ROUTLEDGE REVIVALS

Capital Markets and Institutions in Bangladesh

Some Implications of Japanese Experience

M. Farid Ahmed

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CAPITAL MARKETS AND INSTITUTIONS IN BANGLADESH

To the memory of my mother, Fazilatennesa

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Some implications of Japanese experience

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Preface

In the recent past rapid transformations of economic structure, policies and institutions are being observed on a global scale. More so in case of private sectors, financial markets and institutions, perhaps, because they are identified as crucial factors for sustainable economic growth and the achievement of national development goals in a freer market economy. Bangladesh also has witnessed remarkable macroeconomic stability, sweeping deregulation and liberalization over the past few years. Although economic underpinnings consistent with market economy and liberalization appear sufficient in general for the last few years, development of efficient and stable capital markets has not yet been attained. Substantial growth of a robust and vibrant market depends on overall environment, sound policy, legal and structural frameworks, promotional planning, as well as effective execution thereof. Making them all conducive for the rapid growth of the market is not an easy task. This study has made a modest attempt to explore a sensible approach to these issues rather than offer panacea solutions. In pursuing this objective, this study has focussed close attention on the experience of Japanese capital market development that has contributed significantly in the transformation process from a regulated economy to present-day economic superpower status along with the path of market economy. Thus, the implications of the Japanese corporate practices for developing countries are another aspect of this study based on theoretical and empirical analysis of both Bangladesh and Japanese markets. The conventional standard notions developed in Anglo-American countries constitute a strong foundation for the analysis of those markets, but they cannot give adequately convincing explanations of the Japanese financial system. Capital markets in Japan have experienced a radical structural change after World War II as a consequence of reforms introduced by the Occupation Authorities and the need to rebuild. Besides, Japanese capital markets have been evolving continuously since the War. Thus, the traditional practices have been adapted to a much more complex reality. To the extent our arguments are convincing, the results of the study are expected to indicate a somewhat different emphasis in the market development efforts of present-day developing countries like Bangladesh.

The completion of this book reflects the influence, encouragement and support of many individuals. Special mention of selected persons seems to me invidious as well as humiliating for them as that may relate them with my mistakes and naive judgements. However, the following inventory captures only the most obvious and important ones. As a graduate student at Yokohama National University and Nagoya University of Japan for the period from 1983 to 1989 and subsequently as a Professor affiliated jointly with Nagasaki University of Japan and Dhaka University of Bangladesh I had the opportunity to study and teach finance theory, Japanese and Bangladesh capital markets. The analysis and interpretations of this book are the results of my study and teaching on these areas. I have been in close touch with some insightful empirical studies on the recent Bangladesh financial system at Dhaka. Similarly, I have been exposed to a nice academic environment that promotes rigorous research activities at Nagasaki. This book could not have come out without the interactions with students, teachers and colleagues at all these institutions. I am deeply indebted to them for their inspiring discussions and critical comments.

I should record here the name of Professor Tamao Yamada of Chubu University, formerly of Nagoya University, Japan, who kindled my interest in finance theory and development finance and helped me to grow. I owe a great deal to Professor Shigeru Uchida and Professor Takafumi Yoshida who undertook the task of going through the earlier drafts. I am grateful for their advice and encouragement. I must acknowledge the wholehearted cooperation of Professor Akira Shimada who has provided much important information and responded spontaneously to my frequent requests for arranging logistic support necessary to complete this book. None of them, however, is responsible for errors and omissions. I consider it my pleasant duty to express my sincere gratitude to my wife Naherin and to my sons, Navin and Navid for their encouragement and support extended to me for completion of the book. Finally, I acknowledge the partial financial support by the Research Institute of South East Asia, Nagasaki University, for conducting this study.

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Abbreviations

ABSs	Asset-Backed Securities
ADB	Asian Development Bank
AGM	Annual General Meeting
BB	Bangladesh Bank
BCI	Bangladesh Commerce and Investment Ltd.
BCIC	Bangladesh Chemical Industries Corporation
BJMC	Bangladesh Jute Mills Corporation
BKB	Bangladesh Krishi Bank
BMRE	Balancing, Modernization, Replacement and Expansion
BOGMC	Bangladesh Oil, Gas and Minerals Corporation
BOI	Board of Investment of Bangladesh
BOJ	Bank of Japan
BPC	Bangladesh Petroleum Corporation
BPDB	Bangladesh Power Development Board
BSB	Bangladesh Shilpa Bank
BSC	Bangladesh Shipping Corporation
BSEC	Bangladesh Steel and Engineering Corporation
BSFIC	Bangladesh Sugar and Food Industries Corporation
BSRS	Bangladesh Shilpa Rin Sangstha
BTMC	Bangladesh Textile Mills Corporation
BTTB	Bangladesh Telephone and Telegraph Board
CAPM	Capital Asset Pricing Model
CCI	Controller of Capital Issues
CDS	Central Depository System
CSE	Chittagong Stock Exchange
DFIs	Development Finance Institutions

