The Global Perspective of Indian Financial Markets

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ABSTRACT:

It was found from the literature review that efficient and developed financial markets can lead to increased economic growth by improving the efficiency of allocation and utilization of savings in the economy. The primary requirement of the capital market is allocation of ownership of the economy’s capital stock. The ideal situation of the market exists when the prices of different securities provide accurate signals for the investment decisions to the investors, who can choose such securities that represent ownership of firms’ activities under the assumption that security prices at any time fully reflect all available information. It is also found that, increased movement of investments across international boundaries has lead to the integration of world economies.

The research paper will be divided into 4 sections, wherein Section 1 will discuss about the Introduction of Financial Markets. Section 2 will talk about the historical evolution of Financial Markets. Section 3 deals with the methodology and the Indian Financial markets with its composition. Section 4 helps to clarify the concept of globalization and financial market integration and lastly Section 5 shows the references.

Key Words: Financial Markets, Market Efficiency, Integration of Markets

1. INTRODUCTION

Financial markets are a vital part of an economy making it possible for industry, trade and commerce to flourish without any obstacle in terms of resources. Today most economies around the world are judged by the performance of their financial markets. The financial markets have indicators in place that reflect the performance of companies whose securities are traded in those markets. The financial markets also serve a vital purpose in the growth and development of a company, which wants to expand. Such companies with expansion plans and new projects are in need of funding and the financial market serves as the best platform from which a company can determine the feasibility of such possibilities.

Krishnan (2011) mentioned that, the economic literature acknowledged that efficient and developed financial markets could lead to increased economic growth by improving the efficiency of allocation and utilization of savings in the economy. Better functioning financial systems ease the external financing constraints that impede firm and industrial expansion. “There is a growing body of empirical analyses, including firm-level studies, industry-level studies, individual country studies, and cross-country comparisons, which prove this strong, positive link between the functioning of the financial system and long-run economic growth. In addition, they better allocate resources, monitor managers and exert corporate control, mobilize savings, and facilitate the exchange of goods and services”.

A capital market is a market for securities (debt or equity), where business enterprises (companies) and governments can raise long-term funds. It is defined as a market in which money is provided for periods longer than a year as the raising of short-term funds takes place on other markets (e.g., the money market). The capital market includes the stock market (equity securities) and the bond market (debt).
The capital market of a country can be considered as one of the leading indicators in determining the
process of any economy depends on the functioning of financial markets which also helps to augment
its Capital formation. According to Professor Hicks, the industrial Revolution in England was ignited
more by the presence of liquid financial market than the technological investment”. He writes interestingly-

What happened in the Industrial Revolution ...is that the
Range of fixed capital goods that were used in production...
Began noticeably to increase.... But fixed capital is sunk; it is
embodied in a particular form, from which it can only gradually
...be released. In order that people should be willing ...to sink
large amounts of capital ... it is the availability of liquid funds
which is crucial. This condition was satisfied in England ...by
the first half of the eighteenth century ...
The liquid asset was there, as it would not have been even a few years earlier

Thus, liquidity is a very important component of Financial Market and plays a very vital role in the
long run economic development of any country as it helps not only in promoting the savings of the
economy but also to adopt an effective channel to transmit various financial policies by creating
liquidity in the market. Therefore Financial System of any country should be well developed,
competitive, efficient and integrated to face all shocks

2. HISTORICAL EVOLUTION OF FINANCIAL MARKETS

The financial system and infrastructure of any country at any time can be considered as the result of its
own peculiar historical evolution. This evolution is resulted by continuous interaction between all the
participants existing in the system and public policy interventions. The evolution of Indian financial
markets and the regulatory system has also followed a similar path. India began with the central bank,
Reserve Bank of India (RBI), as the banking sector regulator, and the Ministry of Finance as the
regulator for all other financial sectors. Today, most financial service providers and their regulatory
agencies exist. The role of regulators has evolved over time from that of an instrument for planned
development in the initial stage to that of a referee of a relatively more modern and complex financial
sector at present. Over this period, a variety of financial sector reform measures have been undertaken
in India, with many important successes. An important feature of these reforms has been the attempt of
the authorities to align the regulatory framework with international best practices, keeping in view the
needs of the country and domestic factors. These reforms can be broadly classified as steps taken
towards:

1 Liberalizing the overall macroeconomic and regulatory environment within which
financial sector institutions function.
2 Strengthening the institutions and improving their efficiency and competitiveness.
3 Establishing and strengthening the regulatory framework and institutions for overseeing the
financial system.

