include:

6.2.1 High level of Savings

Industrialization needs capital formation. The source of capital formation is savings. A high level of savings implies big potential for stepping up capital formation, which can give a big push to industrialization. Here, Kerala has a major 'strength'.

Household's account for 83 percent of India's net domestic savings; financial savings constitute 53 percent of the total household saving (RBI Handbook

2000)². Since financial savings constitute the major part of domestic savings, it can be taken as a proxy of savings in the economy. Kerala has a high level of financial savings as reflected in the huge and fast growing deposits of commercial banks. See table 6.1

TABLE 6.1
GROWTH OF BANK DEPOSITS IN KERALA

Year	Domestic Deposits		Year	Domestic Deposits	
	Amount	Annual Growth (%)		Amount	Annual Growth(%)
1991	5554	20.5	1997	13176	9.2
1992	6632	19.4	1998	14817	12.5
1993	7613	14.8	1999	18203	22.9
1994	8926	17.2	2000	19895	9.3
1995	10572	18.4	2001	23419	17.7
1996	12068	14.2	2002	27122	15.8

Source: Economic Review 2003

The big leap in bank deposits experienced in the nineties is evident from the table. During the 10-year period from 1991 to 2000, bank deposits in Kerala grew at an average annual rate of 19.28 percent. This period also witnessed steep fall in the Credit-Deposit Ratio (C.D. Ratio) of banks from 59 percent to 41.28 percent (Economic Review: Various issues)³. The implication of this is that, there are substantial savings in the State waiting to be mobilized for capital formation.

For the year ended March 2000, total deposits in the scheduled commercial banks of Kerala stood at Rs.38619 crores. For India, the corresponding figure was Rs.8,13,345 crores. This means that Kerala accounts for 4.75 percent of

the total deposits in the country (Handbook of Statistics on Indian Economy, 2002 and Economic Review 2002)⁴. Considering the fact that Kerala's population is only 3.1 percent of Indian population, the share of Kerala's savings (as reflected in bank deposits) at 4.75 percent of the national savings, is revealing.

It is true that financial savings through deposits in commercial banks constitute only one segment, though the major segment of savings. In certain regions, Non-Banking Financial Intermediaries (NBFIs) play an important role in financial mobilization. Kerala has her unique NBFIs, prominent of which are the Chitties and Kuris (Miscellaneous Non-Banking Financial Intermediaries). The annual business transactions of these chitties come to around Rs.8000/- crores (Kerala chitties Foremen Association and Kerala State Financial Enterprises 2003)⁵. If these figures are also included in the calculation of financial savings, the share of Kerala's financial savings is likely to increase further. Thus, the high level of financial saving, is a strength of the Kerala economy.

6.2.2 Huge remittances

An important sector of the Indian economy that grew substantially in the 1990s has been her external sector. India succeeded in achieving a current account surplus in 2001 after a gap of 22 years. This was mainly made possible by the surging remittances to India from NRIs. India is the largest recipient of remittances in the world accounting for 15 percent of the total. In India, Kerala leads in remittances accounting for 25 percent of the total.

Burgeoning remittances are getting reflected in the rising NRE deposits of commercial banks. See table 6.2

TABLE 6.2
GROWTH OF NRE DEPOSITS IN KERALA

Year	NRE Deposits		Year	NRE Deposits	
	Amount	Annual Growth (%)		Amount	Annual Growth (%)
1991	2304	14.5	1996	8103	17.7
1992	3039	31.9	1997	10178	25.6
1993	4499	48.0	1998	12735	25.1
1994	6015	33.7	1999	13329	4.7
1995	6886	14.5	2000	18724	40.5

Source: Economic Review 2003

While the decade of the nineties (1991 to 2000) witnessed a 386.7 percent growth in total bank deposits in Kerala, the same period saw a whopping 712.7 percent growth in NRE deposits (Economic Review 2003). The average annual growth in NRE deposits during the period 1990-2000 has been a phenomenal 25.6 percent.

An exhaustive study on migration and its economic consequences came from three economists at the CDS, Thiruvananthapuram (K.G.Zachariah, E.T.Mathew and S.Irudaya Rajan 1998)⁶. According to this study, the annual remittances to Kerala were around Rs. 3530 crores in 1998. The latest study by the same authors (forthcoming) put the amount of remittances at around Rs.18000 crores a year. Regarding the expenditure pattern of remittances, major part went into consumption, construction and education. In the late eighties, a big part of remittances were invested in private finance companies. Soon, these 'blade companies' collapsed. In the first half of the nineties, huge amounts were invested in the real estate business. Declines in the fortunes of

these markets, together with declining interest rates have created a situation where substantial NRE funds are available within the State economy, waiting to be productively mobilized. Whenever opportunities for productive and profitable investments arose, Non-resident Keralites had responded positively. The best example is that of the Cochin International Airport⁷.

In short, the huge flow of remittances from abroad, particularly from NRKs working in the Middle East, has made Kerala, a 'cash surplus' economy. An undesirable consequence of this phenomenon is the transformation of the state into a consumer economy: Kerala has become a huge shopping mall on a 'titanic economy' afloat on gulf remittances. Unless steps are initiated to productively channelise these resources, there is a danger that this 'titanic economy' with a fragile production base, might sink.

Attractive opportunities like the one provided by the oil boom and Middle East migration, do not come often in history. It has been Kerala's good fortune that Keralites could exploit this golden opportunity. It would be realistic to surmise that migration and remittances of the last quarter century, contributed more to addressing Kerala's problem of poverty, than all other programmes of public action, including the much acclaimed land reforms. It is indeed a pity that Kerala failed miserably in channelizing these huge resources provided by migrants into investment, and productive economic activity capable of generating sustainable growth. It is not yet late to exploit this unique strength of Kerala.

6.2.3 High level of awareness of and exposure to financial markets

Kerala has a track record of a high level of financial development. Financial products like chitties and kuries have been in existence in certain parts of Kerala like Trichur for more than a century. Four of the leading private sector banks in the country -The Federal Bank, The Catholic Syrian Bank, The South Indian Bank and The Dhanlakshmi Bank- have their head quarters in Kerala. The Lord Krishna Bank and The Nedungadi Bank, which were merged with the SBI and Punjab National Bank respectively, also had their origins in Kerala. This track record of a long history of financial institutions stood the people of Kerala in good stead, giving them good exposure to financial markets.

