

## **Levels of Liquidity and Concentration of Trading Activity on the National Stock Exchange and the Bombay Stock Exchange: An Analysis**

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*The present study deals with the liquidity function of a securities market and attempts to empirically analyse the extent of liquidity, and the concentration of trading activity of securities traded on the Bombay Stock Exchange (BSE) and the National Stock Exchange (NSE). The factors motivating market participants to undertake trade are described and the concepts of price depth, price resiliency and market breadth are elucidated. Empirical analysis reveals that the liquidity as measured by quantity traded, turnover and price depth measures is low both on the BSE and the NSE. Further, analysis also points out the incidence of high concentration of trading activity in a few securities on both the exchanges.*

The policies of liberalisation and globalisation initiated in the Indian economy envisage a critical role for the financial markets in general and the stock markets in particular. Such emphasis is based on the assumptions that the securities traded on the stock markets are liquid, their prices are stable and the stock markets are efficient from the operational, allocation and information points of view. However, these assumptions are highly debatable and are in contrast to the general perception that the stock markets in India are illiquid, highly volatile and inefficient. The present study focuses on the liquidity function of the stock market.

A liquid market is necessary to enable investors to carry out their transactions within a minimum possible time and with minimum cost, and also for making the market less volatile and more efficient. Liquidity or illiquidity of a security has implications for the financing decision of firms (Amihud and Mendelson, 1988), valuation of firms, and investor sentiment. The decision of a firm as to how much further capital to issue, what type of instrument to be used and when to issue, depends, among other factors, on the liquidity of its outstanding securities. It is relatively easy for a firm whose securities are regularly traded, to issue further capital, than for a firm whose securities are less frequently traded. Illiquidity results in price discontinuities and makes the valuation process a difficult task, as the last price at which the firm's securities were traded cannot be taken as representative of current market price. Further, investors require a greater expected return from companies whose securities are illiquid or less liquid, than from the companies whose securities are liquid. This is to compensate for the illiquidity borne by the investors in holding infrequently traded securities.

Despite its importance, very few studies have analysed the problem of liquidity of securities. Gupta and Rohatgi (1973), Gupta (1992) and Machiraju (1993) analyse the problem of liquidity of securities. These studies find that the stock markets in India are illiquid, trading activity is concentrated and also the presence of 'thin trading' in securities. However, these studies pertain to an earlier period and analyse only a few stocks, though the generality of findings does not appear to be inappropriate. Further, developments in concepts

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