



Liberalisation, the stock market and the market for corporate control: a bridge too far for the Indian economy?

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25 October 1998

Online at <https://mpra.ub.uni-muenchen.de/54929/>
MPRA Paper No. 54929, posted 01 Apr 2014 06:10 UTC

LIBERALISATION, THE STOCKMARKET AND THE MARKET FOR CORPORATE CONTROL: A BRIDGE TOO FAR FOR THE INDIAN ECONOMY?

INTRODUCTION

An outstanding development of the 1990s, closely associated with the economic reform programme initiated by Dr Manmohan Singh, has been the very fast expansion of the stockmarkets and their growing role in the Indian economy. Both internal and external liberalisation measures, undertaken as a part of the financial reform, as well as the more liberal general economic ethos created by the reform, have largely been responsible for this evolution.

The first part of this paper reviews the stockmarket reforms and comments on the available evidence on the effects of stockmarket expansion on corporate growth and on the real economy. The second part focuses on the proposed next stage of the reform, being urged by the financial community. Their specific proposal is to establish a market for corporate control in order to maximise the benefits from stockmarket development. The government has recently published a Takeover Code which suggests that it is not at least opposed to the evolution of such a market.

Takeovers and a corporate control market would have far-reaching effects on the Indian economy, but there has been little informed debate on this subject. The paper attempts to invite

such a debate by putting forward analyses and evidence to suggest that this reform is more likely to harm than help the real economy at India's present stage of development. The proposed reform should therefore be resisted.

Section II: Economic Reform and Stockmarket Development¹

Although India has long had a stockmarket, its development after independence and up until 1980 ebbed and flowed but in general had been quite slow. In 1980, the total market capitalisation on the Indian stockmarkets as a proportion of GDP was only 5%. By 1990, following the liberalisation measures initiated during the 1980s, the ratio rose to 13%. With the accelerated pace of liberalisation under Dr Singh's reforms the stockmarket growth has been explosive. By end-1993, total market capitalisation reached 60% of GDP.

Between 1980 and 1993, the number of mutual funds investors rose from 2 to 40 million, a figure second only to the US (51 million). In terms of listed companies, the Indian stockmarket (7,985 companies in 1995) is now the largest in the world, larger even than the US (7,671 companies), with the UK (2,078 companies) and Germany (678 companies) far behind.²

The daily turnover of shares on the Bombay stock exchange rose from 0.13 billion Rupees in

¹ The sources of data presented in this section are Mayya (1993, 1995); IFC (1996); Singh (1997a).

² Nagaraj (1996) however, suggests that the Indian figures in this paragraph may be somewhat over-stated.

1980-81 to 3.7 billion Rupees in 1993-1994, an almost thirty-fold increase. The average daily trading volume on the Bombay market in the early 1990s was similar to that in London - about 45,000 trades a day. At its peak trading has occurred at double that rate.

Although Indian stockmarket growth during the 1980s and 90s has been impressive, so has it been in several other leading emerging markets. In Taiwan market capitalisation as a proportion of GDP rose from 11% in 1981 to 74% in 1991. Similarly, between 1983 and 1993, the Chilean ratio rose from 13.2% to 78% and the Thai from 3.8% to 55.8%. To put these figures in an historical perspective, Mullins (1993) notes that it probably took the US stockmarket 85 years (1810-1895) to achieve a broadly similar increase in capitalisation ratio, from 7% to 71%.

In Indian stockmarket reforms, liberalisation has occurred simultaneously with fresh regulation (Joshi and Little, 1996). Liberalisation measures have included the repeal of the Capital Issues Control Act 1947 by which the government controlled new share issues and determined the issue price. Externally, liberalisation has allowed foreign institutional investors to directly purchase Indian corporate shares. Similarly, Indian companies have been permitted to raise funds abroad³.

The flagship of the government's new regulations to ensure transparency and above board functioning of stockmarkets has been the Securities and Exchange Board of India Act which came into force in January 1992. Under this act, the authorities have attempted to regulate the

³ These capital account liberalisation measures are subject to restrictions. See further Joshi and Little (1996).

activities of stock brokers, merchant banks and other intermediaries on the primary market. Although the Securities and Exchange Board of India (SEBI) has apparently made progress in some areas, it will be a long time before the Indian stockmarket loses its justly deserved reputation as being a "snake pit" to use Joshi and Little's expressive phrase. Mayya (1995) notes the continuing huge malpractices on the secondary markets.⁴

III. The stockmarket, corporate growth and the real economy

⁴ The gigantic stock market scam of 1992 focused much public attention on these issues.

