Stock Market Crashes: Reasons and Implications

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Abstract

This paper aims to investigate and compare two stock market crashes in Bangladesh and suggest policy measure to prevent such collapses in the future. In doing so, it was found that the crashes have certain similarities between them in numerous aspects. Finally, policy measures such as building the confidence of investors, reducing moral hazard, educating the investors, empowering the regulators etc. were suggested.

Keywords: Stock Market Crash, Bangladesh, Dhaka Stock Exchange, Securities and Exchange Commission

1. Introduction

Stock market constitutes a complex exemplary system having interaction with various interconnected networks. It plays a big role in global and national economy that directly or indirectly exerts influence on individuals' life. Stock market can increase steadily over the years, or have rapid changes wi-

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thin a week, or even crash within a day (Yu, 2004). A stock market crash, a big disaster, transmits huge impact on the economy by having impact on consumer spending and cost of capital on investment (Mishkin and White, 2002). Big crashes can even bring stagnation to an economy for more than a decade. Although it is very difficult to identify the exact cause of the crash, eliciting the reasons help the policymakers to devise appropriate policy measures to recover from the crisis.

Bangladesh has witnessed two major stock market crashes (1996 and 2011) having a permanent impact on the investment climate of the country. Both of these crashes caused panic among the small investors and resulted in negative public confidence in stock market investing. Which in turn affected the entire economy by making the economic policies less effective for a prolonged period of time. On this background, the purpose of this paper is to make a comparison between the two above mentioned crashes to find the causes and suggest measures to control them in the years to come.

2. History of DSE

The stock market of Bangladesh was born on 28th April, 1954, with the establishment of East Pakistan Stock Exchange Association Limited (EPSEAL) (DSE, 2007). Its formal trading started in 1956. In 1958 it was renamed as Dhaka Stock Exchange as a self regulating authority and shifted from Narayanganj to capital city Dhaka. During this period, the market was characterized by a small number of listed companies, narrow shareholding base and thin trading activity (Rahman, 2005). Banks were the main source of finance to the large manufacturing companies. Formation of Investment Corporation of Pakistan (later renamed as Investment Corporation of Bangladesh) was the first major step taken to introduce mutual funds, institutional investment, bridge financing and underwriting. There was no Securities and Exchange Commission at that time. Primary market activities were monitored by a government department under the ministry of finance named the Controller of Capital Issues (CCI).

After the independence of Bangladesh in 1971, Dhaka Stock Exchange suspended all its trading activities due to large scale nationalization of companies. All stock market activities entered into a period of dormancy. Its trading was resumed in 1976 with nine listed companies. This was due to the change in government policy to return ownership of some of the previously nationalized companies and issuance of licences to the private banks on a limited basis. During this period, Controller of Capital Issues used to loosely monitor the primary market activities. Issuing firms carried out most of the activities leading to share flotation with poor disclosure practices (Rahman, 2005). Investment Corporation of Bangladesh (ICB) established in 1976 was the lone investment banker and principal distributor of new issues.

The year 1993 is marked as a turning point for the stock market in Bangladesh because of the establishment of Securities and Exchange Commission (SEC) by transforming CCI into an independent body. In this particular year foreign investors also started showing interest on Bangladesh as an emerging market. During 1993 to 1995 a large number of primary issues came into the market where a significant portion was placed to foreign investors. This was not welcomed by the local investors as they were getting the leftovers. Eventually to protect local interest, one year *lock-in period* was imposed by the government on foreign investment, much to the displeasure of the privileged foreign investors (Rahman, 2005).