3 INDIAN FINANCIAL MARKETS & ITS COMPOSITION

The history of Indian capital markets spans back 200 years, around the end of the 18th century. It was
at this time that India was under the rule of the East India Company. The capital market of India
initially developed around Mumbai; with around 200 to 250 securities brokers participating in active
trade during the second half of the 19th century.
Table 1: Select Macroeconomic Indicators, India, 1951 – 2009 % of GDP

<table>
<thead>
<tr>
<th>Indicator</th>
<th>1951-52 to 1959-60 (Average)</th>
<th>1990-91 to 1999-2000 (Average)</th>
<th>2000-01 to 2008-09 (Average)</th>
</tr>
</thead>
<tbody>
<tr>
<td>Average GDP Growth</td>
<td>3.6</td>
<td>5.7</td>
<td>7.2</td>
</tr>
<tr>
<td>Agriculture</td>
<td>53.4</td>
<td>28.4</td>
<td>20.5</td>
</tr>
<tr>
<td>Services</td>
<td>29.7</td>
<td>51.5</td>
<td>54.4</td>
</tr>
<tr>
<td>Gross domestic saving rate</td>
<td>9.8</td>
<td>23.0</td>
<td>30.3</td>
</tr>
<tr>
<td>Gross fixed capital formation rate</td>
<td>11.1</td>
<td>23.6</td>
<td>30.2</td>
</tr>
<tr>
<td>Total foreign trade</td>
<td>13.3</td>
<td>19.6</td>
<td>35.7</td>
</tr>
<tr>
<td>Two-way gross capital flows</td>
<td>n.a.</td>
<td>41.8</td>
<td>77.9</td>
</tr>
</tbody>
</table>

Source: Central Statistical Organizations, Reserve Bank of India (RBI).

There are a number of factors that have paved path for India market growth. After the economic liberalization, policies were undertaken in the 1990s, the economy of the country has been steadily rising which has led to more demands and supply circles. This has introduced diverse market sectors and industries in the country, which has led to a competitive consumer market. Thus their lies an enormous investment opportunity in India as it has maintained its position as one of the fastest growing economies in the world during 2010-11. Table 1 shows the average growth of GDP of India from the year 1952-2009. According to revised estimates of Central Statistical Organization (CSO), real GDP grew at 8.5 percent in 2010-11 compared to an upwardly revised 8.0 percent in 2009-10. The services sector continued to be the main driver of growth in India, albeit at a slower pace of 9.2 percent in 2010-11 compared to 9.7 percent in 2009-10. Table 2 points out the gross domestic savings and Investment of India for the year 2006 to 2010.

Through this research paper, an attempt is made to understand the evolution of Global financial system with more emphasis on Indian markets. It also aims to study the global perspective of financial markets of any country and to understand that how a country’s financial markets is integrated with the other world markets. Also the concept of efficiency is highlighted which says that a country whose financial markets are well integrated with the world markets are more efficient as compared to one whose financial markets are not very well integrated. Lastly the paper concludes by leaving scope and opportunities to understand these global concepts in an easier way to the reader and further can be used for extensive research.

3.1 Indian Financial System

A financial system or financial sector functions as an intermediary and facilitates the flow of funds from the areas of surplus to the areas of deficit. A Financial System is a composition of various institutions, markets, regulations and laws, practices, money manager, analysts, transactions and claims and liabilities.
Financial System facilitates the flow of funds from the savers (households) to mainly Business Organizations, firms and Government. Against which they provide financial services, incomes and financial claims back to the households.