With this background of financial development, capital market development happened quickly and spontaneously in Kerala. The Cochin Stock Exchange (CSE) was established in 1978 with 14 stockbrokers⁸. Within the next twelve years it grew at a scorching pace overtaking Ahmedabad, Delhi and Bangalore stock exchanges in terms of number of stockbrokers. The volume of securities traded also grew manifold. By 1990, the CSE became the biggest stock exchange in South India. This facilitated the spread of the 'equity cult' of the late eighties and the early nineties.

The initial doze of liberalization and market oriented reforms of the late eighties led to a stock market boom. Again, the boom of 1991-92, in the background of economic reforms, created a favourable climate for stock market development. The booming stock market also created a booming primary issue market. A series of public issues were launched; and the Kerala middle class, flush with funds, positively responded to these issues. However, the investors who subscribed to these public issues in the nineties were in for

disappointment. Many issues were made by 'fly-by-night' operators who capitalized on the euphoria created by the abolition of the office of the Controller of Capital Issues and the consequent freedom given to issuers to price their issues. This aberration has since been corrected by the SEBI, through the introduction of Disclosure and Investor Protection (DIP) guidelines. Now, only quality IPOs are hitting the market and investor response is positive. When the ONGC IPO opened for public subscription in March 2004, with the largest ever single issue worth Rs.10000crores, the response was enthusiastic: the issue was fully subscribed within ten minutes.

6.2.4 Highly Developed Infrastructure for Capital Market Development

Kerala can boast of having the entire modern infrastructure for capital market development. The existence of a well-developed secondary market that can provide the much-needed liquidity to investors is an essential requirement for capital market development. Now, stock market transactions are done through the depositories. Among the major States of India, Kerala has the highest spread of National Securities Depositories Limited (NSDL) accounts. This is evident from table 6.3. This high level of spread of NSDL accounts indicate a well developed capital market infrastructure.

TABLE 6.3
STATE-WISE BREAK-UP OF THE INVESTOR ACCOUNTS
WITH N.S.D.L

States/UTs	No. of Accounts at 2.5 million plus mark				
	Accounts	Spread**	States/UTs	Accounts	Spread
Andaman&Nicobar Islands	78	29	*****	*****	****
Madhya Pradesh	45937	28	Pondicherry	1485	86*
Andhra Pradesh	119399	42	Punjab	27796	56
Arunachal Pradesh	19	22	Rajasthan	47691	37
Assam	5388	26	Sikkim	219	37
Bihar	29646	35	Tamil Nadu	160971	41
Chandigarh	7626	100*	Tripura	108	14
Daman & Diu	23	100*	Uttar Pradesh	143243	38
Delhi	200806	100*	West Bengal	202962	66
Goa	7893	87*	India	2528044	46
Gujarat	501658	64	Maharashtra	794198	48
Haryana	22386	54	Manipur	75	2
Himachal Pradesh	1531	27	Meghalaya	295	33
Jammu & Kashmir	1227	16	Mizoram	2	5
Karnataka	138513	54	Nagaland	64	3
Kerala	57178	86	Orissa	9627	34

Source: National Stock Exchange, Mumbai

Spread denotes accounts as percentages of total Pincode numbers.

It can be seen from the table that among the States, Kerala has the highest spread of Depository accounts in India. This is a distinct advantage in capital market development and can be gainfully used for the State's industrialization through the capital market initiative.

6.3 Kerala's Weakness

If, despite the formidable strengths that Kerala has, she has not exploited this opportunity, it is obvious that there are some major weaknesses that constrain Kerala's industrialization through the capital market initiative. Let us examine what these possible weaknesses are.

6.3.1 Poor image of an investor unfriendly state

Kerala is one of the least industrialized states in India. Even though there is a consensus that industrial stagnation has to be broken to achieve economic growth and development; scholars disagree on the reasons for industrial stagnation. The reasons cited for poor industrialization include:

- a) highly unionized and militant labour
- b) relatively high wages, particularly for casual and head load workers
- c) frequent hartals/bandhs etc that disrupt production and economic activity
- d) high cost of land
- e) power shortage
- f) deficiency of entrepreneurial talent
- g) Deficient industrial structure with poor capacity to create inter-industry demand and agglomeration economies.

Most of these factors might have contributed in varying degrees to Kerala's industrial backwardness. But one fact is indisputable, viz. Kerala failed to project itself as a good investment destination. In this age of liberalization,

privatization and globalization, states are competing with each other to woo capital- both domestic and foreign. Even though successive governments in Kerala rolled out the red carpet for investment in the reform period, the response from entrepreneurs has been poor. An important reason for this poor response is the negative image of Kerala as a poor investment destination. Studies have shown (Sunil Mani 1996) that many entrepreneurs are shying away from the state due to psychological fear caused by recalcitrant labour. The number of days lost due to strikes and lockouts might have decreased, but the psychological fear remains, due to the track record of labour and unions that has not been favourable to investment.

Surveys conducted (Sunil Mani 1996)⁹ among different strata of entrepreneurs viz., entrepreneurs from outside Kerala who have invested in Kerala, entrepreneurs from Kerala who have invested outside Kerala particularly Tamil Nadu and Karnataka and entrepreneurs from outside Kerala who wanted to invest here but finally chose not to, have shown that there is a consensus among all of them that the militant nature of trade unions and high wages of casual and head load workers were the major constraints inhibiting investment in Kerala. Coming as this does from entrepreneurs, this opinion has to be given due respect and importance.

The survey conducted as part of the present study also indicated a very unfavorable investment climate in the state. The study found the investment climate in Kerala very unfavorable. The Investment Climate Index constructed using Likert Scale indicates a very negative image of Kerala as an investment destination. The Consistency Index constructed using Summated Ratings

yielded a value of 0.64, which is statistically significant. An important finding of the survey was the unanimous opinion of all the respondents that the societal attitude in Kerala towards business, industry and entrepreneurs in general is not positive. Yet another important finding is that majority of entrepreneurs regard the work culture in Kerala unfavorable to industrialization.

Frequent hartals and bandhs have vitiated Kerala's investment environment and brought disrepute to the state as a poor investment destination. When the Kerala High Court banned life-paralyzing 'bandhs', the same emerged in its new avatar as 'hartals'. Too many agitations, even for frivolous causes, have become the order of the day in Kerala today. In 2003 a total of 123 hartals – both statewide and region specific- were organized in Kerala. This is driving out potential investment into the state. NASSCOM (National Association of Software Service companies) has rated Cochin as the second best destination in the country for setting up software service projects. But, unfortunately, investment in these sunrise IT and ITES projects has by passed Kerala: Bangalore, Delhi, Mumbai, Chennai and Hyderabad have emerged as the preferred destinations of investment. This is, despite the fact that it was Kerala, which set up the first software technology development park at Trivandrum – the TECHNOPARK. Most of the ITES like call centers operate on a 24/7 mode: they work 24 hours a day, 7 days a week and 52 weeks a year. These services have zero tolerance for disruption. The Kerala environment, where disruption due to frivolous agitations, bandhs and hartals are too frequent, is not friendly to investment in these emerging areas. According to G. Vijaya Raghavan (2004)¹⁰, the first CEO of Technopark, Kerala stands to

lose tens of thousands of potential jobs in these emerging areas, because of its undesirable environment and poor work culture characterized by hartals, bandhs and work- to -rule.

