ISSN: 2349-7300
ISO 9001:2008 Certified
International Journal of Innovative Research in Engineering & Multidisciplinary Physical Sciences
(IJIRMPS)
Volume 2, Issue 1, January 2014

Role of Financial Market in India

Anil Kumar
Associate Professor in Economics
Department of Higher Education
Himachal Pradesh, India.

Abstract - Indian financial market experienced financial deepening after inception of the new economic policy in 1991. The expansion of financial market encourages us to analysis the role of stock market and credit market in the expansion of the financial market. This paper attempts to show an implication of the expansion financial market on the Indian economy during the post-liberalization period. The period of analysis is from 2010 to 2020. Financial market facilitates efficient allocation of capital. It also encourages economic activities such as commerce and trad, investments and growth opportunities in the economy.

Introduction

Financial sector plays a crucial role in the accumulation of capital and the production of goods and services. In many developing nations, limited financial markets, instruments, and financial institutions, as well as poorly defined legal systems, may make it costlier to raise capital and may lower the return on savings or investments. They also help to facilitate the international flow of funds between countries. The banking sector and the capital markets are assumed to be the primary constituents of the financial sector. This study assumes relevance in the context of a fast-growing economy such as of India that has taken several reform measures and continues to do so to enhance the role of financial sector in the economic development and better regulation so that markets are efficient.

The appointment of the Narasimhan Committee in 1991 set the guidelines that provided several measures for reforms in the banking sector and the capital market. The prominent reforms in the banking sector resulted in the deregulation of interest rates particularly, in term deposits and reduction in the cash reserve ratio (CRR) from 25% to 6% and statutory liquidity ratio (SLR) from 40% to 25% from the 1990s to the mid-2000s. To enhance competition, a number of foreign and private banks were allowed to perform commercial banking and also foreign direct investment was allowed up to 74%. The banks were also allowed to access the capital markets to raise additional funds. The reforms in the capital markets involved removal of prior approval of the government to access capital market, an apex regulator Securities and Exchange Board of India (SEBI) was formed in 1992 which would focus on regulating the capital markets and set the rules for it. Foreign institutional investors were allowed to invest in India and the Indian firms were allowed to access foreign markets to raise capital. Electronic trading was introduced with the setting up of a competitive exchange called as the National Stock Exchange (NSE)

ISSN: 2349-7300
ISO 9001:2008 Certified
International Journal of Innovative Research in Engineering & Multidisciplinary Physical Sciences
(IJIRMPS)
Volume 2, Issue 1, January 2014

alongside the older Bombay Stock Exchange (BSE). The Indian stock markets till 1991 have remained stagnant due to the rigid economic controls. After liberalization process, the Indian securities market witnessed a flurry of Initial Public Offerings (IPOs). The market saw many new companies spanning across different industry segments and business to access the capital markets and register themselves in BSE/NSE. Ahead this backdrop, it is interesting and relevant to understand the linkages between the banking sector, capital markets, and economic growth in India. The studies that exist in the Indian context (Chakrabarty, 2013; Pradhan, 2011) provide contradictory evidence on the relevance of the stock market on economic growth. This study probes into the same aspect but with a different set of variables to further understand the nature of relationship between financial sector and economic growth in the Indian context particularly after 1991.

ECONOMIC LITERATURE

In the early 1990s, several theoretical models provided contradictory conclusions on the relevance of the financial intermediaries for promoting long-run growth (Greenwood & Jovanovic, 1990 Saint-Paul, 1992). Prior to this there had already been discussions on whether stock markets and banks act as substitutes or complements of each other (see, Boyd & Prescott1986Stiglitz, 1985). This led to a series of empirical analyses trying to explore the contribution of capital markets and banks to the economic growth. These studies were based on panel data for a large number of countries and the results have been rather mixed. Few studies provide evidence that both stock markets and financial sector have strong influence on economic growth as provided in a detailed discussion in Chakrabarty 2013 on this issue. The nature of the sample, whether it is for developed or developing countries as well as whether it is a time-series data or panel data seems to also influence the empirical findings. In some instances, the results were in favor of unidirectional causality between financial sector and economic growth (Christopoulos & Tsionas, 2004), while in others like Apergis, Filippidis, and Economidou 2007there was a bidirectional causality between financial depth and economic growth.

Many studies exist that explore the linkages for developing countries in Latin America while relatively few studies focus on Asia and even fewer on India (Chakrabarty, Pradhan,) The studies in the Indian context are important and interesting as India embarked on economic policy reforms in 1991 and a major part of these reforms was linked to the financial system. Apart from these, there were a slew of reforms in the industrial sector and trade sector. All of these led to a major spurt in the growth of the Indian economy which surged forward from the Hindu growth rate of about 3–4% per annum to about 7–8% in the 2000s and touched 9% in recent years. Though there has been a decline in the growth rates for India since 2009, it is still among one of the fastest growing regions of the world.

