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Capital growth in India with stock market development

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Abstract
The Indian financial sector has undergone a significant structural transformation since the initiation of the economic reforms in 1990’s. Financial sector reforms mainly entailed reforms of the banking system and the capital market. As a result of reforms since 1991, the financial markets have transited to a regime of market-determined interest and exchange rates, current account convertibility, phased capital account liberalization and an auction based system in the government securities market. Policy initiatives have tried to ensure financial stability, curbing excessive fluctuations and volatility in interest rates, exchange rates and hence moderating inflation without choking credit to productive sectors, thus mitigating risks arising out of deregulation and globalization of financial markets and helping in the efficient allocation of resources in the real sectors of the economy.

Keywords: Capital growth, market development, economic

Introduction

The capital market reform was an integral part of the agenda of financial sector reforms in India. Gupta (2002) has rightly pointed out that improving stock market efficiency, enhancing transparency, checking unfair trade practices and bringing the Indian capital market up to a certain international standard are some of the major objectives of the capital market reforms. Due to this reforming process, the Securities and Exchange Board of India (SEBI) was formed as the apex regulator of the capital market. The new regulatory framework laid down by SEBI sought to strengthen investor protection by ensuring disclosure and transparency rather than through direct controls. The SEBI has apparently made progress in achieving its major objectives such as to protect the interests of investors in securities and to promote the development of, and to regulate, the securities market and for matters connected therewith or incidental thereto [1].

Following the implementation of reforms in the securities industry in the post liberalisation period, Indian stock markets have grown significantly in terms of market capitalization and market turnover ratio. As per Standard & Poor’s Global Stock Markets Factbook (2011), India ranked 7th in terms of market capitalization (11th in 2009), 10th in terms of total value traded in stock exchanges, and 22nd in terms of turnover ratio, as of December 2010. The market capitalization in Indian stock markets has grown over the period, indicating that more companies are using the trading platform of the stock exchange. The market capitalization across India was around Rs. 68,430,493 million at the end of March 2011. During 2010, turnover of Indian stock exchanges in the cash segment increased 43.3 percent to Rs. 55,184.7 billion from Rs. 38,525.8 billion in 2009. The Bombay Stock Exchange (BSE) and National Stock Exchange (NSE) together contributed 99.9 percent of the turnover. Of this, the NSE accounted for 74.9 percent of the total turnover in the cash market whereas the BSE accounted for 24.9 percent to the total. During 2012-13, Indian equity markets staged a slow recovery followed by significant turnaround amidst strong headwinds caused due to strains in global financial markets coupled with lingering domestic economic woes. Markets recovered in the backdrop of strong revitalizing policy announcement and reforms which induced investor optimism and energized the investment milieu. The much needed liquidity for the markets was delivered by the enhanced foreign capital flows in search of higher returns. In spite of the macroeconomic stress, investor confidence and market sentiment remained firm on the expectations of further improvement in the domestic economic scenario.

Despite the substantial growth in India's financial sector, the trend of economic growth is seems to be positive over the last two decades. The growth rate is almost 6.2 percent per annum during 1994-95. The trend was slightly decelerated to 3.8 percent in 2002 and then increased to 9.7 percent in 2006-07. However, the year 2009 saw a significant slowdown in India's GDP growth rate to 6.7 percent (Economic Survey, 2008-09). This is probably due to global financial crisis in 2007- 2008. The deceleration of growth in 2008-09 was spread across all sectors except mining, quarrying, community, social and personal services. This could be concluded that the performance of economic growth depends upon the growth of financial sectors in the economy.

Most importantly, it is widely recognized that the development of the stock market is considered crucial to national economic growth as it: (a) provides an additional channel for encouraging and mobilising domestic savings; (b) ensures improvements in the productivity of investment through allocation of capital/resources; and (c) increases managerial discipline through the market for corporate control. The stock market positively influences national savings, allocation of capital/resources, financing funds and incentives for corporates, and finally paves the way to economic growth. Taking into account the importance of stock market in the process of economic development, the stock market development has a causal influence on economic growth. That is, deliberate creation of financial institutions and markets increases the supply of financial services. The capital market increases savings, and allocates them to more productive investments. Thereby stock market development can stimulate economic growth. This is known as 'supply leading' hypothesis. For example, findings in McKinnon (1973), Shaw (1973), and King and Levine (1993a, 1993b) support this hypothesis [2].

On the other hand, there exists a causal relationship from economic growth to stock market development, i.e., 'demand following' hypothesis. In this view, stock market development appears as a consequence of the economic development. Continual economic expansion requires more financial services and new instruments. The financial system adapts itself to the financing needs of the real sector and fits in with its autonomous development. Therefore, this type of stock market development plays a rather passive role in the growth process. For example, Gurley and Shaw (1967), Goldsmith (1969) and Jung (1986) show that, economic growth propels financial development, supporting the 'demand following' hypothesis.