6.3.2 Poor track record of corporate entities

It is a fact that industrialized states/regions attract more investment. As the saying goes, 'nothing succeeds like success'. Successful companies have attractive share price valuations. This enables them to raise more capital with seasoned offerings (rights issues). Indian corporate history is replete with examples of successful companies raising capital through rights issues for financing ambitious investment projects. The classic case is that of Reliance Industries, promoted by the legendary Dirubhai Ambani, which set up the World's largest greenfield refinery-Reliance Petroleum Ltd - with a capacity of 27 million tones at Hazira in Gujarat, mainly through the capital market initiative. Dirubai Ambani could easily raise resources form the capital market because Reliance Industries had an excellent investor-friendly track record.

Unfortunately, Kerala does not have a corporate sector with many successful and investor-friendly corporates. Listed companies that have rewarded share holders with attractive dividends and bonus issues are very few. This is not the case of other states. For instance, Tamil Nadu has a corporate sector with many companies having excellent track records. This enabled Tamil Nadu companies with excellent track records, to raise huge resources through seasoned offerings. Between 1992 (September) and 1995(November), Tamil Nadu companies made 123 bonus issues and 229 rights issues (Madras stock exchange official year Book 1996)¹¹ while only one Kerala based company-

Kerala Chemicals and Proteins- made bonus issue to investors, during this period.

One reason why Kerala does not have many investor friendly high profile companies is that Kerala's corporate sector itself is very weak. Kerala does not have many large companies with a turnover of, say, more than Rs.1000 crores. The big companies are in the public sector and some large private sector companies promoted by Keralites like MRF and BPL are operating mainly outside Kerala. With the exception of Apollo Tyres, and scheduled commercial banks like the Federal Bank, South Indian Bank and Dhanalakshmi Bank, Kerala cannot boast of any major public limited company in the private sector. Majority of the companies are medium sized outfits without much professional managerial competence, operating in niche markets. Consequently, their financial performance also is far from satisfactory. The present study found that Kerala, does not have a single company with a market capitalization in excess of Rs. 1000 crores (India has106); has only one company with a turnover of more than Rs. 1000 crores (out of 85 at the all India level); and only one company with a turnover in excess of Rs. 500 crores (out of a total of 197 at the all India level)¹².

6.3.3 Adverse impact caused by 'fly by night' operators

Credibility and confidence are crucial attributes in investment. Once credibility and confidence are lost, it takes a long time to repair the damage. During the hay days of the market boom in the nineties, when the new issue market was thriving, a large number of businessmen without any track record what so ever, made hay, while the IPO sun shone. Exploiting the prevailing (purely short-term) favorable sentiments, these fly-by-night operators mobilized the savings of gullible investors. As revealed by the present study,

the promoter contribution in most of these issues has been very low; and the funds were invested in doubtful projects; the result was that investors were cheated of their precious savings. The present study reveals that out of 48 companies that mobilized capital through IPOs, 4 have become sick or closed down, only 9 companies (20.45 percent of the total) have paid dividend to share holders during the last two years, and only eight companies have their shares quoting above their issue prices (as on July 2004). The introduction of the new Disclosure and Investment Protection (DIP) Guidelines as part of the capital market reforms, now, precludes the possibility of such ‘fly-by-night’ operators capitalizing in the capital market. However, a large number of such operators swindled investors during the primary market boom of the mid-nineties; this did a lot of damage to the capital market in general and investor sentiments in particular. As the saying goes, “once bitten, twice shy.” Many investors who burnt their fingers investing in inferior issues, never returned to the market.

6.3.4 Reluctance of good companies to tap the capital market

An interesting feature of Kerala’s corporate sector is the reluctance of some well performing companies to tap the capital market. The success stories of Kerala’s corporate sector in the nineties include famous names like V.Guard Industries of Kochouseph Chittilappilly and Jyothy Laboratories (Ujala brand) of Kandanasserry Ramachandran. V.Guard Group and Jyothy Lab had turnovers of Rs.130 crores and Rs.600 crores respectively, in 2003-04. Surprisingly, these successful entrepreneurs who could have boosted Kerala’s business image in the country through a public issue and listing, chose not to tap the capital market. Jyothy Lab’s Ramachandran says (in an interview with the Researcher) that the company will come out with an IPO in 2006.¹³

6.4 Opportunities

According to the principle of SWOT Analysis, at any given point of time, there will be opportunities waiting to be seized. Old and existing opportunities may disappear, but new ones emerge. This is true of industrialization today. Many powerful corporates of the fifties, sixties and seventies have faded away from the industrial landscape. Blue chips of the stock market twenty years ago like Binny, DCM, Alembic, Orkay Mills, J.K.Industries, Oswal Agro Mills, Ambalal Sarabhai, Metal Box, Modi Tyres etc. are not heard of these days. Companies which did not even exist 20 years ago like Infosys, Satyam Computers, Divis Laboratories, Biocon etc are making waves in the stock market and have become much sought after investment picks by domestic as well as overseas investors.

Perhaps, India's most outstanding success story, post-reforms, has been the spectacular performance of the computer software industry. This sunrise industry grew from a mere \$150 million industry in 1991 to a phenomenal \$12500 million behemoth by March 2004. Entrepreneurs like Azim Premji (Wipro) Narayana Murthy (Infosys) and Ramalinga Raju (Satyam) became familiar names and symbols of success. The capital market played a crucial role in their success enabling them to raise the required resources through capital issues within the country and abroad [Wipro, Infosys and Satyam made American Depository Receipts (ADR) issues and are listed at NASDAQ]. The exposure and publicity which stock market listing gave them was so great, so much so that, many visiting Heads of States visited their campuses. The U.S. President Clinton during his whirlwind tour of India in 2000 took time to visit the Infosys Campus.

