CHAPTER II
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Importance of Capital Markets and the Process of Reforms

The primary role of capital markets is allocation of capital among competing sectors of the economy. The financial sector reforms in India have ushered in wide ranging changes in the financial markets in India. As a result of economic liberalization and reforms in the financial sector, Indian Capital Markets are expected to play an important role in mobilizing savings and channellizing the same to productive sectors of the economy. The changes in law concerning the financial sector during the ‘80s and the economic reforms introduced after June 1991 have contributed to the growth of Indian Capital Markets significantly. One of the main objectives of liberalization of industrial policy and financial sector reforms is to ensure an efficient allocation of scarce resources by encouraging competition (internal and external), entrepreneurial initiative and innovation. This efficient allocation of capital is sought to be achieved through abolition of various controls, industrial policy reforms, trade policy reforms, etc., thus allowing a free play of market forces. The investor base in each of the markets has also been expanded considerably and their active participation is a must to achieve a balanced growth and level of efficiency.

Review of literature

There are considerable number of books on the functioning of financial markets and their role in economy. There are numerous articles published in various journals of
repute. A little research leading to doctoral degree or its equivalent is also being carried on by various people. An effort is being made here to present some of the important contributions made to this field of study.

Hicks\textsuperscript{1} in his study argued that industrial revolution was possible on an economical scale due to investments of large magnitude made in highly liquid and actively specific capital for long periods only through capital market development. According to Hicks, it is the availability of liquid funds which was crucial. This condition was satisfied in England by the first half of the eighteenth century. Thus, technological innovation by itself was insufficient to stimulate growth; which would not have been possible in the absence of financial markets to provide liquidity. Another precondition for the implementation of new technologies was the existence of liquid capital markets.

Cooperman et. al.\textsuperscript{2} examined the response of saving and loan (S\&L) equity prices to the 1985 Ohio Thrift Crisis. Privately insured S\&Ls experienced bank runs during the crisis due to the inadequacy of Federal Savings and Loan Insurance Corporation (FSLIC). They report evidence of significant decline in systematic risk for S\&Ls during the crisis period. This is surprising given the a priori expectation of a negative abnormal returns implied by Contagion Hypothesis. They attributed this anomalous reaction to expected greater future reluctance by regulators to close large, federally insured S\&Ls.

Patnaik, Prabhat and Chandrashekhar\textsuperscript{3} in their paper discussed first the role of IMF and World Bank in influencing the international financial scenario and then the
contradictions of the dirigiste regime subsequently bringing out the consequences of structural adjustment in India. Globalization of finance emerged as the dominant player that brought together the fund and the Bank, on the one hand, and affected the domestic economy of India, on the other. The Indian experience with structural adjustment is stated to clearly show that the real mobility witnessed is that of finance rather than that of capital-in-production. The authors contradict the belief that globalization of finance restricts the possibility of intervention within a national space by undermining the concept of a control area, and that there could be no alternative to the current set of policies.

Parikh⁴ has undertaken overall macroeconomic survey to see if the economic reforms have put Indian economy on a sustainable higher growth path. While reforms have put the Indian economy on a higher path, there are still opportunities to accelerate the growth further and take off into a high growth trajectory.

Thankom G Arun and John Turner⁵, in their paper analyzed the nature of financial repression prior to 1991, the deregulatory process of the last decade, and the development of the supervisory system. Further reforms are required, however, but it is argued that this may only occur under certain conditions. The liberalisation of the Indian Financial System has included the relaxation of some interest rate controls, relaxation on asset constraints, partial privatization of the Public Sector Banks and increased competition by permitting private as well as foreign banks to establish in India. This liberalisation process has been slow and gradual, which may have been the outcome of India’s complex political economy rather than a deliberate policy
decision. As well as deregulating, a supervisory regime, modeled on the Western approach to supervision, has been introduced. This regime has been designed to control bank risk-taking in an era when banks have been given greater freedom from government control. There are even suggestions that banks will become involved in the securities and insurance industry.