How has this enormous stockmarket expansion affected the real economy? Has it brought about larger savings and investment or greater productivity of investment as the stockmarket proponents suggest?⁵

III.1 The financing of corporate growth

At first blush, the answer appears highly positive. During the 1980s and the 1990s, the Indian corporations have raised large amounts of capital on a very active primary market to finance their growth (Balasubramanian, 1993). In 1980, 929 million rupees were raised through corporate securities issuance. This figure had risen to 2.5 billion rupees by 1985, to a huge 123 billion rupees by 1990, and by 1993-4, it reached 225 billion rupees i.e a 250-fold increase since 1980. By contrast, general price level rose less than 4-fold during this period. New corporate securities constituted 12.8% of the country's gross domestic savings in 1993-1994 (Mayya (1995)). Another indicator of an extremely active primary market is that in 1994-1995 nearly 1700 companies raised equity capital (either through direct offerings to the public or through rights issues); of these, 369 were new companies (RBI, 1995).

Singh (1995a) has examined the financing of corporate growth in ten industrialising economies (including India) during the 1980s at a micro-economic level. His sample for each country normally consisted of one hundred largest listed manufacturing companies which existed

⁵See for example King & Levine (1993)

throughout the period 1980-1990. Table 1, reporting his results for India, indicates that the average Indian corporation, during the 1980s, financed about 40 percent of its growth of 'net assets' (the long-term capital employed in the firm) from internal sources (ie. retained profits) and 60 percent from external sources. Of the latter, nearly a third came from equity issues and two thirds from longterm debt. The three financing variables obey the basic accounting identity that the total growth of net assets equals the sum of the internal and external sources of finance. The above results pertain to 1980-1990, but in view of the enormous stockmarket activity in the 1990s, the importance of stockmarket finance, would be even greater for the later period.

This large recourse to external and particularly stockmarket finance by the Indian companies is theoretically surprising as is the great number of stockmarket listings. An underdeveloped capital market, by its inability to provide the desired external finance, may be expected to oblige corporations to grow largely from internal sources. Moreover, in an imperfect stockmarket, which operates like a "snake pit", firms would be discouraged from raising such finance and indeed from seeking a listing at all. Economic theory suggests that in an emerging stockmarket, where information gathering and dissemination activity is not adequately developed, and where most firms have not yet built a 'reputation', the pricing of the firms' shares will tend to be arbitrary and volatile [Tirole, 1991]. This should discourage risk-averse firms from raising stockmarket finance. Moreover, developing country firms are likely to be family-controlled which should also inhibit them from issuing new equity for the fear of losing control. Further, as Schleifer and Vishny (1996) note, if there is inadequate legal protection for the investments of minority shareholders (as is common in emerging markets), one would expect households, or

even prudent institutions, not to buy company shares.

It will be useful in this context to consider the financing of corporate growth in advanced countries. These corporations are widely thought to follow a 'pecking order' according to which firms rely largely, if not entirely, on internal sources to finance their growth. If more finance is needed, they use long-term loans or bank borrowings, and only as a very last resort go to the stockmarket to raise funds. When there is a separation of ownership and control, and when managers are able to pursue their own goals, it is not difficult to see why firms may shun the stockmarket. For management-controlled corporations, internal finance is clearly a cheaper and easier source of finance than the stockmarket where financing is only available subject to wide public scrutiny. However, in a classic contribution, Myers and Majluf (1984) showed that if there was asymmetric information between managers and shareholders, it would be rational even for profit-maximising managers to follow the above 'pecking order'.

Myers and Majluf's general argument applies equally to developing country corporations. However, although the average Indian firm in Table 1 does deviate somewhat from the expected 'pecking order', it is its heavy reliance on external finance and the considerable use of equity finance which are more anomalous for the reasons outlined earlier. However, Table 2, which provides comparative data for ten industrialising countries, shows that the Indian case is by no means unique. The typical Korean corporation financed more than 80% of its growth of net assets from external sources. The corresponding figures for Turkey, Mexico and Thailand are 84.7%, 75.6% and 72.3% respectively. Table 2 also shows that corporations in several sample

countries resorted to equity finance during the 1980s to an even greater degree than their counterparts in India. The 'pecking order' theory is comprehensively violated for nearly half the sample countries. Singh (1994,1995a) has provided an explanation of these anomalous phenomena (including that of the large number of listings in markets such as India's) in terms of: (a) the special circumstances of developing country financial markets in the 1980s, (b) the situation in advanced country markets, and (c) and the encouragement of stockmarket growth by developing country governments in order, inter-alia, to implement privatisation.

III.2 Is the contribution of equity finance to Indian corporate growth overstated?

In a recent paper, Cobham and Subramaniam (1995) [C & S] suggest that the methodology used in Table 1 overstates the contribution of equity finance to Indian corporate growth and therefore exaggerates the apparently positive role of the stockmarket. Using the alternative methodology of Mayer (1990), Corbett and Jenkinson (1994)[MCJ], the C & S estimate of the contribution of new equity to Indian corporate investment is considerably smaller.