Many I.T companies started by first generation entrepreneurs, initially relied mainly on the meagre resources of their promoters. Later on I.P.Os and Stock market listing gave fillip to these companies. Excellent performance and attractive stock prices enabled these companies to raise capital abroad through the issue of American Depository Receipts (ADRs). Now, India has more than a dozen listed I.T. companies which are world class (CMM level 5) and which export more than 90 percent of their production. The phenomenal success of these companies has been made possible by a combination of factors like the opening up of the economy in the early 1990s and stock market reforms like allowing Indian companies to raise capital abroad, permitting foreign portfolio investment by Foreign Institutional Investors (FIIs) etc.

Theoretically, Kerala has all the necessary requisites to exploit the boom in this sunrise industry. Highly land intensive and polluting industries are unsuitable for Kerala. Knowledge intensive, 'clean industries' which are environment friendly are ideal for Kerala's unique socio-political-economic ambience. The I.T. industry presented, precisely this; and Kerala, with the first state sponsored Techno Park (Thiruvananthapuram) was ready. Theoretically, the setting was perfect; but practically Kerala's performance in this industry was at a snail's pace. While States like Karnataka, Tamil Nadu and Hyderabad galloped away, Kerala was left far behind. India's software exports touched a record \$12.5billion in 2003-04.

Karnataka, India's Silicon Valley, led the Indian states with an export turnover of Rs.19000crores, followed by Tamil Nadu, Delhi and Andhra Pradesh. Kerala's performance was dismal, with exports of a mere Rs.185crores (Economic Review 2003)¹⁴.

Why did Kerala miss this great opportunity?

This brings us to the last part of SWOT, - threats.

6.5 Threats

What are the threats to Kerala's industrialization through the capital market initiative?

Today, globalization is no longer an option: it is a fact of our times, a phenomenon sweeping across the world. Globalization has its pains and gains. The ideal response to globalization should be to formulate policies that can maximize its gains and minimize its pains. Globalization has to be managed, not resisted. In a globalizing economy, only globally competitive businesses would survive.

What is Kerala's status in this emerging Scenario?

6.5.1 Absence of globally competitive business enterprises

The performance of India's industrial sector during the post reform period has been creditable. Indian industry survived and prospered even while protective walls were dismantled (peak import duties on non-agricultural products have been brought down from 165 percent in 1991 to 20 percent in 2003). Indian exports and remittances surged enabling her to achieve a current account surplus in 2001 after a gap of 22 years. Foreign Exchange Reserves are now around \$129 billion (December 2004), exceeding total foreign debt for the first time in the history of independent India. In many industries like computer software and BPO, pharmaceuticals, textiles, steel, cement, aluminium, petrochemicals, automobiles, auto ancillaries, gems and jewellery etc, Indian companies are globally competitive and now have a global presence. In computer software, gems and jewellery and textiles, India's exports have crossed the \$10billion mark. Dozens of Indian companies are doing extremely well in the domestic and global markets: Hero Honda, (produced 20 lakh

motor cycles in 2004) is the world's largest producer of motor cycles; Tata Steel is the lowest cost producer of H.R coils in the world; Hindalco is one of the lowest cost producer of aluminium in the world; Moser Baer (exports in 2002, Rs 1000crores) is the world's lowest cost producer of C.D.recorders; Bharat Forge is Asia's largest manufacturer of forgings; Essel Propack is the world's largest producer of laminated tubes; Asian Paints with production facilities in 22 countries is the market leader in paints in 12 countries (Arun Shourie 2003)¹⁵. The list is growing. Indian pharmaceuticals industry is the 6th largest exporter of pharmaceuticals in the world. In computer software exports, Indias performance has been phenomenal, leap frogging from \$150million in 1991 to \$12.5 billion in 2004. As regards resource mobilization, 106 Indian companies raised Rs.33984.14crores through the issue of GDRs /ADRs in the European and American Markets (RBI Handbook 2000).

The million-dollar question is:

Where does Kerala fit in, in this emerging industrial landscape?

The simple answer to the question is that Kerala is nowhere in the picture. There is not even a single Kerala company among India's star exporters. There is not even a single Kerala company among the 106 companies, which mobilized capital abroad.

This, itself, is the major threat.

6.5.2 Herd instinct of investors

In capital formation, the propensity to invest is as crucial as the availability of savings. Keralites' propensity to invest has been characterized by 'herd instinct'. In the eighties, the private finance companies (popularly called 'blade companies' because of the usurious rates of interest they charged on

borrowers) were the main avenues of investment. Large number of NRKs was drawn into this racket. When these companies met with their inevitable collapse, investors flocked to the 'goat' and 'maanchiyam' companies, which fleeced investors by promising them very high returns from investment in goat farms and 'maanchiyam' plantations. This bubble, too, met with its inevitable destiny. Soon, another bubble emerged, viz, the real estate bubble. Starting from around 1992 it boomed till around 1997 when, that too collapsed. Investment in Kerala has been characterized by this 'herd instinct of investors'. They jump on to the bandwagon when it comes, without looking into the economic rationale of investment and later come to grief, when the inevitable collapse happens. This herd instinct is an unhealthy trend for the investors as well as the economy.

In the backdrop of this SWOT Analysis done at a theoretical plane, an enquiry was conducted into the operational and managerial constraints in Kerala's industrialization through the capital market route.

6.6 Operational and Managerial Constraints in Kerala's Industrialization

To study the operational and managerial constraints in Kerala's industrialization, particularly industrialization through the capital market route, a sample survey was conducted among selected entrepreneurs of Kerala. The economic logic behind this approach is simple: theoretically Kerala is favourably placed to embark on industrialization through the capital market route; but practically this has not happened. If entrepreneurs are not forthcoming to invest in Kerala, it would be logical to enquire their perspective about the issue; particularly it would be relevant to enquire the state of the industrial investment climate in Kerala and its ramifications for entrepreneurs.

With this end in view a questionnaire with 20 statements was prepared for obtaining responses from a sample set of entrepreneurs.

Selection of the sample

The sample consists of 24 entrepreneurs from Kerala. According to the K.S.I.D.C. Dossier¹⁶ Kerala has 16 'mega companies' with a gross block in excess of Rs. 50 crores. One fourth (four in number) of these companies, were included in the sample. Apart from this, 50 percent of Kerala companies, with a turnover of Rs. 100 crores and above, were also included. The sample also includes successful N.R.K. entrepreneurs operating in the big league with turnover in excess of Rs. 1000 crores and employment generation in excess of 10000 persons. The sample selection was done in such a way that the entrepreneurs selected had some correlation with the capital market with regard to capital mobilization. Thus the sample selected consisted of representatives of the following groups:

- Entrepreneurs who tapped the capital market and succeeded in business
- Entrepreneurs who tapped the capital market, but did not succeed
- Successful entrepreneurs who do not intent to tap the capital market
- Successful entrepreneurs who are planning to tap the capital market

In the case of a couple of companies where a particular promoter or entrepreneur could not be identified, their C.E.O.s were treated as entrepreneurs. In order to evaluate the attitude of entrepreneurs towards the investment climate in Kerala and ascertain their views regarding the constraints in Kerala's industrialization, the sample entrepreneurs were directly contacted by the researcher and their responses to the statements were recorded.