Hema Kumar Ch\textsuperscript{6} made an attempt at understanding the reform processes and the impact of such reform efforts on the saving and investment performance of two South Asian developing countries, Bangladesh and Sri Lanka. He found that financial deepening (M2/GDP) increased rapidly in the early post reform period and fluctuated at around 30-33\% in late 80's and early 90's and Domestic Investment / G.D.P. increased significantly in Sri Lanka in the post reform period.

Joseph A. Schumpeter\textsuperscript{7} emphasized the positive influence of development of a country's financial sector on the level and the rate of growth of its per capita income. The argument essentially is that the services of the financial sector provides- of reallocating capital to the highest value use without substantial risk of loss through moral hazards. The adverse selection or transaction costs- are an essential catalyst of economic growth. Joan Robinson\textsuperscript{8} argues that the financial system does not spur economic growth; financial development simply responds to developments in the real sector. The work of Gurley and Shaw\textsuperscript{9} made a valuable contribution to identify the relation between financial development and economic growth. But their findings did not answer the important question whether financial development causes economic growth or whether economic growth leads to the development of the
financial structure. The exact nature of this relation is, however, difficult to establish since both financial development and economic growth are observed simultaneously. Shaw also strongly believed that financial liberalization will have a positive effect on the financial intermediation process which in turn would contribute to higher investment and growth. In his analysis, as in McKinnon's, he found that financial liberalization raises real interest rates which in turn raises holdings of savings with banks. Most importantly, he stressed that there will be efficiency gains in the intermediation process if more individuals hold their wealth with banks. He points out institutionalization of savings may contribute to the lowering of costs of lending to investors, since specialized financial institutions may develop which operate more efficiently. The specialized financial institutions may provide information to savers and investors, reduce risk by diversifying their portfolios and diversify the menu of financial assets to their clients. All these developments may lead to increased financial intermediation contributing to higher and better investment. Both McKinnon and Shaw believed that an increase in the amount and efficiency of investment would flow from financial liberalization. They explicitly point out that financial repression not only means lower investment, but also that investment is far less productive.

Baruva S K\textsuperscript{10} in his study entitled valuation of securities and influence of value on financial decisions of a firm, identified that the Indian capital market is efficient in the assimilation of new information into the price structure of securities. The price appears to adjust to new information with in a day or two.
Myers and Majluf\textsuperscript{11} showed that, if outside suppliers of capital are less well informed than insiders about the value of the firm's assets, equity may be mispriced by the market. Myers describes the "pecking order" theory of financing, i.e., that capital structure will be driven by firms' desire to finance new investments, first internally, then with low-risk debt, and finally with equity only as a last resort. As evident, stock market, in a market economy performs three basic functions, i.e. a) a source of finance for investment: b) a signaling mechanism to managers regarding investment decisions: and c) a catalyst for corporate governance. They found that the existence of information asymmetry between suppliers of finance and managers could discourage firms from issuing equity and force them to forego positive NPV projects and thus may lead to under investment.

Bhole L M\textsuperscript{12} has argued in his paper that there is a need to change our outlook on the role, importance and working of the capital market, particularly the stock exchanges, in India. The stock market is only one among many channels for the flow of funds, and, therefore, it is an error to overemphasize its role. The excessive enthusiasm for the equity culture and for the boom in share prices (particularly reflected by the extremely limited indicator such as the SENSEX) ought to be replaced by a more moderate, cautious, and sober view of the market, it is true that the capital market in India has grown substantially in the past 40 years in terms of conventional and quantitative indicators such as the volume of fresh capital raised, the number of equity holders, increase in the share prices, volume of turnover, market capitalization, number of market instruments etc. However, in terms of quality, there has been a regress and the market has tended to become dysfunctional.
Rajan and Zingles\textsuperscript{13} show that, in countries with well-developed financial systems, industries that are naturally heavy users of external finance grow relatively faster than other countries. Alternatively, in countries with poorly developed financial systems, industries that are naturally heavy users of external finance grow more slowly than other countries.

