ABSTRACT

Reserve Bank of India's recent market oriented monetary policy would require well-developed and integrated financial markets. This thesis attempts to study the efficiency of asset markets and inter-linkages among them. These aspects are analyzed in the context of four markets: money market, stock market, and foreign exchange market and bullion market.

A fall in money supply is expected to raise the rate of inflation. However, standard structuralist theories do not take into account equity and foreign exchange markets. When these markets are introduced in the theory, this result holds only under special conditions. Also, there is a tendency for interest rates to rise and for fluctuations in asset prices. Greater integration of asset markets moderates these fluctuations.

Efficiency of stock market is studied by looking at the presence of long memory in stock returns. We observed presence of long memory in daily, weekly and monthly stock returns that can be explained by the presence of positive feedback traders in the market.

The impact of liberalization on money market has been studied with respect to the short-term liquidity conditions and pattern of interrelationship among the different short-term instruments. We found negative relationship between short-term liquidity position in the banking system and 364 days Treasury bill rate and interlinkage among the Treasury bill rates of different maturities. The commercial paper and certificate of deposit rates are not interlinked with other money market interest rates.

We found improvement in informational and operational efficiency of foreign exchange market due to movement from dual to unified exchange rate system. The study of market microstructure of the foreign exchange market suggests that volatility of exchange rate and transaction costs are positively related. We found that the liberalization of import of bullion has helped in the integration of Bombay bullion markets with world bullion markets.

RBI annual report, 1997, reports emerging interlinkages amongst asset markets. Our results suggest absence of long-run relationship amongst asset markets. However, we found that innovations in one market cause innovation in other asset markets in the short run. The degree of integration among markets is sufficient to require investors, mutual fund managers, and regulators to keep track of its nature and extent in making decisions. Agencies like SEBI (stock market regulator) and RBI (regulator of foreign exchange market, money market and bullion market) need to actively coordinate policies.