The differences in the empirical results are indeed due to the different methodologies used in the two exercises. The respective methods however have important implications for economic interpretation of the results. The following points are salient:

First, MCJ include depreciation as a major component of internal finance, whereas in Singh (1995a) [Tables 1 and 2] it is excluded both from the numerator and the denominator in the

relevant ratios. As Singh's research is concerned with measuring the sources of finance for corporate growth of "net assets", it necessarily focuses on the net increase in corporate assets - the depreciation provision for replacement is normally required to merely maintain the stock of assets (see further Prais [1975] for a classic discussion).

Secondly, the MCJ method, when used with the flow-of-funds data (as is generally the case), relates to the corporate sector as a whole, rather than to the individual firms. In this approach intra-corporate sector transactions are normally "netted out" and external finance means funds from outside the corporate sector. Therefore, the question being addressed by MCJ with the flow-of-funds data is: how is 'investment' of the corporate sector as a whole financed, by internal sources (within the corporate sector) and by external sources (from outside the sector, eg. the household or the financial sector). This is a different question from that addressed by Singh, who uses firm-level accounting data to enquire how individual corporations, rather than the corporate sector as a whole, finance the growth of their net assets, net of depreciation.

Thirdly, the differences in the corporate financing patterns between developed and developing countries are greatly reduced when these patterns are estimated by the use of the same methodology - whether MCJ or Singh (see further Singh, 1995a).

In short, the MCJ and the Singh methods are addressing different questions: the latter is concerned with the growth of corporate 'net' rather than 'gross assets', and is considering the financing question from the perspective of the individual firm rather than that of the corporate

sector as a whole.

However, leaving aside these methodological issues, two things are clear. Firstly, the stockmarket has made a far greater contribution in the 1980s and the 1990s to Indian corporate growth than it ever did before. Secondly, the observed pattern of corporate financing for India and several other industrialising countries runs contrary to theoretical expectations.

III.3. The stockmarket financing of corporate growth and the real economy

An important reason why so much finance was raised from the stockmarket by the Indian corporate sector in the 1980s and 1990s was the share price boom which occurred during this period. The Bombay Sensitive Index rose from 123.6 in 1980 to 396.4 in 1985, to 1,040.7 in 1990 to 2,222 in 1992, to over 4,000 by the summer of 1994. However, the market has slumped over the following two years, as is reflected in the end-year index values: 1994, 3,845; 1995, 3,109; and 1996, 3,104.

Confining attention for analytical purposes to the decade 1980-1990, there was a well over eight-fold increase in share prices, while consumer prices rose by less than 10 per cent per annum during this period. Singh (1995a) estimated that between 1980 and 1985, the total (dividend plus capital gains) nominal return to a stockmarket investment was 33 per cent and the real return was 23 per cent; the corresponding nominal and real returns for the period 1986 to 1990 were 26 per cent and 18 per cent respectively, which gives an average real return of 20 per cent for the decade as a whole.

There is agreement that the stockmarket boom of the 1980s was induced by government policy measures (Balasubramanian (1993); Nagaraj (1996)). By the early 1980s, neither the development finance institutions (DFIs) nor the commercial banks could meet their government-imposed requirements to lend to the priority sectors at concessional rates and also meet the private corporate needs. The Reserve Bank of India therefore advised the mobilisation of household savings through capital market expansion for meeting the corporate sector's requirements. This led to several fiscal incentives which helped to greatly increase the number of investors on the stockmarket, mainly through the growth of mutual funds. In that sense the post-1991 reforms can be regarded as a continuation of the process which began in the 1980.

The stockmarket boom created by the entry of large numbers of domestic and subsequently foreign investors (as external liberalisation proceeded in the 1990s) into the capital market, lowered the cost of capital for the Indian corporations encouraging them to raise large amounts of stockmarket finance. A central question is: has this benefitted the real economy?

There is scant empirical work on this subject, but an important recent contribution by Nagaraj (1996) provides very useful information for the period 1980-91. His relevant findings are as follows.

1. The huge increase in stockmarket financing activity is not associated with either a rise in aggregate gross domestic savings, or equally significantly, with an increase in the proportion of

financial savings. Gross domestic savings as a proportion of GDP at market prices reached its peak level of 23 per cent in 1978-9. The savings ratio was, however, generally lower throughout the 1980s, and not higher. The financial proportion of the gross domestic savings fell from its peak level of 55 per cent in 1984-85 to 42-45 per cent in the second half of the decade. However, there was a big change in the composition of financial savings. The share of corporate debentures and equities in total financial savings rose from 3.3 per cent in the 1970s to 6 per cent in the first half of the 1980s, and to 11.8 per cent in the second half of the decade. Over the same periods, the corresponding figures for bank deposits were 45 per cent, 39 per cent and 27 per cent respectively. Thus the enormous stockmarket activity in the 1980s basically involved a portfolio substitution by households and institutions from bank deposits towards stockmarket instruments.