McKinnon\textsuperscript{14} stressed the need for financial liberalization in Less Developed Countries (LDC) in the context of a model which incorporates specific elements of the financial sector of those countries. According to him, production units in less-developed economies are, to a large extent, confined to self-finance for investment since financial markets (where credit could be obtained) are almost non-existent or are highly fragmented and, therefore, unable to intermediate efficiently between savers and investors. The underdeveloped state of financial markets also means that cash balances are the only financial asset available to wealth holders. McKinnon also assumes that investment is characterized by invisibilities. Production units, thus, have to accumulate a considerable amount of cash balances to be able to self-finance these investments. In McKinnon's model, the demand for cash balances from individuals is positively related to income, real interest rates and average rate of return on capital.

Levine\textsuperscript{15} argues that stock markets accelerate growth by (i) facilitating the ability to trade, ownership of firms without disrupting the productive processes occurring within firms and (ii) allowing investors to hold diversified portfolio.
Valerie R Bencivenga et al\textsuperscript{16} derived models where more liquid stock markets—markets where it is less expensive to trade equities—reduce the disincentives to investing long duration projects because investors can easily sell their stake in the project if they need their savings before they mature. Enhanced liquidity, therefore, facilitates investment in longer run, higher return projects that boost productivity and growth.

Sukumar Nandi\textsuperscript{17} on his paper on Globalisation of Indian Capital Markets explained the recent conscious attempts that are being made to open up the economy by initiating structural reforms along with the convertibility of the currency and trade account. An attempt has been made in this article to explain some crucial issues which give important hindsight about the important parameters of the economy which influence the course of economic changes. He concluded that experiences of the capital mobility across the countries show that irrespective of the existence of control on the mobility of capital and exchange rate movement, some sort of a relation gets established between the capital markets of major countries. Whenever, pervasive control on the movement of capital exists, capital flight takes place without the approval of the government machinery.

Arestis and Demetriades\textsuperscript{18} in their empirical work on relationship between financial development and economic growth found that the correlation between the main financial indicator and economic growth is much stronger than the correlation between lagged financial development and growth. Though they agree with King and Levine that financial development and growth are robustly correlated, they do
not think that the question of causality can be satisfactorily addressed in a cross section framework. The relationship between financial developments is established by them by including indicators of stock market development and volatility. They used four variables of each country.

Singh and Nagraj have provided a benchmark for opposition in Indian stock market development. Singh\textsuperscript{19} characterized the possible function of the stock market to help economic growth as growth of savings lead to efficient allocation of investment resources and better utilization of existing resources. Specifically, so far as saving mobilization is concerned Singh asserts that there is little or no evidence of an increase in aggregate savings for India or other developing countries as the result of growth of stock markets or greater new issue activities on those markets.

Levine and Zervos\textsuperscript{20} using data on 47 countries from 1976 to 1993 investigated whether measures of stock market liquidity, size, volatility and integration with world capital markets are robustly correlated with current and future rate of economic growth, capital accumulation, productivity improvements and savings rate. They found that stock market liquidity- as measured both by the value of trading relative to size of the economy- is a robust predictor of real per capita gross domestic product (GDP) growth, physical capital growth and productivity growth after controlling for initial income, initial investment in education, political stability, fiscal policy, openness to trade, macro economic stability and the forward looking nature of stock prices. Banking development and stock market liquidity are both good predictors of economic growth, capital accumulation and productivity growth. Volatility insignificantly correlated with growth in most specifications. Similarly,
market size and international integration are not robustly linked with growth. Finally, none of the financial indicators is related to private saving rates. The results of the study by Levine and Zervos are certainly consistent with the view that services provided by financial institution and markets are important for long run growth.

Makato Nagaishi\textsuperscript{21} in his paper felt that in Indian stock market development from the 1980s onwards has not played any prominent role in domestic savings mobilization. Both Gross Domestic Savings and the share of the financial assets of the household sector have been stagnating since 1992 that is in the post-reform period. Indian stock market and financial intermediaries have generally achieved hand-in-hand development since the 1980s and the World Bank Research Group’s hypothesis is concrete in this respect. These results indicate that the functional relationship between stock market development and economic growth is dubious in the Indian context.

Cooper\textsuperscript{22} explained the money-stock return relationship implied by the Simple Quantity Theory (SQ) model'. He argued that stock prices will rise due to disequilibrium in the public’s portfolio of cash, financial and other assets triggered by unexpected increases in money supply. This portfolio disequilibrium causes investors to shift out of money holdings to financial and other assets thus pushing up their prices in the process.

