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The continued existence of the defunct exchanges and businessless brokers presents a classic case of market and state failures

Market muddle or natural monopoly? Big fish flourish, small perish

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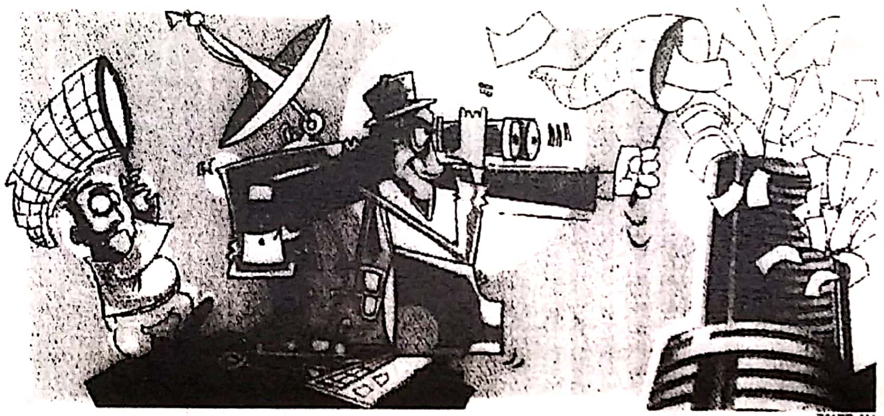
THE time has come', as Lewis Carroll spoke of 'Kings and cabbages' to speak of men and material, lazy, sleeping and sloth littering and the few vibrant ones adorning the market landscape. The time has come for a clean up call for the health of the healthy few and thereby for a healthy market!

At the end of March 2007, there were 21 recognised stock exchanges and 9,443 registered brokers in India. Of these two exchanges, namely, NSE and BSE, which had 1017 and 925 brokers respectively, reported 99.99% of turnover during 2006-07. Top 100 brokers of each of these two exchanges account for about three fourth of turnover on cash segments. Thus, the raison d'être of 19 exchanges and associated 7,500 brokers has disappeared. A vast majority of brokers on NSE and BSE have marginal, also-in-the-business existence. Other participants and intermediaries in the securities market have similar excess capacity. In biological terms, some of the participants have grown enormously in size strangling others like huge banyan trees: natural growth in a situation of natural monopoly.

The exchange business presents one of the clear examples of natural monopoly — where greater productive efficiency is achieved with higher scale of operation. With intensive use of technology in trading, clearing and settlement, setting up an exchange requires substantial initial cost, while the marginal cost of operation is negligible. Further, network externality is inherent in exchange business — if the volumes on an exchange reaches or goes beyond the threshold level of liquidity, the liquidity begets liquidity. If it falls below that level, the liquidity dries up. As a result, the big becomes bigger trampling the small players unknowingly: like Gulliver in the land of the Lilliputians. These operational features provide strong incentive for an exchange to operate at a higher scale and become a monopolist. Since all exchanges initially set up systems, but business concentrates in a few in course of time, most of them end up having excess capacity. This is not desirable from an economic efficiency angle.



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The cost of setting up systems and ensuring compliance of heightening rules and regulations have become too heavy for small brokers to shoulder. This trend would continue – big brokers will continue to invest in technology and human resources and expand, while small brokers would fail to do so and consequently fail to provide quality service to clients and gradually be forced to withdraw from the market. This is exactly parallel to the business of stock exchanges – most of the brokers have excess capacity. As one or two stock exchanges can now cater to the needs of the entire market (which may be true for the global market in the medium future), a few brokers, with financial muscle and superior technology, can also cater to the needs of the whole market.

There was a time when we needed a large number of exchanges spread across the length and breadth of the country through a widespread network of brokers. The circumstances have changed making most of them redundant. The market simply does not have space for many exchanges and thousands of brokers. We are in a catch 22 situation: there is neither enough justification for their continued existence nor do we like to hasten their exit. We seem to be waiting for their natural death, which is not happening for a long time. As a result, clinically dead exchanges and brokers have blocked sizable resources, a part of which can be released for some other use without affecting the quality or quantity of output. This is akin to disguised unemployment, which was supposed to be a feature of the primary sector affected by seasonality. Who ever thought a vibrant service sector such as financial services would be a victim of the poor primary sector disease! In any case, the standard remedy for such syndrome, a la Arthur Lewis, is to withdraw or transfer the underutilised resources to other uses, which would improve overall productivity.

An economic agent carries on business as long as it earns normal profits; it pulls down shutters when failing on this target. Despite their non-performance, the redundant exchanges and brokers are not voluntarily exiting from the market. This soft market resembles a typical soft state where economic agents do not receive or fail to receive the signals emanating from the economic environment and respond to them appropriately. Consequently, the market has failed to reach desirable outcomes in resource use. This is striking because these are the organisations which profess to ensure the best allocation of resources. If market is efficient and yielding desirable outcomes, the state is not expected to interfere in their functioning in normal circumstances. The state is, however, expected to interfere if the market malfunctions. When the economic agents, for whatever reason, do not receive the right signals or make use of opportunities available in the environment, the state needs to guide them. Unfortunately, when the exchanges and brokers are having huge excess capacity, the state is not guiding them properly. Supporting their continued existence is not helping allocative efficiency either: it is like swimming against the powerful currents unleashed by technology and market forces with very little chance of success.

The continued existence of the defunct exchanges and businessless brokers presents a classic case of market failure and state failure. It is market failure because the economic agents have failed to receive the signal emanating from the changing environment. It is state failure because it has not incentivised the optimum utilisation of resources. This continuity-at-whatever-cost approach is not only increasing the moral hazard problem but also keeping cost of regulation high. Hastening the exit of the defunct entities assumes importance both for the sake of better resource use as well for reducing the regulatory cost by cleaning up the system.

(Sahoo is with [illegible] [illegible])