DSE	Dhaka Stock Exchange
EMH	Efficient Market Hypothesis
EPF	Equity Participation Fund
EPIDC	East Pakistan Industrial Development Corporation
EPZ	Export Processing Zone
ERA	Economic Research Association of Japan
FCBs	Foreign Commercial Banks
FFYP	First Five Year Plan of Bangladesh
GDP	Gross Domestic Product
GNP	Gross National Product
IACB	Industrial Advisory Center of Bangladesh
ICB	Investment Corporation of Bangladesh
ICP	Investment Corporation of Pakistan
IDBP	Industrial Development Bank of Pakistan
IFC	International Finance Corporation
IMF	International Monetary Fund
IPDC	Industrial Promotion and Development Corporation
IPO	Initial Public Offering
JBC	Jiban Bima Corporation
LCs	Local Companies
MITI	Ministry of International Trade and Industry
MNCs	Multinational Companies
MOF	Ministry of Finance
MOU	Memorandum of Understanding
NCBs	Nationalized Commercial Banks
NCL	National Credit Ltd.
NIP	New Industrial Policy
NIT	National Investment Trust
OECD	Organization for Economic Cooperation and Development
OSE	Osaka Stock Exchange
PBR	Price Book Value Ratio
PCBs	Private Commercial Banks
PER	Price Earnings Ratio
PICIC	Pakistan Industrial Credit and Investment Corporation
PIDC	Pakistan Industrial Development Corporation
RIP	Revised Industrial Policy
SABINCO	Saudi Bangladesh Agricultural and Industrial Company
SBC	Shadharan Bima Corporation
SCAP	Supreme Commander of the Allied Powers
SEC	Securities and Exchange Commission
SER	Securities and Exchange Rules

SFYP	Second Five Year Plan of Bangladesh
SOEs	State Owned Enterprises
TBs	Treasury Bills
TFYP	Third Five Year Plan of Bangladesh
TSE	Tokyo Stock Exchange
TYP	Two Year Plan of Bangladesh

1 Introduction

Capital markets and financial institutions are investment intermediaries linking the savers and users of capital. These intermediaries are interposed between the ultimate borrowers and lenders permitting them efficient transfer of funds. Individuals having surplus funds can lend them for reasonable return to those who need funds to take the advantage of economically and financially viable investment opportunities. The existence of capital markets facilitates such exchange of resources. As a result, both the borrowers and the lenders are better off than they would have been without market intermediaries. Thus, these intermediaries have a positive role in economic growth which is a multidimensional process involving the complexity of many interrelated and interdependent factors of diversified nature. It is difficult to assess the contribution of each factor independently. More so in the case of capital markets and financial institutions whose contribution produces much wider ramification. Of all the factors affecting the rate of growth in any economy, the rate of new capital accumulation plays a role of paramount importance in the process of economic growth. The main function of a capital market along with other financial and non-financial institutions is to assist in the allocation of a nation's limited capital resources among numerous competing alternative uses. The essence of this function is the diversion of a part of society's currently available resources to the purpose of increasing the stock of capital goods so as to make possible an expansion of consumable output in the future (Nurkse, 1952). This process involves three distinct but interdependent activities: a) an increase in the volume of real savings, so that resources that would have been used for consumption purposes, can be released for other purposes; b) a finance and credit mechanism, so that the resources may be claimed by investors; and c) the act of investment itself, so that resources are used for the production of capital goods (Meir & Baldwin, 1964). If capital resources are not provided through such allocative functions to those industries or activities which are capable of increasing production and productivity, the rate of growth of the economy will inevitably suffer. Here lies the importance of finance and credit mechanism. In fact, this is the prime economic role of the financial intermediaries (Gurley & Shaw, 1955). On the subject of the relationship between financial development and economic development, a consensus appeared to have been reached by the mid-1970s, among the leading writers of the subject, that financial development is important and leads to economic development (Patrick, 1966; Porter, 1966; Gurley and Shaw, 1955; McKinnon, 1973; Shaw, 1973; Drake, 1980). This, however, is not to deny the importance of other factors. The economic history of developed countries shows that their periods of expansion have always been characterized by the high rate of capital formation. Shaw's (1973) argument is that the development of financial markets and institutions is a necessary condition for economic growth, and that developing countries typically suffer from a condition of financial repression which keeps finance 'shallow' and restricts economic growth. However, the development experience of Japan demonstrates a different picture which has been analyzed for having an insight of the development problems in the following chapters.