Kaul\textsuperscript{23} reported evidence from four industrialized countries viz. U.S.A., Canada, U.K., and Germany confirming the proxy hypothesis in the post-war period. He regressed stock returns on both inflation and real variables such as annual growth rate of industrial production and real GNP. The results of the regression suggested
that the proxy hypothesis may be the basis for the spurious negative inflation-stock return relationship as inclusion of real activity variables eliminates this negative relationship consistently in all the four countries.

Sankaran Venkateswar\textsuperscript{24} has explored the relationship of the Indian stock market to Other International Stock Markets, as reflected by the Bombay Stock Exchange (BSE) index vis-à-vis other prominent International Stock Markets and found that there is practically no meaningful relationship between the B.S.E. index and other international stock market indices. Interestingly though, the British and the South Korean stock indices are inversely related to the BSE index.

Ghosh and Ortiz\textsuperscript{25} argued that financial markets are becoming more sensitive to fundamental factors on a worldwide basis due to increasing globalization and declining barriers to investment and capital flows.

The explanation provided by Singh\textsuperscript{26} is that unlike in the U.S and the U.K in the nineteenth century, stock market development in developing countries is not an evolutionary response to market forces but instead developing county governments have played a major proactive role in the development of this market. Besides, for the period of the 1980s, firms in developing countries resorted a lot to equity financing as the relative cost of equity capital fell significantly during those years. The fall in the cost of equity was due to a large rise in share prices that resulted from internal and external financial liberalization. As access to stock markets became easier the participation in stock markets increased in the 1980s. This was also the
time when the relative cost of debt financing increased with embarkation of financial liberalization in developing countries and the steep rise in international interest rates. The cost of equity capital relative to debt was thus favorable to equity during 1980s and firms as a result resorted to equity financing more heavily.

Anil K Sood suggested that the risk-return relationship in the Indian market is not in accordance with the CAPM hypotheses. The hypothesis of positive relationship between expected returns and the market risk-factor is not supported by the results. However, the prediction about non-pricing of the residual risk-factor is observed to be valid. Based on these results, it may be concluded that the return generating process of Indian capital market is characterized by a multi-factor macro-economic model and the risk-return relationship is in accordance with the APT hypothesis.

In his study Vijaya Sarathi indicated that there are substantial phase differences between the financial markets in India as compared with the US financial markets. Even at the volatility level, the inter linkages are greater in the US than in India. The study provided evidence regarding the increased degree of interdependence of the Indian stock market with the US stock market, since the onset of the capital market liberalization in 1992. The results showed that there are unidirectional volatility spillovers from the US stock market to the stock market in India. The study shows that by increasing the access of market players to multiple markets, it is possible to increase the degree of interdependence between these markets.

Nagaraj confirms Singh’s view and his findings as follows

i) In India, the huge increase in stock market financing activity is not associated with either rise in aggregate gross domestic savings (GDS) or equally...
significantly with an increase in the proportion of financial savings. This seems the enormous stock market activity in the 1980s basically involved portfolio substitution by households and institutions from bank deposits towards stock market instruments.

ii) The increase in external finance available with the corporate sector through the capital market has replaced to a great extent their internal funds during this decade, which could be due to a decline in corporate profitability.

Nagaraj concluded that the hypothesis of capital market resource mobilization could have favorably influenced corporate physical investment growth does not seem valid.

Sanjay K Hansda and Partha Ray\textsuperscript{30} studied whether there is synchronized movement of BSE and NASDAQ. They interpreted that there is an indication of integration catching up with the Indian financial markets with that of NASDAQ. The authors have looked into the nature of relationship between the daily share price in BSE and NSE on the one hand and NASDAQ and New York Stock Exchange on the other, for 1999-2000 through 2000-2001 and have found a unidirectional casualty from NASDAQ to BSE or NSE. The relationship as well as direction of causation also hold good for the technology segment of the New York Stock Exchange and BSE or NSE. However, domestic prices of technology stocks and overall domestic share prices were found to be independent of each other.