2. Using both aggregate accounting as well as the flow-of-funds data for the private corporate sector as a whole, Nagaraj reports a considerable fall in the 1980s in the proportion of either gross or net fixed capital formation which was financed through internal sources, ie retained earnings or depreciation. This combined with other evidence in his paper suggests that the increase in external finance available to the corporate sector through the capital market appears, to an appreciable extent, to have replaced corporations' internal funds during this decade. This could in part be due to a decline in corporate profitability (see below).

3. Importantly, Nagaraj also reports some increase in the corporate sector's gross fixed capital formation as a proportion of (1) GDP at market prices, (2) of the aggregate fixed capital formation. However, whether this observed increase can be ascribed to the growth of the capital

raised on the stockmarket is more problematical. Nagaraj finds that whereas there was previously a statistically positive correlation between the annual growth rates of capital raised externally and the corporate fixed capital formation, the relationship between the two variables (including that with suitable lags) has become statistically insignificant in the 1980s. It is however still positive but the value of the coefficient is much smaller (.25 between 1980-81 to 1990-92, versus .45 between 1961-62 to 1979-80)

4. On the question of whether or not the stockmarket activity has led to improved productivity of investment, Nagaraj provides two pieces of evidence. First, he finds that the growth rate of real value added in the corporate manufacturing sector in the 1980s was lower than that of the registered manufacturing sector as a whole. This suggests that the smaller non-corporate firms which did not have access to stockmarket funds were able to grow at a faster rate than the larger corporate firms. Secondly, there was a secular decline in corporate profitability during the 1980s, a result which is similar to that of Singh (1997a) for the hundred largest Indian quoted companies. Of course it could be argued that the fall in profitability does not indicate a decline in efficiency, but that it simply reflects greater product market competition as a result of liberalisation.

The above hypothesis can fortunately be tested on the data available in the IFC data bank. The data bank permits a decomposition of the rate of return into two components: the profit margin (profits/sales) and output-capital ratio (sales/net assets). The results show that secular fall in profitability of the 100 largest firms in the 1980s was entirely due to a decrease in the

productivity of capital rather than a reduction in profit margins. The latter event is what would have been expected if the fall in profitability had been caused by greater product market competition.

Nevertheless, it could still be argued within a neoclassical framework that reduced profitability does not necessarily indicate inefficiency since the real cost of capital had fallen. The latter however was caused by the stockmarket boom which was by no means permanent. This leads to a related point which is concerned with the volatility of share prices. Share prices in India in recent years have been highly volatile (El-Erian and Kumar (1995)). Apart from the other drawbacks of volatility, we note in the present context that it reduces the efficiency of the stockmarket pricing signals for allocating investment resources. (Tirole, 1991)

In assessing the effects of stockmarket expansion on the real economy, in addition to its effect on savings, investment and the productivity of investment, it is also necessary to examine the impact of foreign portfolio capital inflows. As a consequence of the government's external liberalisation measures in the post-1991 period, there was a huge increase in such flows. Joshi and Little (1996) report that non-debt creating private capital inflows in 1993/94 amounted to \$4.1 billion and to \$4.9 billion in 1994/95. Nearly three quarters of these comprised portfolio equity capital, including share issues by Indian companies on overseas stockmarkets.

At one level, these capital inflows helped the real economy. The flows contributed to resolving the liquidity crisis of 1991 and to assisting the central bank to build up sizeable foreign exchange

reserves; the latter reached a high point of nearly \$20 billion in 1994/95. Ironically, these foreign exchange reserves helped to reduce the government's dependence on the IMF giving it extra degrees of freedom to pursue a more independent economic policy if it wished or if it was politically required.

However, the government has also been keenly aware of the dangers of such flows. Although these flows were non-debt creating, they could not be regarded as being permanent. Their sudden withdrawal could land the economy in difficulties similar to those experienced in Mexico. As Singh (1996a; 1997b) points out, a sudden withdrawal of these portfolio flows for totally extraneous reasons could lead to a negative interaction between two inherently unstable markets, the currency and the stockmarkets, which could do enormous damage to the real economy. The Indian government has followed generally pragmatic and prudent policies towards these inflows, including taxation measures to discourage short-term flows and sterilisation. The present author would concur with Joshi and Little's (1996) judgement that the government policy in this area has been broadly sensible and successful. Although portfolio capital inflows do create serious macroeconomic difficulties, the government policy measures have so far stopped them from doing any harm to the real economy.