Methodology

A questionnaire with 20 statements covering almost all aspects related to investment in kerala, viz., constraints and prospects associated with land, labour, capital, entrepreneurship, infrastructure, work culture, societal attitude etc was prepared (the questionnaire is given in the appendix). The sample entrepreneurs were personally contacted by the researcher and their responses to the statements were taken. The Principle of Likert Scale¹⁷ (Method of Summated Ratings) was used for analysis. The responses were converted into indices. Since there were positive and negative statements, the scores were reversed wherever necessary for standardization and appropriate interpretation.

The Investment Climate Index was constructed using the following formula:

$$Z = \frac{(f_1 \times -2) + (f_2 \times -1) + (f_3 \times 0) + (f_4 \times 1) + (f_5 \times 2)}{F \times \text{Maximum score}}$$

Where,

f_1, \dots, f_n are the respective frequencies

n is total number of items

Z is the respective index

The Investment Climate Indices based on entrepreneurs responses to statements are given in table 6.4

TABLE 6.4
INVESTMENT CLIMATE INDEX BASED ON ENTREPRENEURS'
RESPONSE TO STATEMENTS

Statements	Score	Index	Statements	Score	Index
i	0	-46	xi	-23	-47.91
ii	-4	8.33	xii	11	22.91
iii	-6	-12.5	xiii	-22	-45.83
iv	-2	-4.16	xiv	3	6.25
v	9	18.75	xv	-1	-2.08
vi	20	41.66	xvi	-3	-6.25
vii	32	66.66	xvii	-21	-43.75
viii	7	14.58	xviii	2	4.16
ix	-19	-39.58	xix	-5	-10.41
x	-25	-52	xx	5	-37

Calculated by the Researcher based on responses to questionnaire

The indices were classified into three zones, based on values, as follows:

Below 33.33: least favourable

33.33 to 66.66: moderately favourable

Above 66.66: most favourable

It is important to note that sometimes negative responses become favourable and positive responses become unfavorable depending on whether the statements are positive or negative. Appropriate adjustment for standardization has been done in such cases.

Out of the twenty statements, eight elicited positive responses and twelve elicited negative responses. The best of positive responses related to statement numbers 6,7,and 12. The statements that 'bandhs, harthals etc are major constraints on investment;' 'the labour situation has improved in recent times;'

and 'tapping the capital market is beneficial' have elicited very high positive scores.

Conversely, twelve statements elicited negative responses. The best of the negative responses relate to statements 10,11and 13. Statements like 'it is difficult for Kerala companies to raise capital from the capital market;' ' it is difficult for Kerala companies to grow beyond a particular level and enter the big league;' and 'transparency, accountability and procedural hassles stand in the way of tapping the capital market route,' elicited strong negative responses. It is important to note that these statements have positive connotations for industrialization through the capital market route. Similarly statements 1 and 2 elicited strong negative responses. These negative responses have negative implication.

An attempt was also made to assess the extent of agreement among the various respondents. Coefficient of agreement was computed using the methodology of Summated Ratings on a five-point scale as follows:

$$F = (\sum n f_{ij}^2 - m \sum f_{ij}) + (mc_2) (nc_2)$$

Where,

$\sum f_{ij}^2$ = the sum of the squared f_{ij} entries below the diagonal

m = number of judges

$\sum f_{ij}$ = the sum of the f_{ij} entries below the diagonal

mc_2 = the number of combinations of the m judges taken 2 at a time or $m(m-1)/2$

nc_2 = the number of combinations of the n stimuli taken 2 at a time or $n(n-1)/2$

The rank correlation for measuring judgment consistency yielded a value of 0.64, which is statistically significant.

To study the responses of sample entrepreneurs towards selected statements, the consolidated attitude scores were calculated. This is given in table 6.5

TABLE 6.5
CONSOLIDATED ATTITUDE SCORE OF SAMPLE
ENTREPRENEURS
TOWARDS SELECTED STATEMENTS

Entrepreneurs	Score	Index	Entrepreneurs	Score	Index
1	2	10	13	-2	-10
2	-12	-60	14	-6	-30
3	8	40	15	-3	-15
4	-1	5	16	2	-10
5	-4	-20	17	-3	-15
6	-9	-45	18	-9	-45
7	-7	-35	19	0	0
8	-3	-15	20	0	0
9	0	0	21	2	10
10	-1	5	22	-3	-15
11	-3	-15	23	1	5
12	-3	-15	24	-1	-5

It is important to note that only six out of the sample of 24 entrepreneurs got positive scores. There are 3 zero scores while the vast majority of 15 (63 percent) got negative scores. Again it is significant to note that only 1 respondent (Mr. Roy Mathew of Mini Muthoot Group) got a reasonably high positive score of 40; and that he belongs to the non-banking financial sector

and not from manufacturing. Conversely, the three entrepreneurs with the highest negative scores are from manufacturing. This difference in the perception of entrepreneurs can be explained by the fact that the investment climate and business conditions are different in financial services and manufacturing.

The survey revealed some very interesting pointers relating to the investment climate in Kerala. These are as follows:

- 79 percent of the sample entrepreneurs regard the work culture in Kerala as unfavourable to industrialization; only 4 percent regard it as favourable and 17 percent consider it neutral.
- The entire sample (100 percent) regard bandhs, hartals and other work stoppages as constraints and 87.5 percent strongly feel that it is a major constraint on investment and spoiler of the investment climate.
- None of the entrepreneurs regard the societal attitude in Kerala towards business, industry and entrepreneurs in general as positive. 62.5 percent regard it as negative and the rest consider it indifferent. This is a very significant reflection on the mindset of the Kerala society at large.
- An important positive indication is that majority (62.5 percent) of entrepreneurs recognize the improvement in the labour situation in recent times.

An attempt was made to group the extreme statements and also to assess the relative deviations based on the following formula:

$$t = \frac{X_H - X_L}{\sqrt{\frac{S_H^2}{n_H} + \frac{S_L^2}{n_L}}}$$

where,

X_H = the mean score on a given statement for the high grade

X_L = the mean score on a given statement for the low grade

S_H^2 = variance of the distribution of the high grade

S_L^2 = variance of the distribution of the low grade

n_H and n_L = number

If $n_H = n_L = n$

$$t = \frac{X_H - X_L}{\sqrt{\frac{\sum(X_H - X_H)^2 + \sum(X_L - X_L)^2}{n(n-1)}}}$$

The best and least statements were taken by applying the above formula.