Pitabus Mohanthy\textsuperscript{31} found that size (measured by market capitalization), market leverage, price-to-book value, and earnings-to-price ratio were highly correlated with stock returns. While size and price-to-book value were negatively correlated with
stock returns, earnings-to-price ratio and market leverage were found to be positively correlated with stock returns. The study also found a flat relationship between returns and beta.

Madhusudana Karmakar, Mudhumitha Chakraborty\textsuperscript{32} investigated whether Indian stock market showed the same calendar anomalies as has been found in developed markets of the world, primarily in the United States. Their paper examined return anomalies of Indian stock market for the presence of six calendar anomalies that have been documented in other countries. These are the day-of-the-week effect, the monthly effect, the turn-of-the-month effect, the holiday effect, the month-of-the-year effect and Friday-the-thirteenth effect. Investigations of these issues have been made for the whole period 1981-95 as well as for three different sub-periods. The results indicated the presence of Friday effect, the monthly effect, the turn-of-month effect and holiday effect in Indian stock markets.

Cox, Kleiman and Stout\textsuperscript{33} examined the stock market reaction to the Tax Reform Act (TRA) of 1986 in the U.S.A. The most important provisions of the TRA, according to them, were the reduction in marginal tax rate on business income, elimination of the Investment Tax Credit (ITC), reduction and extension of several less important tax credits, and the modification of depreciating schedules. They reported evidence for significant abnormal security returns around the date of announcement of the TRA.
Nageswara Rao found that Federal Budgets were associated with increases in volatility whereas half yearly credit policy announcements by the Reserve Bank of India (RBI) had no impact on the market. Of all the events, changes in administered prices seem to have the maximum impact on the market. This is due to the large gap between demand for and supply of the commodity and the consequent expectations of a rise in their prices resulting in wind fall gains to the firms in that industry. Changes in industrial policy (de-licensing) and Foreign Exchange Regulation Act did not seem to enthuse the market participants, whereas regulatory actions by Monopolies and Restrictive Trade Practices Commission was associated with negative abnormal returns.

Pratap Chandra Biswal and Kamaiah evaluated the behaviour of stock market development indicators, namely, market size, liquidity, and volatility and examined whether these inflictors have exhibited any trend changes after India liberalized its financial policies. The findings of the study suggested that stock market has become larger and more liquid in the post liberalisation period. In respect of volatility, however, the market does not exhibit any significant change. This analysis also looked into the time series properties of stock market size, liquidity and volatility following liberalisation measures in India.

Fama hypothesized that the negative relation between stock returns and inflation is proxying for the positive relation between stock returns real variables which are more fundamental determinants of equity values. He further argues that the observed negative relationship between stock returns and inflation is spurious and is induced
by the negative relation between inflation and real activity. This hypothesis is known as Fama’s Proxy Hypothesis.

Abhay Pethe and Ajit Karnik have looked at the role that stock exchanges are expected to play in an economy viz. that of providing liquidity and helping in price discovery. And they found that in the Indian context, neither seems to be fulfilled at the present time, at least not to the full extent. There are indications that we are getting there. This may be seen from the macro-economic changes that are taking place, especially in the policy design environment. The physical characteristics such as computerization and volatility seem to be mimicking the western more developed-economies, but whether this implies development or is merely a superficial similarity remains to be seen. The relationships between the macro-economic variables and stock indices are as yet, not very conclusive.

Roy M K felt that there is an increasing recognition among policy-makers of Less Developed Countries (LDC) about the beneficial role of stock market in mobilizing and allocation of resources in support of growth and development. Specially, it is increasingly recognized that, given the competition for foreign sources of funding and the limited availability of domestic finance in LDCs relative to their development needs, equity market could play an important role in providing capital to the productive sectors, as well as facilitating the process of privatization. But efficient functioning of the market is an essential condition to ensure the above benefit to the economy.
Sarat Malik\textsuperscript{39} examined the relationship between stock markets and economic growth in India. The data and the results suggested that stock market development remain positively and significantly correlated with economic growth. Studies focused mainly on one way relationship between stock market development and economic growth, the present findings extended empirical implementation to show the both way relationship. The results which are consistent with theories suggest that there is a relationship between stock market development and economic growth in India.

