Economics of Financial Markets in India

Operation, Integration and Efficiency

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Dr. Iti Vyas

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AKHAND PUBLISHING HOUSE
DELHI (INDIA)

Published by



AKHAND PUBLISHING HOUSE

Publisher, Distributor, Exporter having an Online Bookstore

Head Office : L-9A, First Floor, Street No. 42,
Sadatpur Extension, Delhi-110094 (INDIA)
Phone No.: 9968628081, 9555149955 & 9013387535
E-mail : akhandpublishinghouse@gmail.com,
akhandpublishing@yahoo.com
Website : www.akhandbooks.com

Economics of Financial Markets in India
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© Author
Ist Edition 2019
ISBN 978-93-88998-31-4

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Printed in India

Published by Jhapsu Yadav for Akhand Publishing House, Delhi.

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Preface

The financial system plays a pivotal role to channelize the surplus funds from savers to investors through direct, market based financing or by indirect and bank based finance. The financial system comprising of all financial markets, instruments, institutions and services. This book addresses the issue of whether the design of the financial system matters for economic growth. In that respect are different school of thought on this finance- growth nexus debate and the debate are still unsettled in the recent literature. For example, Robert Lucas asserted in 1988 that economists badly over-stress the role of financial factors in economic growth. Moreover, Joan Robinson declared in 1952 that *"where enterprise leads, finance follows"*. According to this view, economic development creates demands for particular types of financial arrangements, and the financial system responds automatically to these demands. Other economists strongly believe in the importance of the financial system for economic growth. They address the issue of what the optimal financial system should seem alike. Overall, the impression seems to produce that the optimal financial system, in combination with a well-developed legal system, should incorporate components of both direct, market and collateral, bank-based finance. A well-developed financial system should improve the efficiency of financial decisions, favoring a better allocation of resources and thereby economic growth. The financial scheme is also especially important in reallocating capital and therefore providing the groundwork for the continuous restructuring of the economic system that is demanded to sustain growth. In countries with a highly developed financial system, we observe that a greater share of investment is allocated to relatively fast growing sectors. (Duisenberg, W.F, 2001).

Financial Markets are arrangements that offer facilities for buying and selling of financial claims and services. The major participants in the financial market are fundamentally classified into investors versus

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speculator and institutional versus retail. Financial market participants might enter on the supply side, thus supplying surplus of cash (as investments) favouring demand, or entering on the demand side, thus requiring surplus currency (borrowed capital) preferring the demand side. The demand side consists of those in need of cash flows (daily operational needs); those in need of interim financing (bridge financing); those in need of long-term funds for special projects (capital funds for venture financing). The supply side consists of those who have aggregate savings (retirement funds, pension funds, insurance funds) that can be used in favor of the demand side. The participants on the demand and supply sides of these markets are financial institutions, agents, brokers, dealers, borrowers, lenders, savers, and others who are interlinked by the laws, contracts, covenants, and communication networks. A well developed and competitive financial market has defined by the characteristics such as (i) there should be large number of buyers and sellers of the financial product, (ii) the price of the product is determined by the market forces of demand and supply, (iii) there should be a secondary market for the financial instruments, (iv) turnover of instruments in both primary and secondary markets should be fairly large and (v) agencies involved in the process of intermediation between buyers and sellers should provide intermediation services at a minimum spread.

The role of a stock market in the process of development has been well recognized. A developed stock market is considered as the major barometer of economic growth because (a) it provides an additional channel (along with banks and financial institutions) for encouraging and mobilizing domestic savings, (b) ensures improvements in the productivity of investment through market allocation of capital, (c) increases managerial discipline through the market for corporate control. In brief, the various indicators of stock market development are Market Capitalization Ratio (MCR), which is considered as a measure of stock market size. In terms of the economic significance, market capitalization as a proxy for the market size is positively related to the ability to mobilize capital and diversify risk. The next major indicator is market liquidity, which is measured by value-traded ratio and turnover ratio. Value traded ratio equals the total value of traded shares in the stock market divided by GDP. While, in turn, turnover ratio is the value of total shares traded divided by market capitalization. The next important indicator of stock market development is the volatility parameter, which conceptualizes the asset price movement in a stock market and conveys important signals for its development.