Two major conclusions emerge from the analysis. They are:

- There is a positive response from entrepreneurs towards industrialization through the capital market route. The desirability of this strategy and its advantages are clearly recognized.
- Entrepreneurs feel strongly about the unfavourable investment climate prevailing in Kerala.

The study validates the observations made by many entrepreneurs of Kerala, some of them highly successful, about the investment climate as well as attitude towards entrepreneurs. To quote some of them:

“ In the early stages of a small-scale venture, when there is no union, the hero of the workers will be their own proprietor. Workers will talk highly about

their organization and its proprietor. But once there is interference by union leaders from outside, their attitude will turn upside down. After that the proprietor will be seen as the greatest enemy of the workers. I am writing this from my own experience.”(Kochousph Chittilappilly, Founder Chairman, V.Guard Group¹⁸)

“ You cannot attract industrial investment to Kerala unless you change the culture which sees employment generators as exploiters.”(M.E.Meeran, Founder and Chairman, Eastern Group of Companies¹⁹)

“An environment favourable to industrial investment will emerge in Kerala only when the attitude of Keralites undergoes a fundamental change.”(M.Joy Varghese, Chairman M.C.V.Group of Companies²⁰)

“ It is the attitude of Keralites that stand in the way of Kerala’s industrialization. Once we cross the Kerala border the attitude changes.”(N.Sreekumar, Former Vice President Apollo Tyres²¹)

“Kerala society does not recognize entrepreneurs. Entrepreneurs are seen as smugglers and criminals. This is not the case in other states.”(Isac Joseph, Chairman, Lunar Rubbers²²)

The study found most of the above observations of some of Kerala’s most successful entrepreneurs and technocrats to be true for the entire class of entrepreneurs.

Test of the Hypothesis

This Study started with the hypothesis that Kerala could not exploit the large number of favourable factors that could have facilitated her industrialization through the capital market route and that many factors might have acted as constraints in this process. The study found this hypothesis to be largely true. The study found that there is one major constraint in Kerala’s industrialization

through the capital market route: this is the poor stock market perception of Kerala companies as reflected in their poor P.E.ratios. Other constraints are the general constraints in Kerala's industrialization. The Investment Climate Index, as worked out in the study, reflects Kerala as a poor investment destination. Particularly, Kerala's work culture, societal attitude etc. have strongly constrained her industrialization. Signs of a favourable attitudinal change and improvement on the labour front are indeed, positive trends.

* * *

Notes and References:

¹ Jean Dreze and Amartya Sen(1989): *Hunger and Public Action*, Oxford University Press, Clarendon Street, Oxford.

Particularly, the authors draw attention to the fact that as early as 1817, the ruler of Travancore, Rani Gouri Parvathi Bai had issued a rescript that the State would 'defray the entire cost of education of its people'.

² RBI Hand book 2000, Op.Cit.p.16

³ Economic Review, Government of Kerala, State Planning Board, Thiruvananthapuram, various issues

⁴ RBI Handbook 2000, Op.Cit., p.259 and Economic Review2003,Op.Cit., p.356.

⁵ Report of the Working Group on NBFCs, State Planning Board, Thiruvananthapuram, forthcoming

⁶ K.C.Zacharia et al (1999) :Impact of Gulf Migration on Kerala Economy, Working Paper, CD.S.Thiruvananthapuram

⁷ The Cochin International airport which made a profit of Rs. 21.11 crores out of a total turnover of Rs. 85.26 crores for the year ended 2003-04, is a classic example of highly successful public- private participation. NRIs hold 32.01 percent in the equity of CIAL.

⁸ Information obtained from the official records of the Cochin Stock Exchange.

⁹ Sunil Mani (1996): "Economic Liberalization and Kerala's Industrial Sector. An Assessment of Investment Opportunities", *Economic and Political Weekly*, August.

¹⁰ V.Vijayaraghavan (2003): “ How a tiny minority robs the majority of its tomorrow: How we are losing lakhs of job opportunities”, Development Digest, Jan. – March 2004, vol.ii, no.1, State Planning Board, Thiruvananthapuram

¹¹ Maras Stock Exchange Official Year Book 1996, Madras Stock Exchange, 11 Beach Lane, Chennai

¹² Economic Times, Cochi, 14th October, 2004.

¹³ Ramachandran said in an interview with the Researcher that the I.P.O. is planned for early 2006.He added that F.I.I.s have already invested a sizeable sum in Jyothi Lab.through the private placement route.

¹⁴ Economic Review 2003, Op. Cit., p.403

¹⁵ Arun Shourie (2003): “Listen to New India: Hear success ring in her ears”, The New Indian Express, August 17th, 18th and 19th.

¹⁶ The list of Kerala’s Mega companies was given to the researcher along with the Dossier on Kerala companies (1998) by the K.S.I.D.C., Thiruvananthapuram.

¹⁷ Edwards (1932): Attitude Scale Construction, Brown and Brown

¹⁸ Kochouseph Chittilapilly (2003): *Practical wisdom*, V. Guard Publishers.

¹⁹ As told in interviews to Dhanam Vyavasaya Vanijya Dwaivarika, vol.xiv No.11 and 12,p.4

²⁰ Ibid., p.5

²¹ Ibid., p.5

²² Ibid., p.6

CHAPTER 7

SUMMARY OF FINDINGS AND POLICY IMPLICATIONS

7.1. SUMMARY OF FINDINGS

7.2. CONCLUSION AND POLICY IMPLICATIONS

CHAPTER 7

SUMMARY OF FINDINGS AND POLICY IMPLICATIONS

Industrialization is an essential requirement for economic growth and development. Arguably, the key to solving most of the pressing economic problems of developing countries lies in their industrialization. In the first three decades following India's independence, her industrialization was mainly financed by development banks and term lending institutions set up by the government; the capital market played only a subservient role. This situation changed slowly in the eighties and drastically since the nineties following the economic reforms.

A clear trend of increasing preference of the corporate sector for direct financing through equity and debt, in lieu of indirect financing through bank intermediated debt, emerged. Raising capital through the securities market route became easy for companies; particularly for those with a good track record, in the new liberalized environment. Capitalising on the market boom, many fast industrializing investment-friendly states of India, successfully mobilized huge resources from the primary market and used it for their aggressive industrialization and growth. The present study is an attempt to probe the performance of Kerala in industrialization through the capital market route.