Table 1: Historical Development of Stock Market in Bangladesh

Year	Event	Remarks
1954	Establishment of East Pakistan Stock Exchange Association Limited (EPSEAL)	The first stock exchange of Bangladesh, erstwhile East Pakistan
1956	Formal start of East Pakistan Stock Exchange Association Limited (EPSEAL)	Very limited activity
1958	EPSEAL was renamed as Dhaka Stock Exchange	Primary market activities were monitored by a government department under the ministry of finance named the Controller of Capital Issues (CCI)
1971-1975	Dhaka Stock Exchange suspended all its trading activities	Large scale nationalization of companies
1976	Establishment of Investment Corporation of Bangladesh (ICB)	First investment banker and principal distributor of new issues
1976	DSE trading was resumed in 1976	Nine listed companies
1993	Establishment of Securities and Exchange Commission (SEC)	Independent regulator for stock market
1994-95	DSE attracted foreign investment	*Lock-in period* was imposed to protect local investors
1995	Second stock exchange named Chittagong Stock Exchange (CSE) started its operation in the port city Chittagong	An alternative to DSE having better infrastructure

Table 2: Security listing details at DSE and CSE

	Numbers	
	DSE	CSE
Listed Securities	500	239
Companies	231	200
Mutual Funds	37	36
Debentures	8	3
Treasury Bonds	215	
Corporate Bonds	3	

Source: DSE, 2011a and CSE, 2011

The security markets in Bangladesh were developing step by step and in 1995 another security market known as Chittagong Stock Exchange started its operation in the port city Chittagong, with the aim to assist local companies to raise capital locally and perhaps to create an alternative to DSE (see Table 1 and 2 for details).

3. Stock Market Crashes

3.1 Collapse of 1996

The year 1996 is considered as a milestone in the history of stock market development in Bangladesh. The market index of DSE kept on rising with the aid of expectations from the newly elected government after a year of political unrest. For the first time in the history of this country, stock market attracted the attention of common people such as housewives, pension earners, students and private employees. As the manual open outcry trading system of the DSE failed to cope with this huge demand, the road in front of DSE transformed into a long kerb market. With the absence of central share depository system, a lot of investors also ended up with trading for fake stock certificates.

In order to control price rise above 10 percent in a day SEC imposed *circuit breakers*. But even this could not control the mad rush and DSE (all share price) index rose from about 800 points in June, 1996 to around 3,600 in November, 1996. However, the unavoidable collapse began. Foreign investors safely offloaded their holdings with profit with the expiry of the lock-in period. Some proprietary traders also reaped their profits leaving the small investors to bear the suffering of sharp price decline and to see their valuable stock turning into paisa's. Government investigation team alleged

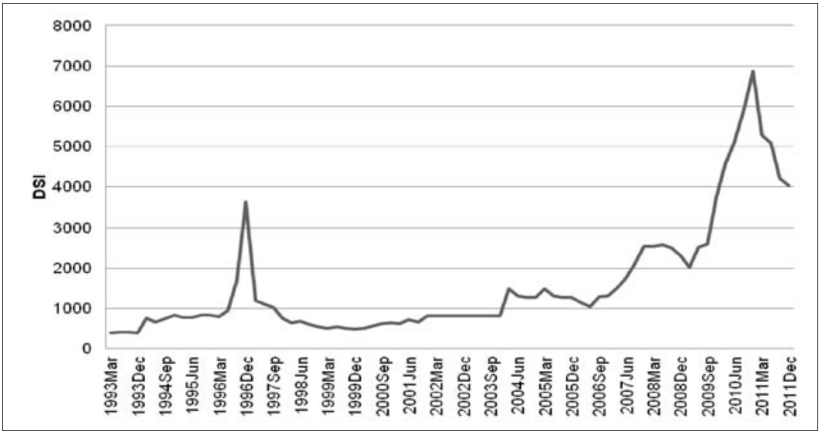

Fig. 1 : Movement of DSI **1993-2011**

some brokerage firms and companies to be responsible for this bull run without handing adequate penalty and punishment on time. However, DSE index kept on falling and reached 488 in 1999 (see Fig. 1).