Efficient and well integrated financial markets are a crucial infrastructure for an economic development. An underdeveloped and rigidly segmented financial market works against efficient allocation of financial resources within an economy. The integration of financial markets across boundaries had been initiated by the capital market integration in developed countries. Financial integration involves a process where a country's financial markets become linked or integrated with those of other countries or with the rest of the world. In fully integrated markets, all forms of barriers are eliminated to enable foreign financial institutions to participate in domestic markets. In such an environment, domestic banking networks, equity and other types of financial markets are linked to their foreign counterparts. There are several ways in which a country's financial markets could be integrated. It could occur through membership in a regional integration community where formal protocols have been established to link up the financial markets of the community. In this arrangement, the regional integration community would remove or minimize restrictions that impede the flow of capital, and harmonize all financial rules, regulations and taxes between member countries. Financial integration could also occur through the penetration of foreign financial institutions in domestic markets, in the absence of formal integration agreements. For example, developed countries allow foreign participation in the banking and insurance markets and pension funds, securities trading abroad and direct borrowing by domestic firms in international markets. These activities are possible because domestic laws permit the operation of foreign financial institutions in the domestic markets. Whether a country chooses to integrate its financial markets formally or informally, it needs to create an enabling environment that would attract foreign participation. (Economic Commission of Africa, 2008)

National or domestic financial market integration entails horizontal linkages of various segments, reflecting portfolio diversification by savers, investors, and intermediaries. Under horizontal integration, market interest rates revolve around a basic reference rate, which is defined as the price of a short-term low risk financial instrument in a competitive and liquid market and central banks often use it to measure the tightness of monetary policy. Regional financial integration occurs due to ties between a given region and the major financial centre serving that region. Economic integration is easier to achieve at a regional level due to network externalities and the tendency of market makers to concentrate on certain geographical countries. Regional financial integration can be an important means of developing local financial market, for instance, through peer pressure to strengthen institutions

and upgrade local practices (BIS, 2006). Global integration refers to the opening up of domestic markets and institutions to the free cross-border flow of capital and financial services by removing barriers such as capital controls and withholding taxes. A deeper dimension of global integration entails removing obstacles to the movement of people, technology and market participants across the border (BIS, 2006). Global integration is promoted through harmonization of national standards and laws, either through the adoption of commonly agreed minimum standards or the mutual recognition of standards (Reddy, 2005c).

Theory guides practice, and practice, enrich theory. When combined, they provide powerful insights for effective policy making. This book draws lessons from applying various economic theories in the financial markets, empirical analysis on the different segments of market integration and efficiency such as domestic market integration, regional market integration and global market integration. Especially, this book emhpasises the structure, conduct, and performances of the financial markets from the standpoint of financial sector stability with reference to the global financial crisis. The book also assesses the impact of the Indian financial sector on the eve of global financial crisis and the emergence of Basel III.

While writing this book, I have relied on my research experience as a Research and Teaching Assistant at IGNOU, New Delhi, as a faculty member at Magnus School of Business, Pune, as an Assistant Professor and Head, Department of Economics, St. Ann's College for Women, Mehdipatnam, Hyderabad and as a UGC Post Doctoral Fellow at School of Economics, University of Hyderabad. These responsibilities gave me insights into many apparently intractable issues of financial sector led economic growth. My academic background also helped me in applying the underlying economic theory to address the operation, integration and efficiency of the financial sector in India. I owe gratitude to my postdoctoral adviser, Prof. R. Vijay at University of Hyderabad and Ph.D. advisor Prof. Narayan Prasad at IGNOU, New Delhi. They taught me the importance of theory and empirical research in the design of coherent policy.

This book would not have been possible without the guidance and contribution by my father Prof. Ravindra Nath Vyas, UUM, Malaysia, my husband Dr. Alok Kumar Mishra, University of Hyderabad. Last but not least, I express my sincere thanks to Mrs. Manorama Vyas, my mother, Nana-Bou, Ayati, my daughter and Aayan, my son, for their constant unflinching support, encouragement, love, care, concern during this invaluable journey to complete this book.

Dr. Iti Vyas

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