Bencivenga and Smith\textsuperscript{40} emphasized the fact that financial intermediaries stimulate savers to hold their wealth increasingly in productive assets, contributing to productive investment and growth, in the context of an endogenous growth model. They explicitly point out that individuals are willing to hold wealth in financial assets, as long as these assets can be easily liquidated. Commercial banks issue these liquid assets to servers in the form of (term and savings) deposits. At the same time, they use these savings to finance high-technology investment projects locking up capital for longer periods to yield high returns. This stimulates overall economic growth performance. These projects would not have been easily financed by individual servers since financing them would make their wealth less liquid. Levine\textsuperscript{41} follows more or less the same line of thought, but stresses the importance of stock markets in stimulating the financing of investment in less liquid investment projects.
Joushua D Coval and Anjan V Thakor proposed a new framework for understanding financial intermediation. In contrast to previous research, they considered a setting in which intermediaries possess no inherent information processing or monitoring advantages. Instead, in an economy with overly optimistic entrepreneurs who require funding from pessimistic investors, they showed that intermediaries can rise endogenously. In such a setting, only a rational intermediary will be sufficiently optimistic to find it worthwhile to invest in a technology for screening entrepreneurs' projects, and yet be pessimistic enough to use this technology.

Dann and James examined the central issue in the economics of regulation concerning the behaviour of regulators. They argued that regulators act in the interest of the regulated, while others argue that they act in "public" interest or perhaps in their own interest. They explored the effect of deposit-rate ceiling changes on the stock prices of Savings and Loan institutions (S&L's). Their results suggest decrease in share prices of S&L's around the date of announcement of the removal of ceilings on certain types of deposits. They argued that S&L's have earned economic rents from restrictions on deposit interest rates. The decline in equity prices has been attributed to reduction in these rents as a result of removal of ceilings on deposit interest rates.

Ruback explored the effects of mandatory wage and price controls in the United States. He estimated the impact of many decisions of the price commission, the regulatory agency responsible for administering phase II (price controls) of Nixon's
Economic Stabilization programme, on the equity values of firms. He reports evidence of significant abnormal losses of 3.03 percent to stockholders of firms which were accused of violating the regulations and hence were ordered to reduce their prices. The reported evidence suggests that equity prices respond to the decisions of the price commission.

Swapan Sen\textsuperscript{45}, in his paper examined the share price movement in India during 1985-94 to ascertain the role of foreign capital vis-à-vis internal economic factors such as GDP growth, changes in interest rate and exchange rate movements in the determination of stock prices. He was of the opinion that though the stock prices have received significant support from foreign equity capital, internal economic factors also have been important. His examination of the P/E ratios indicated that the stocks were possibly overpriced in April 1994 when the foreign capital inflows peaked. The subsequent market corrections and an improved showing by the Indian economy once again poised the Indian capital market for significant growth.

In their research paper Chalapathi Rao, Ranganathan, Murthy\textsuperscript{46}, explained that only a few FIIs are active on the Indian stock market. While portfolio investments are known to be volatile, the fact that only a few FIIs and that too mainly from two countries namely USA and UK are interested in the Indian stock market increased its vulnerability to fluctuations. An interesting finding from their study is that net FII investments influences stock prices in India as it traces the relationship to the sectoral level. One implication that can be drawn from the similarity between FII investments and trading on the Indian stock market is that the Indian investors, since
they perceive FIIs to trade on the basis well researched strategies, may have followed the FIIs like a "herd" and in the process accentuated the selective process introduced by the FIIs.

Kumar examined whether the surge in FII inflow to India is consistent with the standard models of international portfolio choice and found that the FIIs are investing in India primarily due to the high returns that may be earned by investing in India and not because of the diversification benefits that accrue to a foreign portfolio investor by choosing to invest in an emerging market like India. Therefore any attempt by the policy makers to use the FOREX reserves for financing any real assets have to be very carefully weighed because substantial part of the Indian FOREX reserves are built from the portfolio flows.