The burst of stock market bubble in 1996 is considered as one of the worst nightmares for the small individual investors in Bangladesh. Some still hold negative impression about the stock market and share their experience with the new generation of potential investors. The stock market of Bangladesh slowly recovered from the 1996 crisis. New companies started to float shares. In the year 2002 a number of listed securities stood at 165 and DSE index at 822 (Islam et al. 2007).

3.2 Collapse of 2011

Again at the end of 2009 DSE stock prices started also to experience exponential rise. The DSE (SPI) index almost doubled from about 2,600 points in October, 2009 to about 4,600 in February, 2010. It continued to rise and hit as high as 6,800 points in December, 2010. Lower interest rate for deposits in the financial markets and short-term trading behavior of the investors accentuated the stock market bubble. Then again the same sliding started as in 1996s crash. The index started to fall and reached as low as 4,200 points in September, 2011 and further down to 4,040 in December, 2011 (see Fig. 1). Though certain uncoordinated policy changes by the SEC and Bangladesh Bank resulted in short-term up-tick in the market, eventually an abrupt fall could not be prevented.

In the wake of the market crash and protest from the small investors, government formed a committee to investigate into the crisis under the leadership of K. I. Khalid. Khalid submitted a comprehensive report. However, no action was taken based on the report (TDS, 2011). This forced public confidence even further down.

In order to prevent further fall in stock prices SEC declared " stock market stimulus package " in November, 2011. The package included short-term (relaxation of capital market exposure calculation for banks, withdrawal

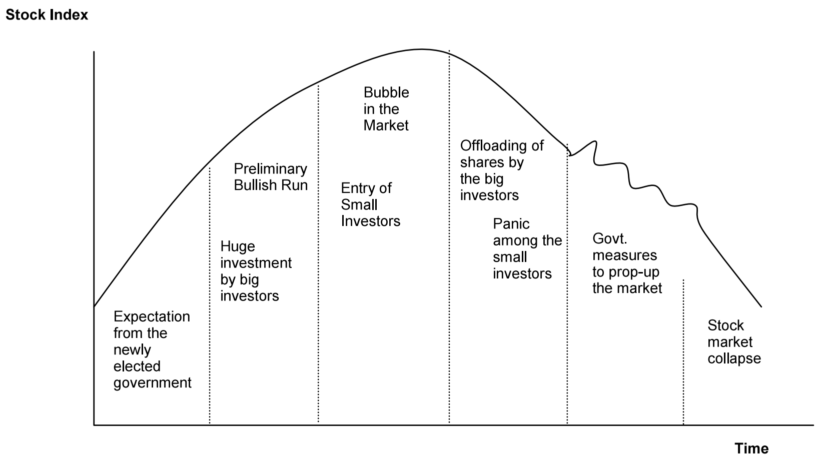

Fig. 2: Market collapse pattern in DSE

of capital gains tax for foreign firms etc.) mid-term (raising capital of merchant banks, developing corporate governance guidelines, opening of investment advisory services etc.) and long-term (demutualization of stock exchanges, formulation of financial reporting act etc.) measures. Introduction of the stimulus package is expected to reduce volatility in the market. However given the low confidence level of the investors due to non-action against the persons responsible for the market crash initially, one should not expect much.

3.3 Comparing the two crashes

If we compare the two market crashes of 1996 and 2010 then we can find some similarities as shown in Fig. 2. In both of these stock market crashes, investors had positive expectation regarding the economy and the capital market from the newly elected government. These expectations were used by some big investors as they poured a significant volume of funds to set an initial bullish trend in the market. Without realizing this as a trap, small investors flocked into the market with whatever funds they accumulated. Once the stock price heaved sky high without any relation to the fundamentals, the manipulators sold their shares and got out of the market. This left the small investors helpless only to see their investment becoming worthless. In both the cases regulators took some sporadic measures to stabilize the market, however these had only created temporary bumps in the stock index curve and failed to prevent the ultimate crash.