Indian Financial market can be considered as one of the oldest across the globe and is experiencing favorable time during the recent years, which have prospered the economy of the country to a great extent. Presently, India is rated by six international credit rating agencies, namely Standard and Poor’s (S&P), Moody’s Investor Services, FITCH, Dominion Bond Rating Service (DBRS), the Japanese Credit Rating agency (JCRA), and the Rating and Investment Information Inc., Tokyo(R&I).

According to World Bank, India is considered to be one of the five countries classified as big emerging market economies. This list also includes People’s Republic of China (PRC), Indonesia, Brazil, and Russia. These countries have made the critical transition from a developing country to an emerging market. The World Bank has predicted that these five biggest emerging markets’ share of world output will have more than doubled from 7.8% in 1992 to 16.1% by 2020.
4. GLOBALIZATION AND FINANCIAL MARKET INTEGRATION

As mentioned by Dr Jaimini Bhagwati, joint secretary, Ministry of External Affairs, any country’s financial sector is exposed to global financial markets, which should be based on meeting the following objectives:

- Increase competition and thereby enhance the efficiency of financial intermediation and promote overall savings;
- Widen and deepen the reach of the formal financial sector;
- Ensure that the country’s savings are utilized most productively; and
- Manage the risks stemming from disturbances in global markets to insulate the financial sector and the Domestic economy.

According to International Monetary Fund, globalization is the growing interdependence of national economies, in particular as a result of the growing trade and financial flows. Such economic interdependence between nations has facilitated cross border flow of goods, services, capital, and even labor and this process of cross border financial activity becomes a cause for integration of the financial market globally.

Increased globalization of investment has not only resulted in search of higher rates of return and opportunity to diversity risk internationally but has also significantly increased the degree of integration of financial markets around the world during the late 1980s and 1990s. Financial markets all over the world have witnessed growing integration within as well as across boundaries, spurred by deregulation, globalization and advances in information technology.

Jain S and Bhanumurthy N R. (2005) mentioned that, many countries have encouraged inflows of capital by dismantling restrictions, deregulating domestic financial markets, and improving their economic environment and prospects through the introduction of market-oriented reforms. This increase in the degree of integration of world capital markets has been accompanied by a significant increase in private capital flows to developing countries. Central banks in various parts of the world have made concerted efforts to develop financial markets, especially after the experience of several financial crises in the 1990s. As may be expected, financial markets tend to be better integrated in developed countries. At the same time, deregulation in emerging market economies (EMEs) has led to removal of restrictions on pricing of various financial assets, which is one of the pre-requisites for market integration. Capital has become more mobile across national boundaries as nations are increasingly relying on savings of other nations to supplement the domestic savings.

Obstfeld (1994) refers that, “Financial openness is often regarded as providing important potential benefits. Access to world capital markets expands investors’ opportunities for portfolio diversification and provides a potential for achieving higher risk-adjusted rates of return. It also allows countries to borrow to smooth consumption in the face of adverse shocks; the potential growth and welfare gains resulting from such international risk sharing can be large”.

Financial market development and financial liberalization is believed to affect the real economy through at least two broad channels: First, the size of the financial sector and the volume of available credit are seen as a proxy measure for how effectively the banking sector manages to collect savings and allocate them to productive investments. This transformation process not only raises productive capacity but should also enhance the efficiency of the economy by reallocating funds from least to most productive investments. A second broad channel involves the capacity of the financial sector to absorb shocks and provide insurance. A growing financial sector will raise the possibilities for households and enterprises to hedge against idiosyncratic and – in certain cases even – systemic shocks. This second channel, however, is heavily dependent on the types of available financial products and the quality of regulation. In practice, financial development has often shown mixed
results as regards the stability of the real economy. Both channels have been subject to a large and growing literature, sometimes producing controversial results.

Integrated financial markets assume vital importance for several reasons. First, integrated markets serve as a conduit for authorities to transmit important price signals (Reddy, 2003). Second, efficient and integrated financial markets constitute an important vehicle for promoting domestic savings, investment and consequently economic growth (Mohan, 2005). Third, financial market integration fosters the necessary condition for a country’s financial sector to emerge as an international or a regional financial centre (Reddy, 2003). Fourth, financial market integration, by enhancing competition and efficiency of intermediaries in their operations and allocation of resources, contributes to financial stability (Tricht, 2005). Fifth, integrated markets lead to innovations and cost effective intermediation, thereby improving access to financial services for members of the public, institutions and companies alike (Giannetti et al., 2002). Sixth, integrated financial markets induce market discipline and informational efficiency. Seventh, market integration promotes the adoption of modern technology and payment systems to achieve cost effective financial intermediation services.