To sum up, the available evidence suggests that despite the benefits of stockmarket expansion to the corporate sector, the real economy in the 1980s does not appear to have benefitted from either increased savings and investment or greater productivity of investment allocation. On the other hand, the government's policy stance towards portfolio capital flows enabled it to prevent any

harm to the real economy from the huge capital surges which occurred in 1993/94 and 1994/95. It should, however, also be recorded that much of the evidence on savings and investments and resource allocation outlined above refers to the period 1980-90. The data for the 1990s could in principle lead to a more favourable verdict. Nevertheless, it is worth noting that the real economy, particularly industry has achieved its fastest growth in the last two years when the stockmarket has not been doing well. During 1995/96 and 1996/97 the real economy has expanded at a rate of nearly 7% per annum - quite unprecedented for India. In the same period, the Bombay Sensitive Index has fallen from its peak of over 4,000 in the summer of 1994 to 3,104 on December 31 1996. All this would suggest that the stockmarket may have so far been a 'sideshow' with relatively little impact, positive or negative, on the real economy. However, with the advent of the market for corporate control, the stockmarket will become much less of a sideshow. It is likely to come to play a much more prominent role in the real economy, arguably to the latter's considerable disadvantage as will be suggested below.

IV. The Market for Corporate Control: Theory and Evidence

IV.1. Takeovers and the Stockmarket: Analytical Considerations

In textbook theory, takeovers provide an economy with an important additional mechanism through which the stockmarket can promote a more efficient utilisation of capital resources. There are two distinct ways in which the establishment of a market for corporate control may do

this.

- 1) The threat of takeovers may lead inefficient firms to perform better;
- 2) Even if all firms were on their efficiency frontier their amalgamation through the act of takeovers may lead to a better social allocation of resources through synergy.

Moreover, there are many quoted companies which hardly ever raise stockmarket finance as they have adequate internal sources for their expansion. Such firms cannot therefore be disciplined by the normal pricing process of the stockmarket whereby the efficient companies are rewarded with, other things being equal, high share prices and a lower cost of capital and the inefficient firms face a higher cost of capital. However, even these firms, if they are inefficient, would be subject to the direct sanctions of the market for corporate control.

Nevertheless, more recent economic analysis suggests several reasons why these potential virtues of a market for corporate control may not actually materialise in the real world. To summarise:

1. Real world markets for corporate control even in advanced economies are subject to an inherent imperfection: it is far easier for a large firm to take over a small one than the other way around (Hughes (1991); Singh (1992)). Although a small efficient firm can in principle take over a large inefficient corporation (and to some degree this did happen in the U.S. takeover wave of the 1980s through "junk bonds"), its incidence is very small.

This consideration is particularly important for developing countries like India where there are large, potentially predatory conglomerate groups⁶. These could take over smaller, more efficient firms and thereby reduce potential competition to the detriment of the real economy. In a takeover battle it is the absolute firepower (absolute size) which counts rather than relative efficiency.

2. The efficient operation of takeover mechanism requires that enormous quantities of information are widely available. Specifically, how profitable is each firm under its existing management and what would be its potential under any other management if it were taken over. Such information is not easily available even in advanced countries (Helm, (1989)). For reasons discussed earlier, it would be far scarcer in emerging markets.
3. There are in practice huge transactions costs involved in takeovers in countries like the US and the UK which hinder the efficiency of the takeover mechanism. Changing management through takeover turns out to be a very expensive way of accomplishing this task (Peacock and Bannock (1991)). This consideration is particularly important for developing countries which can ill afford such high transactions costs.
4. Recent work based on asymmetric information, signalling and involving the concept of signal jamming suggests that the market for corporate control may not just be inefficient but may

⁶ See further Amsden and Hikino, 1994; Singh, 1995a.

in fact generate perverse outcomes. Stein (1989) showed that under plausible assumptions if the information about the firm's operations is, or is perceived to be asymmetric, it may pay rational managers even in rational markets to be myopic. This would lead to short-termism and to lower rates of investment than would otherwise be the case - an issue which is particularly significant for developing countries trying to achieve fast economic growth.

5. A similar socially perverse outcome of the takeover process has been suggested by Schleifer, Summers, and Vishny.(19??) They point out that the takeover mechanism in the US is often used as a device not to honour the implicit contracts of workers in the acquired firm with the pre-acquisition management. Such abandonment of implicit contracts according to the authors is socially harmful because it discourages firm-specific accumulation of human capital by workers.

Takeovers could also in principle reduce previous over-manning. Which outcome actually prevails will depend on the specific circumstances. It may be suggested that in countries like India with strong employment protection laws, the Schleifer et al line of reasoning is not relevant. However, if such laws were to be repealed under the economic reform, this argument will become significant.

6. Grossman and Hart (19??) have suggested that because of the "free-rider" problem, the takeover mechanism may not work efficiently. Any individual shareholder may feel that their action is unlikely to affect the outcome of a disciplinary takeover bid. It would therefore be best

not to accept the raider's offer and to wait until the share price increases further after the successful bid. Grossman and Hart argue that if all shareholders act in this way, the disciplinary takeover bids will not materialise. Indeed in these circumstances, raiders will not have adequate incentives to undertake such bids at all.