Academic discussion relating to capital markets and institutions of developing countries has not been extensive. Wai and Patrick (1973) are a widely referred paper on this issue who favors its development rather with caution. Drake (1977, 1980, 1985) supports the capital market development. Although Samuels (1981) and Samuels and Yacout (1981) appear to be supportive of capital market development but they have indicated their inefficiency that may result in increasing inequality in income and wealth distribution. Calamanti (1983) and Parkinson (1984) have emphasized the limited role of equity markets in raising new capital in a developing economy. It will be relevant to quote here from Baumol (1965) as:

> All in all, one cannot escape the impression that, at best, the allocative function is performed rather imperfectly as measured by the criteria of the welfare economist. The oligopolistic position of those who operate the market, the brokers, the floor traders and the specialists; the random patterns which characterize the behavior of stock prices; the unresponsiveness of supply to price changes; and management's efforts to avoid the market as a source of funds, all raise some questions about the perfections of the regulatory operations of the market . . .

This remark indicates some of the problems that the capital markets are to encounter. Added to these, developing markets like Bangladesh are likely to face a considerable number of more complicated issues involving structural, institutional and non-economic constraints. There is no easy answer to many of these problems. In this study, an attempt has been directed to explore a sensible approach to the problems of capital markets in a developing country than to offer panacea solutions.

It is generally agreed that capital markets under general equilibrium plays a very important role in an economy in collecting and allocating funds in an efficient manner. In order to ensure these economic activities in developed economies capital markets have or should have a significant link to the overall economy (Baumol, 1965). Capital markets also reflect investors' attempt to forecast economic trends. It is evident that the capital markets and economic activities move in a similar cyclical pattern (Moore, 1975). It is also recognized that the stock price index is a major component of the index of leading indicators of the economy (Zarnowitz and Boschan, 1975). However, it is not an easy task to establish an adequately efficient capital market particularly in an environment of an underdeveloped country. The capital markets are required to meet at least two basic requirements. It should support industrialization through savings mobilization, investment fund allocation and maturity transformation. Besides, it must be safe and efficient in discharging the aforesaid function. In a developing economy such conditions usually do not exist due to prevalence of informal credit markets that tend to limit the capacity to mobilize financial savings, a low degree of ownership-management separation associated with the drawbacks of informational asymmetry and low level of accumulated financial assets making maturity transformation difficult. Of course, these conditions differ widely from country to country.

Many developing economies have attempted to develop capital markets, not only to raise capital but also to diversify ownership of companies. These attempts have produced mixed results. Critics may characterize attempts to develop capital markets in developing economies as misguided efforts to introduce Western institutions into entirely different socioeconomic system or as a naive, if the mere establishment of security markets is expected to have a significant effect on the allocation of resources (Lloyd, 1977). However, they fail to consider that the motives for establishing security markets in developing countries have generally been more political than economic. Security markets in the United States and Western Europe evolved in response to the need for capital generated by the industrial revolution. Security markets in developing countries, however, have typically sprung less from private economic need than government decisions to pursue political and economic goals (Wai and Patrick, 1973), such as financial deepening. Capital markets are considered as an integral part of the developed economies like Japan, U.S.A., U.K. and so forth.

One can hardly escape the impact of activities in capital markets of such economies. On the one hand, these markets are deep, resilient and highly sensitive, and on the other the capital markets of developing countries like Bangladesh are narrow, underdeveloped, shaky and less sensitive. In the middle of the spectrum are the emerging markets such as Korea, Taiwan, Brazil and the like. If the major problem in the process of development is to increase the level of savings and to channel those savings into productive investments, then the mechanism of the capital market is a crucial intermediary element in the process of growth. It becomes a major significance to understand how the existing capital markets operate to assist the accumulation of savings and their allocation in various sectors. Then it may be possible to shape the markets in a manner to provide a more efficient mechanism for channeling increasing savings into productive investment.

Bangladesh markets offer an opportunity to study the development problems of the present day developing markets. With the adoption of a socialistic approach in economic management and nationalization of virtually all large scale industry immediately after liberation of the country in 1971 Dhaka Stock Exchange (DSE), the only bourse of the country at that time, was closed. With the change of government policy it reopened in 1976 after suspension of its activities for about four years. It is still in an early stage of development. In its efforts to design a sound financial system for Bangladesh, the government has had the opportunity to observe the other security markets including the developed security markets and their development experience. However, it is needless to say that security markets do not function in a vacuum; political economic, cultural and institutional constraints affect the development and success of the markets and its institutions.