Moreover, the third view stresses the reciprocal relationship between stock market development and economic growth. Economic growth makes the development of financial intermediation system profitable, and the establishment of an efficient capital market system permits faster economic growth. By specializing in fund pooling, risk diversification and liquidity management, the capital market system improves the efficiency of capital allocation and increases the productive capacity of the real sector. At the same time, the technological efficiency of the stock markets increases with its size, because economies of scale and learning-by-doing effects are present in financial intermediation activities. As a result, the real sector can exert a positive externality on the capital market through the volume of savings. Therefore, stock market development and economic growth positively influence each other in the process of development [3].

The above theoretical arguments primarily revolved around two major empirical questions: first whether there is a casual relationship between development of stock market and economic growth. Second, what could be the nature and direction of the causal relationship between stock market development and economic growth? Various researchers and policy makers alike have focused to understand the various ways in which economic growth can be enhanced. The relevance of policy implications pertaining to stock market development and growth nexus becomes an important substance among academics, policy makers and economists in India. If the Indian stock market acts as an engine for economic growth, then the market regulators and economic policy makers should focus their attention towards establishing and sustaining a dynamic capital market in order to foster a sound and continued economic growth. On the other hand, if economic growth leads to capital market development, then much concentration to be needed towards countries' sustained growth performance in order to enhance the development of capital markets in the economy. In this backdrop, the present study attempts to examine the causal linkage between the stock market development and economic growth in India.

On the other hand, Singh (1997) focused his research on developing countries and investigated the role of stock markets towards long run economic growth in the 1980s and 1990s. He concluded that in developing countries, long run economic growth does not show dependency towards the stock market. A study by Harris (1997) on forty-nine countries for the period 1980-1991, found out that there is no significant relationship between stock market and economic growth. Recently, Boubakari and Jin (2010) proposed a positive links between the stock market and economic growth for some countries for which the stock market is liquid and highly active. However, the causality relationship is rejected for the countries in which the stock market is small and less liquid. Okoye and Nwisienyi (2013) found that the capital market in Nigeria has the potentials for growth inducing but has not contributed meaningfully to the economic growth of Nigeria [4].

Moreover, the empirical studies showed that causality runs in both the directions i.e. economic growth causes the stock market development and vice versa (Arestis *et al*. 2001, Demetriades and Hussein, 1996, Luintel and Khan, 1999). Tuncer and Alovsat (2000) investigated the causal nexus between stock markets and economic growth for twenty countries and showed the bi-directional causation between stock market development and economic growth for the selected nations. Further, Shahbaz *et al*. (2008) confirmed the long-run bi-directional causality between stock market development and economic growth in Pakistan. As regards to the research concerning India, Kamaiah and Biswal (2000) attempted to assess the empirical relationship between stock market development indicators and economic growth in India. They found stock market size was positively associated with economic growth. However, there was no support for the association between stock market liquidity and economic growth in India. Biswal and Veerashekharappa (2002) found that stock market development plays a significant role in the economic growth process in India. Agrawala and Tuteja (2007) confirmed a stable long run equilibrium relationship between stock market developments and economic growth. Chakraborty (2007) revealed the causality runs from growth rate of real GDP to stock market capitalization. Padhan (2007) and Paramati and Gupta (2011) exposed the bidirectional relationship between stock market development indicators and economic activity. Deb and Mukherjee (2008) and Acharya *et al*. (2009) observed a strong causality runs from the stock market development to economic growth. Recently, Sahoo (2013) revealed that market-based indicators of financial depth have positive impact on economic development in India. However, he found no evidence of causality between market capitalization and economic development [5].

From the related literature, it was worth noting that empirical evidence is still inconclusive and remains ambiguous in the context of Indian capital markets. With the pace of economic reforms and the rapid integration towards the world economy followed in India, the importance of capital markets has grown significantly and has been receiving global attention, especially from sound investors. The Indian stock market has witnessed major fundamental institutional changes, resulting in drastic reduction in transaction costs and significant improvements in efficiency, transparency and safety which led the stock exchanges to do a remarkable task for the economic development of the country.

Conclusion

The economic expansion through technological changes, products and services innovation in the post-reforms period is expected to create a high demand for the development of stock markets. This paper attempts to examine the causal nexus between stock market development and economic growth in the Indian context. Most importantly, this study will seek to provide more effective and appropriate policy for the Indian economic planners, financial market regulators, market participants, academicians, and alike who seek to develop economic policies to best target for a sustainable economic development as well as the future direction of stock market developments.

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