The study has the following objectives:

- i. To analyze the trends and patterns in resource mobilization by the financial system in India and the trends in relative efficiencies of the banking system and

the capital market.

- ii. To assess the quantitative and qualitative dimensions of Kerala's performance, in tapping the capital market route for industrialization.
- iii. To identify Kerala's strengths and weaknesses in industrialization through the capital market route.
- iv. To critically examine the managerial and operational constraints in Kerala's industrialization through the capital market route.

The study is based on both primary and secondary data. Secondary data available from Reports and publications of the R B I, N S E, C M I E etc. were used to study the trends and patterns of resource mobilization by the financial system. Efficiencies in resource mobilization were calculated on the basis of these data. To study the quantitative and qualitative dimensions of Kerala's industrialization through the capital market route, official records of the Cochin Stock Exchange and issue prospectus of companies were used. Ratio analysis of companies was done based on their annual reports. To study the operational and managerial constraints in Kerala's industrialization, primary data were collected through a questionnaire. Sample entrepreneurs were personally interviewed by the researcher and information was elicited. Information elicited from the survey was also used for the SWOT analysis.

The study made a hypothesis that even though Kerala is theoretically well positioned to pursue the capital market route to industrialization, practically she could not succeed in it, due to some operational and managerial constraints.

The study used various methodologies like Ratio analysis, SWOT analysis, Likert scale etc for analysis.

The important findings are summarized as follows:

7.1 Summary of Findings

- i. Resource mobilization through the primary capital market route has experienced a substantial jump in the nineties, spurting from Rs. 14219 crores in 1990-91 to Rs. 72450 crores in 1999-2000: a more than four fold jump in the decade. This is a quantum leap compared to that of the seventies and eighties.
- ii. The pattern of resource mobilization through the primary market has undergone a change in the nineties, particularly in the latter half of the nineties, with the private placement route eclipsing the I.P.O. route.
- iii. The dependence of the corporate sector on the securities market for external financing increased from 19.35 percent in 1990-91 to 33.58 percent in 1999-2000.
- iv. The capital market reforms have resulted in substantial improvement in the efficiency of resource allocation. The transactions costs of the capital market have declined from 4.75% in 1990-91 to 0.6 % in 1999-2000. The efficiency of the banking system too, has improved; the transactions costs of the banking system have declined from 4% to 2.5%. Clearly, the improvement in relative efficiency is in favour of the capital market.
- v. Kerala's performance in resource mobilization through the capital market route has not been satisfactory, in both quantitative and qualitative aspects. Kerala, which accounts for 4.75 % of the total bank deposits in India could mobilize only 0.4% of the total resources mobilized through the capital market

route. The qualitative dimension (the performance of the companies that mobilized resources) is summarized as follows.

vi. During the decade 1990-2000, 48 Kerala companies raised capital through I.P.Os. Of this, three had closed down and one was merged. Out of the remaining 44, only 17 (38.63 percent) were making profits while 27 (61.36 percent) incurred losses. The fact that only 9 companies (one fifth of the total) paid dividend during the last two years reflect unsatisfactory performance by companies and losses to investors. Out of the 48 companies only 8 have their share prices quoting above the issue price. The fact that 14 companies (31.82 percent) have completely wiped out their entire net worth reflects colossal losses to investors.

vii. The 17 profit making companies had made a profit of Rs.460.03 crores, and the 27 loss making companies had incurred a loss of 302.99 crores. Thus, the net profit of all companies put together stood at Rs.157.04 crores

viii. Regarding the performance of companies, when one looks at the big picture, the return on equity at 34.21 percent looks impressive. However, further analysis into industry groups, throws light on many other dimensions.

ix. Out of the total profits of Rs.460.03 crores, the financial sector including banks and NBFCs accounted for Rs.437.95 crores. The return on equity of the financial sector stood at an impressive 346.89 percent.

x. When the profits of the financial sector are excluded, the total profits turn negative i.e., it becomes a loss of 280.91crores.This translates into a return on equity of -84.4percent. Thus, a clear dichotomy in performance emerges: excellent performance of the financial sector and very poor performance of the manufacturing sector.

xi. Further industry-wise analysis into 11 industry groups revealed wide variations among industry groups in profitability with the banking sector and the NBFCs

emerging as the clear leaders with a GPM of 25.03 percent and 15.57 percent respectively. The chemical industry, 'others' and processed marine products were the laggards with GPM of -43.74, -30.69 and -22.03 respectively.

xii. SWOT analysis revealed that high level of savings, particularly financial savings (4.75 percent of the Indian economy's total), high level of remittances (25 percent of the total), exposure to financial markets, advanced capital market infrastructure (highest density of N.S.E. terminals in the country) etc. are some of Kerala's strengths in industrialization through the capital market route.

xiii. Image of an investor unfriendly state, poor track record of corporates, adverse impact created by 'fly by night' operators, poor stock market perception of Kerala companies, reluctance of successful companies to tap the capital market, small size of operations etc. are some of Kerala's weaknesses. The study found that Kerala does not have a single company (in the private sector) with a market capitalization in excess of Rs. 1000 crores (India has 106); Kerala has only one company with an annual turn-over of more than Rs. 1000 crores (India has 85); and only one company with a turnover in excess of Rs. 500 crores (India has 197).

xiv. Not even a single Kerala company figures in the list of the 106 companies in India that mobilized Rs. 33984 crores through the issue of GDRs and ADRs.

xv. The modern 'sunrise industries' like computer software, I.T.E.S, Business Process Outsourcing, Bio-Technology etc. which are knowledge intensive and environmentally 'clean' are eminently suited to Kerala's unique ambience and is a great opportunity. However, absence of globally competitive enterprises like those found in other states, herd instinct of investors, small size of Kerala companies, and inability to attract entrepreneurs from outside, pose major threats. The survey revealed some very interesting pointers relating to the investment climate in Kerala. These are as follows:

xvi. 79 percent of the sample entrepreneurs regard the work culture in Kerala as unfavourable to industrialization; only 4 percent regard it as favourable and 17 percent consider it neutral.

xvii. The entire sample (100 percent) regard bandhs, hartals and other work stoppages as constraints and 87.5 percent strongly feel that it is a major constraint on investment and spoiler of the investment climate.

xviii. None of the entrepreneurs regard the societal attitude in Kerala towards business, industry and entrepreneurs in general as positive. 62.5 percent regard it as negative and the rest consider it indifferent. This is a very significant reflection on the mindset of the Kerala society at large.