Stock markets are historically found to be very weak conduits for channelizing investment funds in Indo-Pak-Bangladesh Subcontinent. Investment funds have usually been raised from internal sources or managing agents or from financial institutions as loan. However, with the spree of privatization and success of stock markets in many of the South-East Asian Newly Industrialized Economies (NIEs), Bangladesh presents an optimistic ground for effectively developing and utilizing the capital markets and relevant institutions for industrial financing. With a low saving rate, even lower than South Asian standard, Bangladesh has so far been meeting the resource gap between saving and investment predominantly from external aid. In a more competitive aid environment in recent years, the need for the development of sound and well functioning capital markets have become more urgent than ever before. Recently, with the changing political and economic environment in Bangladesh and elsewhere, the government of Bangladesh emphasized the need for development of capital markets and institutions in the country. Currently, the major institutions working toward development of capital markets are: Dhaka Stock Exchange (DSE), Investment Corporation of Bangladesh (ICB), two long term credit banks - Bangladesh Shilpa Bank (BSB) and Bangladesh Shilpa Rin Sangstha (BSRS), some General Insurance Companies and some Life Insurance Companies, both in private and public sectors. All these are predominantly engaged in long term fund management. Besides, Chittagong Stock Exchange (CSE), the second bourse of the country, started functioning in October 1995. There are commercial banks, both in private and public sectors, for providing short term funds to productive sectors. Bangladesh Bank, Securities and Exchange Commission (SEC) and Registrar of Joint Stock Companies (RJSC) are mainly engaged in regulatory functions. Notably, loan financing through banking system in Bangladesh is facing difficulties due to their unusually low recovery position. They can't recover overdue amounts which are more than 50 percent of total lending. There is some evidence of concern among the aid donors who made significant financial contribution to sustain the lending programs of these financial institutions. But the bank-based financing system has contributed significantly in the successful industrial development of Japan which also eventually paved the way for developing one of the largest well functioning stock markets in the world.

In Bangladesh, the processes of industrialization have suffered in the past due to a lot of factors, such as, lack of entrepreneurs, low levels of productivity, lack of capital, lack of discipline in the financial sectors in general and banking sectors in particular and the like. The industrial sector accounts for about 15 percent of the GDP and absorbs about 8 percent of the total labor force. Since the first industrial policy announced in 1976 it has undergone revision several times toward liberalization and market economy up to 1995. Bangladesh has a vast labor force unemployed. Only industrial development can facilitate their employment. Thus, the need for rapid industrialization can hardly be overemphasized in the context of Bangladesh. Only the process of rapid industrialization of the country can bring about desired upliftment of the country from a traditional economy to a modern economy. In this process the role of the capital markets and institutions in providing finance for new upcoming industrial and servicing units as well as for the existing ones is predominantly important.

Historically, public issues by the private companies are small both in Bangladesh and Japan. Government of Bangladesh has been making efforts to develop the capital markets through different policy measures and tax concessions. Various measures have been directed toward fostering privatization and equity segments of the capital markets. These measures are likely to encourage mobilization of domestic resources and development of industrial sectors. The country has achieved remarkable macroeconomic stability, sweeping deregulations and liberalizations over the last few years although some sporadic and spurious impediments have been observed here and there. In fact, the country seems to be on the right track in respect of privatization and capital market development, still their progress could not be attained at a desired level. It is encouraging to note that the private sectors have come of an age and equity markets displayed an upward growth in terms of number of the companies listed in the stock exchanges, investors' response to public offerings of securities and market capitalizations. Nevertheless, cautious observers tend to believe that the progress so far achieved is below expectation and appears to be experiencing some strangulation. The market capitalizations, average trading volume, average company size etc. are smaller than those of other South Asian nations. Speculative elements along with the investors' expectations bring abnormally sharp fluctuations in the stock market, sometimes rather irrationally.