4. Policy Implications

In the wake of the two market crashes having great similarity with respect to the cause-effect relationship, the policy makers can be guided by the following guidelines in order to prevent future crashes:

Maintaining Investors Confidence

The first thing that the policy makers and regulators need to do is to bring back the investors confidence. Probe committee report should be implemented and the manipulators should be brought under justice. Stimulus package will fail to achieve its target unless general investors regain their confidence in stock market investing. The authority must ensure that nobody is beyond the legal and regulatory framework.

Role of Regulatory Authorities

Regulators such as SEC and Bangladesh Bank should take the policy measures in a coordinated and continued manner. Policies taken should be consistent with the market conditions and must also take future implications into account. Regulators also need to be equipped with people who understand contemporary finance.

Moral Hazard

Frequent attempts by the regulators to prop-up the market creates moral hazard. This increases investors' expectations and motivate them to make irresponsible investment. Also frequent rescue attempts by the regulators will encourage the manipulators to re-enter the market by buying stocks at lower price.

Investors should realize that stock market investing does not guarantee high profit; rather it is a very risky investment option. The sum of the profit made by some investors would be equal to the sum of the loss made by other investors and the aggregate is zero. In stock market profit and loss are to be shared by the investors themselves. Also the investors should be educated so that they know that it is not possible for the government to pay monetary compensation in case they suffer losses. So they should take calculative risk.

Capacity Building

There is a lack of understanding regarding the mechanics of stock market investing among the investors, company management staffs and even in the midst of regulators. Significant investment is required for institutional strengthening and capacity building both at national, company and individual level for developing the knowledge, skill and expertise to understand and disseminate the concept of modern stock market investing. Already efforts are being made by government, non-government and private organizations in this line. However, recurrence of stock market collapses indicates that an effort like these does not seem to be sufficient. In this respect policymakers, academicians and researchers have greater role to play.

Educating the Investors

Policy measures should be taken to increase the knowledge base of the investors. Because lack of ability on the part of the investors to interpret relevant information on the stock market may lead to inappropriate investment decisions. This may channel the investment to inefficient firms. Though Securities Exchange Commission (SEC) has established institutes like the government funded Bangladesh Institute of Capital Market (BICM) in 2010, or initiate programs like the Asian Development Bank funded " Improvement of Capital Market Programme " (MoF, 2010), SEC and stock exchanges should take more planned initiative to arrange courses on stock market to educate the investors.

Increase the Supply of the Stock

Before both the crashes stock price went up abnormally due to the shortage of available stock which also forced the investors to pick inefficient companies. Policy measures should be initiated to increase the supply of the stock in the stock market by offloading the stakes of the state and multinational firms and making the initial public offering (IPO) process less time consuming. Recent government decision to offload 49 percent stake of 27 state-owned enterprises (SOEs) was a good move in this direction, but unfortunately not been implemented yet. However more integrated long-term policy measures are needed to reduce the supply-demand mismatch.

Involvement of Banks

Regulators should not make the banking sector over-exposed to the stock market. Recent relaxation of the *capital market exposure calculation* for banks under ' stock market stimulus package ' will make the banking sector more exposed to stock market risk. Banks are thrift institutions safe-keeping depositors' money. Regulators should not make the banking sector sick on the way to stabilize the stock market.

5. Conclusion

In spite of having serious negative impact on the investment climate of Bangladesh, experiences from these crashes were not all negative. It forced SEC to go for more strict regulations relating to primary offering, secondary market transactions, brokerage firms and insider trading. This turmoil of

1996 encouraged the establishment of *automated trading system* to increase trading capacity and *central share depositary system in 1998*. Also the crash of 2011 led towards positive measures such as raising capital of merchant banks, developing corporate governance guidelines, opening of investment advisory services, demutualization of stock exchanges, formulation of financial reporting act etc. Although these developments are positive, it must not be achieved at the expense of recurring turmoil. Policymakers, regulators, academicians and researchers should come forward to play their diligent role to prevent artificially generated stock market crashes in future.

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