An important positive indication is that majority (62.5 percent) of entrepreneurs recognize the improvement in the labour situation in recent times.

xix. An important finding of the study is that other than the poor stock market perception of Kerala companies as reflected in their low P.E. ratios, there is no major constraint in Kerala's industrialization through the capital market route. In other words, the constraints in Kerala's industrialization through the capital market route are the general constraints in Kerala's industrialization.

xx. Another important finding of the survey was that the vast majority of entrepreneurs perceive the work culture in Kerala to be a constraint on investment even while they recognize that the labour situation has improved in recent times.

xxi. The study found the investment climate in Kerala very unfavourable. The Investment Climate Index constructed using Likert scale indicates a very negative image of Kerala as an investment destination. The Consistency Index constructed using Summated Ratings yielded a value of 0.64, which is statistically significant.

7.2 Conclusion and Policy Implications

The improvement in the efficiency of resource mobilization through the capital market route and the all round development of the capital market, borne out by the study, point to the desirability of this route for industrialization. Therefore, all policy initiatives to strengthen and promote this mode of industrialization have to be pursued. It is heartening to note that this is being done at the national level.

At the state level bold initiatives are necessary to exploit the capital market route. Since Kerala has formidable strengths in industrialization through the capital market route, these strengths have to be exploited. Since, other than the poor stock market perception of Kerala companies, there are no other constraints in Kerala's industrialization through the capital market route, it can be argued that the constraints in Kerala's industrialization through the capital market route are the general constraints of investment in Kerala. The study points out some of these constraints in Kerala's industrialization, particularly constraints from entrepreneurs' perspective. The Government should take the lead to address these constraints. Constraints like poor work culture vitiated by many unwarranted agitations like hartals and bandhs, have to be addressed by the entire society, with perhaps, the enlightened citizenry and concerned organizations taking the initiative.

The negative societal attitude towards industry and business in general, which the entrepreneurs consider a major constraint, cannot be realistically expected to change for the better, overnight. Attitudinal change requires time; initiatives to speed up the process are to be thought of. Starting of the Entrepreneurship

Development Clubs (E D Cs) at the college level is a step in the right direction. The EDC concept has to be extended and strengthened.

In this age of globalization, Kerala has to focus on those industries in which she would be globally competitive. The government's job should be to concentrate on providing the infrastructure and creating the right investment climate. Since cost cutting and quality enhancement are crucial for survival in the emerging world, all options to achieve this objective should be pursued. Learning lessons from the Chinese success in manufacturing, Kerala can adopt the cluster system and focus on knowledge and skill intensive industries unique to her ambience.

Since Kerala cannot boast of even a few large public limited companies in the private sector, this deficiency has to be compensated by wooing successful entrepreneurs, who can invest large capital and tap the capital market on the strength of their brand equity. To achieve this objective the government can think of giving tax breaks and such other incentives to widely held companies.

There are a few closely held companies in Kerala, which have an excellent track record of corporate governance, profitability and social commitment. Organizations like Chambers of Commerce, associations of industrialists, the business Press and even government departments facilitating industrialization can give due publicity to the good work done by these entrepreneurs (Fortune magazine's publication of America's most admired companies would be a good example to follow). If these highly respected companies go public, it will be a big morale booster to the image of public limited companies and this will help the cause of Kerala's industrialization through the capital market initiative. The government can either use its good offices to persuade such companies to tap the capital market route or offer them incentives to go public.

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APPENDIX

DEPARTMENT OF ECONOMICS

JOHN MATTHAI CENTRE
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THRISSUR-680651

KERALA'S INDUSTRIALIZATION THROUGH THE CAPITAL MARKET ROUTE

QUESTIONNAIRE

Tick your responses to the following:

- 1) Work culture in Kerala is favourable to industrialization.

Strongly disagree Disagree Indifferent Agree Strongly agree

- 2) Labor and trade union militancy is a problem adversely affecting Kerala's industrialization.

Strongly agree Agree Indifferent Disagree Strongly disagree

- 3) Wages in Kerala are higher than in other states and this is a major constraint on investment.

Strongly agree Agree Indifferent Disagree Strongly disagree

- 4) Head load workers often disrupt work and their wages are on the higher side.

Strongly agree Agree Indifferent Disagree Strongly disagree

- 5) Politicization of unions and political interference is a constraint.

Strongly agree Agree Indifferent Disagree Strongly disagree

- 6) Bandhs/hartals and work stoppages are more in Kerala vis-à-vis other states: this is a major constraint on investment in Kerala.

Strongly agree Agree Indifferent Disagree Strongly disagree

7) Labor situation in Kerala has improved in recent times, say, from 1990s onwards.

Strongly disagree Disagree Indifferent Agree Strongly agree

8) There is a 'Psychic Cost' (a risk premium arising out of psychological fear of labor and trade union militancy) for investment in Kerala.

Strongly agree Agree Indifferent Disagree Strongly disagree

9) Banks in Kerala are reluctant to lend to entrepreneurs.

Strongly agree Agree Indifferent Disagree Strongly disagree

10) It is difficult for Kerala (based) companies to raise capital from the capital market.

Strongly agree Agree Indifferent Disagree Strongly disagree

11) It is difficult for a Kerala based company to grow beyond a level and enter the big league.

Strongly agree Agree Indifferent Disagree Strongly disagree

12) Tapping the capital market and becoming a public limited company is beneficial.

Strongly disagree Disagree Indifferent Agree Strongly Agree

13) Higher level of responsibility, accountability and procedural hassles associated with public limited companies act as disincentive to tapping the capital market route.

Strongly agree Agree Indifferent Disagree Strongly disagree

14) Poor quality of roads in Kerala is a constraint on investment.

Strongly agree Agree Indifferent Disagree Strongly disagree

15) Power shortage in Kerala is a constraint on investment.

Strongly agree Agree Indifferent Disagree Strongly disagree

16) Cost of land in Kerala is relatively higher and this is a constraint on investment.

Strongly agree Agree Indifferent Disagree Strongly disagree

17) Kerala is deficient in entrepreneurial talent relative to other states.

Strongly agree Agree Indifferent Disagree Strongly disagree

18) Government's role as a facilitator in industrialization is:

Very negative Negative Indifferent Positive Very positive

19) The attitude of the bureaucracy (tax officials, inspectors, officials from electricity boards etc) towards industry is:

Very negative Negative Indifferent Positive Very positive

20) The societal attitude in Kerala towards business, industry and entrepreneurs in general, is:

Very negative Negative Indifferent Positive Very positive

Name of the entrepreneur:

Name and address of the company:

Industry category (product):

Details of the company

- a. Income from operations:
- b. Net Profit (PAIDT):
- c. Equity capital:
- d) Total capital employed:
- e) Return on capital employed
- f) Total employment