Pradhan (2011) based on monthly data finds that there exists a long-run relationship between stock market development (proxied by market capitalization) and financial development (captured by broad

ISSN: 2349-7300
ISO 9001:2008 Certified
International Journal of Innovative Research in Engineering & Multidisciplinary Physical Sciences
(IJIRMPS)
Volume 2, Issue 1, January 2014

money supply as a proportion of gross domestic product [GDP]) that are important determinants of economic development (proxied by Index of Industrial Production [IIP]) for the period between 1994 and 2010. In the Granger sense of causality, the study further reports that there is a bidirectional relationship between economic development and financial development, while economic development influences stock market development in a unidirectional sense. No causal relationship was observed between stock market and financial development. Firstly, the analysis does not provide adequate economic intuition on the choice of variables for the analysis in particular, on why IIP was used as a measure of economic development and why the ration of broad money to GDP was used as a measure of financial development. Secondly, the paper also provides no discussion on the type of results obtained.

In comparison to this, Chakrabarty (2013) provides a theoretical framework within which the empirical model is embedded. Clearly, the nature of variables used in the model though with similar econometric technique shows based on quarterly data that for the period 1993–2005, stock market development makes no significant contribution while the reforms in the banking sector, particularly those related to interest rate deregulation plays a significant role in the economic growth. Firms would depend on both capital market (for equity) and credit market (for debt) for capital. There are several studies in India in this context that have tried to understand the determinants of variations in debt-equity ratio across firms (Guha-Khasnobis & Bhaduri, 2002. Similarly, households also invest in equity market and in banks which are also a source of formal sector credit for them. Hence, these different sources of supply of domestic capital try to meet the different sources of demand for capital. Apart from these sources of finance, international financial flows also play a major role in meeting the demand for capital in the form of foreign direct investment, migrant remittances, and overseas development assistance. From this perspective, it is useful to understand the nature of interrelationship between stock market, credit market, and economic development.

OBJECTIVES

It has been deduced that the results are not very conclusive on the direction and the strength of linkage between stock market development, financial development, and economic development. There is a paucity of empirical studies on the exploration of the linkage between stock market and credit market and this study tries to consider this using a different choice of variables. Firstly, this study uses the non-food bank credit as variable to capture the flow of capital, level of stock market activity captured by the stock index, and the level of non-agricultural GDP as a measure of economic development to further probe into the mentioned objective.

RESEARCH METHODOLOGY

We have done a theoretical analysis of stock market and credit market and this study tries to consider this using a different choice of variables. An attempt has been made to know the relationship of non-

ISSN: 2349-7300
ISO 9001:2008 Certified
International Journal of Innovative Research in Engineering & Multidisciplinary Physical Sciences
(IJIRMPS)
Volume 2, Issue 1, January 2014

food bank credit as variable to capture the flow of capital, level of stock market activity captured by the stock index, and the level of non-agricultural GDP to affect the economic development of the economy.

THEORETICAL INTERPRETATION

1. Non- food bank credit positively affects the economic development.
2. Annual average of CNX Nifty is affected linearly by the non-agricultural gross domestic product.
3. The negative effect of stock market on GDP is surprising, although the effect is pretty small.

In short, we find that there is a long-run relationship between the financial market and GDP, but there is no such significant long-run relationship between the credit market and GDP. On the other hand, it is interesting to note the GDP does adjust in the long run to changes in credit market.

CONCLUSION

The objective of this paper was to show the linkage between stock market, non-agricultural credit market, and non-agricultural GDP. In other words, we attempted to understand how these variables have contributed toward the growth of an economy in relation to the financial market. we conclude that there is a long-run relationship between financial market and gross domestic product, while the latter is also affected in the long run by changes in credit market.

REFERENCES

[1] Pergis, N., Filippidis, I., & Economidou, C. (2007). Financial deepening and economic growth linkages: A panel data analysis. Review of World Economics, 143, 179–198.
[2] Chakrabarty, I. (2013). Financial development and economic growth in India: A post reform analysis. South Asia Economic Journal, 11, 287–308.
[3] Greenwood, J., & Jovanovic, B. (1990). Financial development, growth, and the distribution of income. Journal of Political Economy, 98, 1076–1107.
[4] Pradhan, R. P. (2011). Financial development, growth and stock market development: The trilateral analysis in India. Journal of Quantitative Economics, 9, 134–145.
[5] Reserve Bank of India. (2021). .Handbook of statistic on Indian Economy.
[6] Saint-Paul, G. (1992). Technological choice, financial markets and economic development. European Economic Review, 36, 763–781.
[7] Stiglitz, J. E. (1985). Credit markets and the control of capital. Journal of Money, Credit and Banking, 17, 133–152.