The Grossman and Hart theory, however, applies only to disciplinary bids. In practice it is difficult to distinguish between such raids and those undertaken for other motives, for example, empire-building or increasing monopoly power. The latter motives, however, are likely to be very relevant in many emerging markets because of the presence in these countries, as mentioned earlier, of large conglomerate business groups.

IV.2 Evidence on Takeovers

Although there are embryonic markets for corporate control in a few developing countries (eg. Brazil, and for that matter even in India⁷), most do not yet have hostile takeovers and fullfledged markets for control. The evidence on the characteristics and operations of such markets can therefore only come from advanced countries such as the UK and the US.

IV.2.A Selection Process and the Threat of Takeovers

⁷ For Brazil see Acquisitions Monthly (19??); for India see Business Line (May 1997).

Singh (1971,1975) were among the first studies to systematically examine the nature of the selection process in the market for corporate control. This involved a comparative analysis of the multivariate characteristics of four kinds of populations of firms :the acquired, the acquiring, the non-acquired, and the non-acquiring. Singh's research was based on takeovers in the UK and covered two periods - one of normal takeover activity (1954 to 1960); and the other of the takeover boom of 1967 to 1970. His results have proved to be extremely robust and have been confirmed in most subsequent studies both for the UK and the US⁸.

The central finding of the Singh's exercises can be summarised as follows. Contrary to the expectations of neoclassical theory as well as the folklore of capitalism, selection in the market for corporate control does not take place entirely on the basis of efficiency , ie profitability or stockmarket valuation. Although profitability matters, absolute size matters much more. A relatively unprofitable large company has a much better chance of survival than a small profitable company. Moreover, it is almost always the large which takeover the small. Thus the acquisition process may indeed act in a perverse way since a large unprofitable company can increase its immunity to takeovers through the takeovers process itself - by becoming bigger through the acquisition of small firms⁹.

IV.2.B. Effects of Takeovers: Microeconomic efficiency

⁸For the UK studies see Meeks (1977); Cosh, Hughes and Singh (1980,1989, 1996); for the US see Schwarz (1982); Mueller (1980; Warshawsky (1987); Ravenscraft and Scherer (1989). For recent review articles see Hughes (1991), Singh (1992,1993a).

Apart from the threat of takeovers and the nature of the selection process, there is a large literature for industrial countries on the effects of actual takeovers on the post-merger efficiency of acquiring firms. Here there is an important divide between industrial organisation studies based on accounting data and studies by financial specialists which use stockmarket data. The former invariably show that on average, controlling for the effects of industry and of the business cycle, the post-merger profitability of the amalgamating merging firms declines relative to their weighted average of the pre-merger profitability. Since the amalgamated firm is likely to have greater (and certainly no less) monopoly power than the pre-merger firms considered on their own, this empirical finding is interpreted as indicating mergers lead on average to a decline in micro-economic efficiency.

A radically different view of the efficiency of mergers comes from specialists in finance who use stockmarket data and the so-called 'event studies' methodology to investigate the effects of mergers. Here the basic empirical finding is that in the period immediately preceding the takeover event the is on average an appreciation of the value of the victim firm by about 20%, while the raider's stockmarket value either remains the same or appreciates or depreciates by a relatively small amount. Since the overall result of the merger is an increase of about 20% on average in the stockmarket value of the amalgamating firms, finance specialists conclude that this reflects an increase in net social welfare.

⁹ See further Greer (1986) and Singh (1971)

This inference is, however, subject to an extremely important qualification. It is valid only if the real world share prices are always efficient in Tobin's (1984) fundamental valuation sense, i.e., relative share prices of firms reflecting their relative (rationally) expected earnings. There is considerable support for the hypothesis that share prices are, broadly speaking, efficient in what Tobin calls 'the information arbitrage' sense, i.e., that all information percolates quickly in the market and is therefore immediately reflected in the price. Such efficiency, however, does not necessarily imply efficiency in the fundamental valuation sense.

There is a large body of analytical and empirical work to indicate that share prices are often dominated by whims and fads, by speculators and the so-called "noise traders."¹⁰ Several investigators have suggested that the observed increase in the aggregate value of the merging firms is more satisfactorily explained in terms of other theories. Charkham (1989) suggests, for example, that there is at any time a normal share price for a company based on its future prospects, reflecting valuation at the margin. However, when this company is put into 'play', or becomes the subject of an actual or rumoured takeover bid, its price goes up. This does not reflect an increase in the social value of the company's assets, but simply the higher price which has to be paid in order to buy out the intramarginal shareholders for the control of the company. This alternative theory is compatible both with the industrial organization economists' more or less universal finding, mentioned earlier, of a post-merger decline in profitability and efficiency of merging firms. It is also compatible with another important result in the literature

¹⁰ See further the collection of papers presented in the Symposium on Bubbles, *Journal of Economic Perspectives*, Vol.4 No.2, Spring 1990

which shows that sometime after the merger 'event', the share price of the acquiring company almost always declines.¹¹

IV.2.C. Takeovers and Industrial Structure

In assessing the economic effects of takeovers, it is also essential to take into account their impact on the structure of industry. Here the evidence for the advanced countries is ambiguous.

