

Financial Market Integration in India: A Cointegration Approach

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During the last decade, significant progress was achieved in terms of policy and institutional reforms in the financial sector in India. A question that needs to be addressed is: how far have these initiatives resulted in narrowing the inter-market divergences and achieved a reasonable degree of market integration? This paper examines this issue empirically and attempts to provide some evidence on market integration in India. It is found that while the reform process has helped in removing institutional bottlenecks to the free flow of capital across various segments of the financial market, this has not yet been translated into complete integration among them.

I Introduction

Since independence, the financial sector has been subject to strong government control in India. This period is characterized by government control over all financial institutions and the markets, directed credit programmes, a pre-emption of funds through SLR and CRR, controls over pricing of financial assets, barriers to entry into different sectors, and restrictions on transactions and flows (Bhole, 1999). This resulted in highly segmented and arguably inefficient markets (Chakravarty Committee Report 1985). The secondary market of Government securities was dormant. Both the money and capital markets were underdeveloped. The foreign exchange market was extremely thin, mainly due to stringent restrictions under Foreign Exchange Regulation Act (FERA)¹. Moreover, the basket-linked exchange rate was administered and the financial markets stood segmented. Although the financial sector grew considerably in the regulated environment, it could not achieve the desired level of efficiency.

A comprehensive package of financial sector reforms were undertaken following the recommendations of Narasimhan Committee (1991), in order to build an operationally and allocatively efficient financial market by allowing the market forces to determine both rates and volumes in different segments of the market since 1991. The reforms have taken the form of opening several sub sectors of the financial system to the private sector, deregulation of interest rates and a greater market orientation for financial institutions as regards both sources and placements of funds. The convertibility of the rupee on current accounts together with dilution of FERA has activated the foreign exchange market (Reddy, 1999). An important objective of reform has been to develop the various segments of the financial market into an integrated one, so that their inter-linkages can reduce arbitrage opportunities, help achieve higher level of efficiency in market operation and increase the effectiveness of monetary policy in the economy (Reddy, 1999). During the last decade, significant progress has been achieved in terms of policy and institutional

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¹ For instance, see, Ananthakrishnan, V. (1994).