4.1 Empirical evidences about stock market

Different studies have been carried out by financial economists on the implication of stock market development for various components of an economy. The growing importance of stock markets around the world has recently opened a new avenue of research into the relationship between financial development and economic growth, which focuses on the effects of stock market development. In this context, various stock market development indicators have been found to explain part of the variation of growth rates across countries (Atje and Jovanovic 1993; Levine and Zervos 1998).

Some of the recent theoretical contributions by (Diamond 1984; Greenwood and Jovanovic 1990; Williamson 1986) suggest that stock markets may promote long-run growth and encourage specialization as well as acquisition and dissemination of information. (Greenwood and Smith 1997) suggested that, it may reduce the cost of mobilizing savings, thereby facilitating investment. Well-developed stock markets may enhance corporate control by mitigating the principal-agent problem through aligning the interests of managers and owners, in which case managers would strive to maximize firm value (Diamond and Verrecchia 1982; Jensen and Murphy 1990).

As per the study done by (Demirguc-Kunt and Maksimovic 1996), on the stock market development and financing choice of firms using data from 30 developing and industrial countries from 1980 to 1991, it was investigated that the extent to which the variation in the aggregate debt-equity ratio within these can be explained by:

(a) The level of development of the country’s financial markets
(b) Macroeconomic factors
(c) The differences between the tax treatment of debt and equity securities

The study also reveals that in many developing countries with emerging stock markets, banks are fearful of stock market development because they think stock market will reduce the volume of their business. Instead, the results imply that initial improvements in the functioning of a developing stock market produce a higher debt equity allocation for firms and thus more business for banks. Levine and Zervos (1996) in their research “Stock Market development and long run growth” documented theoretical disagreement which exists about the importance of stock markets for economic growth. It gauged the robustness of the relationship between overall stock market development and economic growth changes in the conditioning information set and found a strong support correlation between overall stock market development and long run economic growth.

4.2: Stock Market Efficiency

Rakesh Mohan (2007) stated that, Development, leading to greater integration of markets. Financial integration leads to reduction of speculative movements of funds that may occur due to arbitrage that market segmentation offers. In the process it ensures that intermediation is efficient and resource
allocation is optimized. The chances of improving the effectiveness of polices are also enhanced as transmission mechanisms function more smoothly as market integration takes place. Compared to the stock markets in developed countries, the emerging stock markets are in many cases characterized by a lower volume and frequency of trading (‘thin trading’), ease of manipulation by a few large traders, weaker disclosure and accounting requirements, settlement delays, and a generally less than smooth transmission of financial information. If correct information on business performance and prospects fail to be quickly and fully reflected in the stock prices, those who have access to such information can benefit by anticipating the course of such prices. Such forecasting results in heavy buying or selling in the market, which makes the market inefficient.

The primary requirement of the capital market is allocation of ownership of the economy’s capital stock. In general, the ideal situation in the markets exists when the prices provide accurate signals for resource allocation, i.e. a market in which firms can make production and investment decisions, and investors can choose among the securities that represent ownership of firms’ activities under the assumption that security prices at any time fully reflect all available information. A market in which prices always fully reflect available information is called “efficient”.

Therefore it can be concluded that efficient and developed financial markets can lead to increased economic growth by improving the efficiency of allocation and utilization of savings in the economy. The primary requirement of the capital market is allocation of ownership of the economy’s capital stock. The ideal situation of the market exists when the prices of different securities provide accurate signals for the investment decisions to the investors, who can choose such securities that represent ownership of firms’ activities under the assumption that security prices at any time fully reflect all available information. It is also found that, with the increased movement of investments across international boundaries owing to the integration of world economies, the understanding of efficiency of the emerging markets is also gaining greater importance. This directs to study further the importance of the market efficiency.

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