**Need for the Study**

The importance of capital market in any economy cannot be overemphasized. The development of capital market is vital for the growth of real economy. A significant feature of developed capital market is the degree of its integration and interaction with major sectors of the economy. A stronger capital market promotes sound and sustainable financial system. The growth and development of Indian capital market, in particular during the last two decades has been spectacular. The impacts of international trends of the developed and emerging capital markets were evident in India also. The turnover in the developed markets has grown more sharply than that in emerging markets. This is a fact that financial stock markets world wide have grown in size as well as depth during the last twenty years.
The deregulation, liberalization and globalization of the Indian economy have provided much needed impetus to the capital markets for its growth and development. The earlier reforms facilitated the faster growth and the latest one focused on strengthening the functioning of the capital markets in India by adoption and implementation of best international practices, systems and products. This trend would definitely increase the efficiency and effectiveness of Indian stock market.

The Securities Market in India has undergone a major transformation during 1990s. The role played by the Securities Market has become far and wide as compared to that of its role in the initial stages.

The plethora of reforms that have taken place over a period has changed the outlook of the Securities Market. The important reforms introduced in the Indian Securities Market are more particularly, the establishment and empowerment of SEBI, market determined allocation of various recourses, screen based trading system, dematerialization and electronic transfer of securities, banning trading deferral products, introduction of rolling settlement, trading in derivatives and risk management, efficient trading and settlement system. This has led to lot of development both in terms of volumes of the trade and in terms of the depth of the market. Now, Indian securities market can be compared to that of the developed countries in terms of the infrastructure and sophistication. The process has solved many problems and at the same time it gave birth to certain other problems. The legislature has been taking all the necessary steps to overcome the problems in the market. The review of literature presented above shows that there are no studies on
the Impact of Financial Sector Reforms on Securities Market in India. Hence, it is felt that there is a need for a study on the topic selected. This study makes an effort to understand the impact of reforms on the securities market in India and to ascertain the impact of the same on the investor confidence.

Objectives of the study

1. To study the process of financial sector reforms relating to the Securities Market.

2. To study the role of intermediaries' viz. Brokers, Sub brokers, Mutual Funds, Depositories, Depository Participants, FIIs etc. in the growth of Securities Market.

3. To study the origin, growth & development of derivatives market in India.

4. To study the role of SEBI in regulating the Capital Market & to evaluate the efforts of SEBI & Stock Exchanges in promoting investor awareness & protection.

5. To understand the impact of reforms, examine the growth of the stock market and identify the reasons for the same.

6. To study the investors' perception towards return & risk of the stock market instruments and to study impact of reforms on the confidence of the investors in the market.

7. To make necessary suggestions for the improvement of the Securities Market.

Methodology

To achieve these objectives, data has been collected from both the primary and secondary sources. The primary data has been collected through structured questionnaires from both the investors (Annexure I) and the intermediaries (Annexure II). Apart from the questionnaires, discussions are undertaken with the
stock market specialists to elicit their opinions on various matters. The questionnaire has focused on the investors' attitudes towards risk return parameters of an investment alternatives and their perception towards impact of reforms on Securities Market in India. The perception of the intermediaries towards impact of reforms on Securities Market is also ascertained. Secondary data has been collected from reports, Bulletins of RBI, Bulletins of SEBI, books, journals, magazines, conference papers etc. To understand the impact of the reforms, the data relating to the GDP, Market Capitalization etc., has been collected from economic surveys, union budgets, SEBI bulletins, Indian Securities Market review etc.

The analysis is based on averages, weighted averages, Chi-square & Anova. To understand the impact of reforms on Securities Market the relationship between GDP, Market Capitalization etc. are calculated and the results are interpreted.

Hypothesis

In this study two types of hypotheses are framed. They are (a) relating to risk and return attributes of investors and (b) relating to the perception of investors and intermediaries.

While looking at the basic attributes of the investment i.e. expected return and risk tolerance the question that arises in the mind of the researcher is that, whether there are any factors that may explain the difference in these attributes. In that direction the test of homogeneity is undertaken by using Chi square ($\chi^2$) analysis.

The hypotheses framed at this level relating to the expected return are:
$H_0$ (Null Hypothesis): The expected returns by the investor do not depend on the place of stay and gender & education level.