It is believed by many scholars and policy makers that the Japanese experience in the post-Meiji Restoration period is relevant and useful in the context of Bangladesh (Farouk, 1974). The security market in Japan has experienced an unprecedented expansion in the past decades and has established itself as one of the leading markets in the world. It was primarily a regulated market during its growth period. It has been undergoing liberalization gradually but steadily since the late 1970s. Subsequently it has become one of the world's largest security markets. The processes of this development through times have drawn the attention of researchers and practitioners at home and abroad. The way in which Japanese markets have been governed and the nature of market structure supported by government is fundamental to the understanding of Japanese market development. In the backdrop of the scenario portrayed above, this study is a modest attempt to identify the actual deterrents attributable to the underdeveloped condition of the capital markets of Bangladesh and to see whether any relevance can be drawn from the experience of Japanese capital market development processes. Simultaneously, the analysis has been extended in the light of relevant text book models.

Objectives of the study

The primary aim of the proposed study is to assess and analyze the development processes of capital markets in Bangladesh and Japan in terms of finance theory. The focus will be given mainly in mobilization and promotion of savings, meeting the financial needs of the industrial sectors of the economy. In this context we do not merely review the overall growth and their quantitative performance but also critically evaluate their qualitative functional performance in general. The impact of the policy/structural changes introduced in the development process of both Bangladesh and Japan will be examined from the standpoint of growth requirements. In this connection the successful use of different structural/policy change will be analyzed and evaluated. Attention will be given on useful relevances that may be drawn from the experiences of Japanese capital market development processes for having suitable market structure and operational efficiency in the capital markets of developing countries in general and Bangladesh in particular. The study of the Japanese markets separated from the Western world by distance, institutional arrangement and culture, is likely to deepen our insight about the development processes and problems of developing markets like Bangladesh. Thus, the Japanese experience in capital market development seems to be more useful than that of other developed market of the West. To the extent the arguments are convincing, the results of the study are expected to present a different direction and emphasis to the academics, policy-makers in the government, entrepreneurs, concerned authorities and institutions including stock exchanges, regulatory bodies like Securities and Exchange Commission (SEC), Central Bank, and others who are interested in it. Accordingly, the specific motivations of this study are as follows:

1 To analyze and evaluate the development processes of capital markets and institutions in Bangladesh and Japan.

2 To examine the trends in the equity prices with a view to discovering their behavioral pattern and also to locate the main factors, both economic and noneconomic, which influence the course of equity price behavior.

3 To investigate whether the rate of return on the stocks in Bangladesh can be explained in terms of finance theory.

4 To evaluate the existing institutional framework and their performance in the capital markets of Bangladesh.

5 To assess the implications of the experience of Japanese capital market development processes for Bangladesh.

Scope and methodical approach of the study

In this study we cover the role, actual and potential, of most of the important financial intermediaries forming capital markets of Bangladesh and Japan. While examining the overall importance of capital markets and relevant institutions, we attempt to assess the role which they should be called upon to play in the context of the emerging needs of Bangladesh. In these efforts assessment of Japanese experience has been taken into account.

In order to attain the objectives of the study various methods for data collection and analysis has been used. For collecting basic data relating to Bangladesh markets, we have largely relied on various publications of Bangladesh Bank, Dhaka Stock Exchange, Securities and Exchange Commission of Bangladesh, various government publications and so forth. Similarly, for collecting basic data on Japanese markets we have mainly depended on the various publications of Bank of Japan, Tokyo Stock Exchange and Japan Securities Research Institute, Government publications, research output of individual researchers connected with different segments of our study and so on.

Moreover, we have tried to remove some of the gaps in our study by visiting important institutions working in the area of our research. Accordingly, we have discussions bearing on important problems and issues with different top executives of relevant institutions/agencies. We had the privilege of exchanging views with some of the top ranking academic economists of Bangladesh and Japan or drawing direct impetus and inspiration from the learned articles and books of such scholars. Relevant data and statistical results have been analyzed and interpreted in the light of the finance theories. In this effort suitable statistical tools and techniques have been used.

Plan of the study

The study is divided into seven chapters where:

Chapter 1 gives an introduction containing a broad overview of the study, research design and coverage of the study.

Chapter 2 examines the privatization process of industries, its implications for capital markets, the role of the regulatory authorities and the changing dimension of the government policies.

Chapter 3 elaborates the present structure of financial markets and evaluates the role of financial institutions.

Chapter 4 deals with the corporate securities markets, barriers in their development processes and an assessment of market participants.

Chapter 5 evaluates the securities pricing mechanism with reference to the macroeconomic, microeconomic and non-economic variables.

Chapter 6 presents an empirical analysis of risk-return relationship of an emerging market like Bangladesh by using Capital Asset Pricing Model (CAPM).

Chapter 7 investigates the Japanese corporate finance, capital market structure and their development. An effort has been made to see the implications of

Japanese corporate finance for the efficient development of emerging markets like Bangladesh.