In the 1950s and 1960s mergers are generally thought to have contributed to an increase in industrial concentration, both in the US and in the UK. However, in the 1970s and 1980s, despite the big merger wave of the 1980s in both countries, there was little increase in industrial concentration. The reason for this ambiguity is essentially that changes in industrial concentration also depend on a number of factors. These factors can easily outweigh the normal concentrating effects of mergers.¹²

IV.2.D Takeovers and short-termism

An important allegation against the takeover mechanism in the USA and the UK is that it encourages short-termist behaviour. At the simplest, the argument is that managers in the Anglo-Saxon firms are obliged to meet the earnings per share target (set by market expectations) every

¹¹ See further Frank, Harris and Meyer (1988); Ruback (1988); Hughes (1991).

¹² There is a large literature on these issues. It is reviewed in Hughes (1991) and Singh (1992).

quarter or every half year, depending on the frequency of the stockmarket's reporting requirements for corporate earnings. If these market expectations of short-term earnings are not satisfied, the firm's share price falls making it vulnerable to takeover. At the same time, on the other side of the market, the investors who are by and large the institutional fund managers, are also obliged to have a short-termist outlook. This is because of the highly competitive structure of the fund management industry and the fact that fund managers' own performances are often judged by their principals on the basis of their performances over relatively brief time periods. The net result is a culture dominated by immediate gain and takeover speculation on both sides of the market.¹³

Survey results for the UK indicate that the chief executives of British companies spend an inordinate amount of their time on 'road shows' - making presentations to investors at home and abroad. Similarly, considerable energy is devoted to either avoiding being taken over themselves, or in planning acquisitions of other companies. This distracts from their chief managerial task of creating new products, winning markets and satisfying customers needs in an increasingly competitive global economy. Similarly, there is survey evidence for the USA which indicates high 'hurdle' rates and short pay-off periods for investments by corporations in that country (Porter (1992)).

IV.2.E Experience of Japan and Germany

¹³ For a fuller discussion of these issues, see further Singh (1995b) .

In examining the virtues or the lack of them, of the market for corporate control in industrial countries, it is relevant and instructive not only to consider the experiences of the USA and the UK but also to look at those of Japan and Germany. The latter two countries do not have a free market of corporate control in the Anglo Saxon sense whereby raiders can mount hostile takeover bids against the wishes of the incumbent management. The incidence of hostile takeovers is extremely rare in either country. Odagiri (1994) ascribes the Japanese phenomenon to that country's life time employment system in large corporations. It is also due to the pattern of shareholdings in Japanese companies whereby 75% of a typical corporation's shares are held in "friendly hands", ie. the corporation's suppliers, subcontractors and other stakeholders. With only about a quarter of the shares with the general public, it is unlikely that there will be hostile takeover activity. The virtual absence of a market for corporate control in West Germany is attributed by the students of the subject to a number of factors, including the corporate culture of the country, the 1976 co-determination act and the employee representation on the corporate supervisory boards, and the concentration of share ownership.

In the context of this paper a central point is that the lack of a market for corporate control has not in any way held back economic development in these countries. Indeed, the extraordinary post-war success of these economies and their ability to dominate world markets is thought by many to be precisely due to the fact that managers in these countries were not subject to a constant threat of takeovers enabled them to pursue long term investments, to seek to expand their share of world markets rather than to be concerned with short-term movements in share

prices or profits.¹⁴ Particularly important in this respect has been the ability of the corporations in these countries to invest in the training of their work forces. Equally significantly, with a stable corporate environment to which the absence of hostile takeovers make an important contribution, the workers have the necessary incentives to undertake expensive investments in firm-specific human capital, ie. unlike in the USA and the UK, the Japanese and the German workers could count on their implicit contracts being honoured.