$H_1$ (Alternate Hypothesis): The expected returns of the investor vary with the place of stay and gender & education level.

To check whether the risk taking ability is influenced by any of the factors such as the place of stay, the gender and level of education and the level of average income.

The hypotheses framed at this level are:

$H_0$ (Null Hypothesis): The investments in risky assets by the investor do not depend on the place of stay, gender & education level and the average income.

$H_1$ (Alternate Hypothesis): The investments in risky assets by the investor vary with the place of stay, gender & education level and the average income.

When it comes to the perception of the investors and intermediaries it is assumed that there is no difference in the perception of investors and intermediaries by using one way ANOVA to test equality of population means.

The hypotheses are:

$H_0$ (Null Hypothesis): There is no significant difference in the perception of among investors and intermediaries relating to reforms of the market, attributes of the market, role and efforts of SEBI and protection of investors’ interests.

$H_1$ (Alternate Hypothesis): There is a significant difference in the perception of among investors and intermediaries relating to reforms of the market, attributes of the market, role and efforts of SEBI and protection of investors’ interests.
Sampling

In order to ascertain the opinions of the investors and the intermediaries, the state of Karnataka has been selected as it is truly cosmopolitan in its nature. A Sample of 300 investors from Karnataka state is taken for the study on the basis stratified, convenience and judgmental sampling. While selecting the investors, care has been taken to select them from Urban (State Head Quarters), Semi-Urban (District Head Quarters) and Rural (Other) areas. A sample of 150 investors from urban area i.e. Bangalore, 50 investors from semi-urban i.e. Gulbarga and Mangalore and 100 investors from rural areas is selected as the number of investors at urban area is comparatively more than that of the other areas. When it comes to the semi-urban areas, the number is taken as 50, as the number areas are comparatively lesser than the rural areas. The rural areas are given its due and accordingly ten places are selected for the study. The places covered under rural areas are Nanjanagud, Gauribidanur, Hospet, Thithahalli, Somavarpet, Harihara, Karkala, Nippani, Birur and Bhalki.

A sample of 50 intermediaries from urban area (Bangalore) such as stock brokers and depository participants is also taken for the study to understand their perception towards the reforms and market.

The data relating macro economic variables is taken from 1980 to 2006 for identifying the trends etc. relating to the growth of securities market and to see as to how the reforms have influenced the market.
Limitations of the Study

Any research by its inherent nature is bound to have some limitations and this study is not an exception to that rule. The major limitation of the study is that it is restricted to the state of Karnataka only and the size is also limited. However an effort is being made to minimize the impact of this limitation by selecting maximum number of investors from Bangalore, which is truly a cosmopolitan city. As this study is based on the responses of the investors and intermediaries there is a possibility of personal bias. A care has taken to bring down the impact by asking cross reference questions. Some of the investors could not relate themselves to the impact of reforms as they were new entrants to the market. The investment activity is the outcome of innumerable factors. Where as in this study only a limited number of factors are considered. With all these limitations all the efforts are made to evaluate the situation as accurately and objectively as possible.

Presentation of the Study

Chapter one deals with the basic structure of the financial market in India and its evolution and growth over a period of time to reach to this level. An effort is also made to understand the reforms that have been initiated and how the reforms have made an impact on the overall securities market in India. In the second chapter review of literature, need for the study, objectives of the study, methodology, hypothesis, sampling, limitations and chapter scheme are presented. The role played by various intermediaries and other participants in the development of the Securities Market in India is explained in detail with relevant statistics in chapter three. Chapter four analyses the reasons for growth of derivatives and traces its origin and growth
not only in India but also in the world. In chapter five, the role played by SEBI in regulating the market and its intermediaries is being presented. It also deals with the origin, functioning and the initiatives undertaken by SEBI. A study on SEBI in providing investor protection is also done in this chapter. The trends in the stock market are given in chapter six. In this chapter an analysis of its movements and the reasons for the same are being presented. Chapter seven deal with the perception of investors and intermediaries towards the role played by SEBI, their opinion about the role of reforms and their attitudes towards risk and returns. In chapter eight the whole study is summarized and appropriate suggestions are given.


