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Op-Ed

DEBATE

Are the steps being taken by the government and Sebi to curb volatility in the market adequate?

It won't reduce volatility, but create a vibrant market

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I am in favour of the ideas that have been mentioned not because they will reduce volatility but because they are the right things to do to create a vibrant and efficient market.

It is a good idea to liberalise institutional participation in derivatives because this deepens the derivative market and also provides hedging facilities to institutions. The restrictions that exist today are based on an irrational fear of derivatives. The smooth functioning of the derivative market over the last five years should be sufficient to dispel these fears. We should now move to put the regulation of institutional participation in the derivative markets on a more rational footing.

Similarly, direct participation in the securities markets by a wider range of foreign investors will bring greater diversity of participants and thereby enhance the resilience of the markets. We have long had a mistaken belief that we can make markets safer by restricting them to a small coterie of "trusted" institutions. Our fixed income and currency markets have suffered as a result. Equity markets have been immune to this delusion, except when it comes to foreign investors. Our experience with trusted coteries has always been that they produce narrow, one-sided markets that lack resilience. We should work towards wider participation in all our financial markets.

The recent change in the cash market margining system is a technical improvement that essentially brings the system on par with what we already have in the derivative market. It is a relatively small but correct move.

In short, all these proposals are good in their own right and are, therefore, welcome.

However, it is unlikely that any of these measures will have a significant impact on volatility in the short-term. More important, I do not believe that at the current point of time, reduction of volatility should be the objective of regulatory policy.

It is my view that the current volatility is due to fundamental uncertainty about the future evolution of the global economy and not due to any structural flaws in our securities markets.

In recent years, both the Indian economy and the global economy have performed very well and this performance has been reflected in asset prices both domestically and globally. However, at least some part of this good performance is due to the tail wind provided by abundant liquidity. What is not clear is how much has been the contribution of excess liquidity. There is a sharp divergence of opinion among economists and analysts on this issue. This matters a great deal as we enter a phase of coordinated monetary tightening worldwide. As the tail wind of rising liquidity gives way to a head wind of tightening liquidity, there is a great deal of uncertainty about how this will impact economic growth, corporate profits and asset prices. In addition, there is considerable uncertainty about how far the monetary tightening will go in different parts of the world.

In this phase of heightened fundamental uncertainty, a great deal of volatility is perfectly natural as markets try to make sense of every bit of information about these complex issues.

The volatility that we have witnessed so far has been benign. While there have been large losses, there have been no major defaults or bankruptcies. Risk management systems at the exchanges have held up well. The volatility has been large enough to grab headlines but not large enough to cripple the markets. Volatility on this scale serves to focus attention on the huge fundamental uncertainty that exists. Several years of booming economies and rising asset prices have led to a reduction of risk premiums to the point where risk is probably under priced in many markets. A period of heightened volatility serves as a gentle reminder that prices can go down as well as go up. If this reminder leads to a re-pricing of risk in domestic and global markets, that is also welcome.

—The writer, an IIM- Ahemdabad professor, is a former Sebi member

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