V. Conclusion and Policy Implications

The enormous expansion of stockmarkets in India since 1980 has been a part of a worldwide trend towards deregulation, financial liberalisation and globalisation. The Indian corporate sector has benefited considerably and directly from this evolution which has in a large part been induced by the government's internal and external liberalisation measures. Contrary to a priori expectations concerning developing country firms and the capital markets, Indian corporations have been willing and able to raise large sums of money (including more recently foreign exchange) at competitive rates from the stockmarkets. However, despite this largesse for the corporate economy, it is difficult to detect any gains to the aggregate real economy, at least in the 1980s. During that period there was no rise in the overall savings rate; evidently, all that happened was portfolio substitution by households and institutions from bank deposits to

¹⁴ For a fuller discussion of these issues and the survey evidence on managerial objectives in the USA, Germany and Japan see Abegglen and Stalk (1985); Blaine (1993); Kojima (1995) and Singh (1996b).

corporate securities. It is also problematic to attribute variations in corporate investments to variations in resources raised from the stockmarkets, essentially because the latter tended to replace corporations' internal resources, i.e. corporate savings. Nor is there evidence of a more productive use of investment resources. Nevertheless, the government's prudent handling of portfolio capital inflows has ensured that the country did not suffer any serious losses from the surges in such flows which occurred. Thus as far as the progress of the real economy is concerned, despite their extraordinary expansion during the last fifteen years, the stockmarkets so far have been a side-show.

This situation may however change with the market for corporate control, the advent of which would appear to be imminent. As Business Line (March 2, 1997) reported: "mergers, takeovers, de-mergers, divestments and de-subsidiarisation have become fairly commonplace on the Indian scene, especially over the last two years". Left to itself, with the enormous profits to be made on takeovers by merchant banks and other players, there may be sufficient political momentum to enable a full-fledged market for corporate control to emerge within a relatively short time.

The important question is whether the evolution of such a market would be conducive to Indian industrialisation and faster economic growth. The review of the analysis and evidence on the markets for corporate control in the USA and the UK indicate several drawbacks, particularly from the perspective of economic development. First, takeovers greatly intensify the normal stockmarket pressures towards speculation and short-term returns. Secondly, there is no evidence that the market works in such a way as to always punish the inefficient and unprofitable

companies and reward the efficient ones. Empirically, selection in the market for corporate control occurs much more on the dimension of size than that of profitability or the firm's stockmarket valuation. Thirdly, an active market for corporate control is likely to seriously distort the incentive system facing corporate managers. In Japan and Germany, which do not have markets for corporate control, managers are induced to seek the organic growth of the corporation they work for. In contrast, incentives in the Anglo Saxon system emphasise financial engineering and growth by merger. Fourthly, in view of the existence of large conglomerate enterprises in India as in many other developing countries, a freely functioning market for corporate control runs serious dangers of increasing concentration of industry as well as stifling the development of small and medium-sized efficient firms. Finally, it is particularly relevant for developing countries to bear in mind the huge transactions costs involved in takeover activity, as well as the very large unfavourable re-distributions of wealth it often leads to.¹⁵

There are serious problems with the present Indian system of corporate governance: conflicts of interest and lack of cohesion among many controlling families, the adverse effects of large inter-locking, inter-group investments on small shareholders in the group companies; the total exclusion of ordinary shareholders from decisions with respect to corporate re-structuring, mergers, divestments etc. It may therefore appear attractive to deal with the whole gamut of such governance problems through the invisible hand of the market - by the evolution of the takeover mechanism. However the evidence surveyed in this paper from advanced countries suggests that

¹⁵ On takeovers and wealth distribution, see Schleifer and Summers (1988).

the end result of this whole process may not necessarily be better and could be considerably worse than the current situation. The government should follow the example of Japan, Germany and other countries in Europe and attempt to find other ways of solving these governance problems. A developing country like India simply cannot afford the burden of an extremely expensive and a hit and run system of management change which takeovers represent.

The country today stands at an important juncture with respect to questions of corporate governance and of further capital market development. One alternative will be - and unfortunately the one most likely to be followed more by default than by design in the absence of a serious debate - to continue the present drift towards the establishment of the market for corporate control. Another, and the one proposed here, is that the government should take a leaf from the Japanese book and simply not allow such a market to develop.

If the government were to accept the wisdom of the second course, complimentary actions would be required in two important areas. First, the government should take steps to improve the lead bank system which has been in operation in India for the last four decades. This system has not worked as effectively in India as it has in Japan and South Korea. At the theoretical level, there is general recognition of the many advantages of this system relative to a stockmarket based one. The lead bank system has lower transactions costs and is much better able than the stockmarket to deal with problems of asymmetric information and agency costs as well as short-termism. Bhatt (1995, 1996) has recently provided an excellent institutional and empirical analysis of the reasons why the lead bank system has been less successful in India than in Korea and Japan. His

observations and conclusions would be a useful starting point for a purposive programme for remedying the shortcomings of the system in the Indian context.

The second group of complementary policies in the absence of a market for corporate control would involve stimulating much greater competition in the product markets. In the normal calculus of a capitalist economy, such competition is the main constraint on inefficient managements. In the current Indian context, this would require inter-alia a fundamental rethinking of the government policies on exit.

In conclusion, this paper will be a fitting tribute to Dr Manmohan Singh if it leads to a serious discussion on the desirability of the market for corporate control in India: Should its evolution be welcome or, as argued here, should it be regarded as "a bridge too far" at the present and foreseeable level of development of the Indian economy?