Chapter 8

Volatility and the Regulation of Stock Markets: Evidence from South Asia

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ABSTRACT

In recent years, one of the most important topics related to stock market volatility which is attracting attention, is stock returns, or in other words, the relationship between stock price volatility and trading volume. The aim of this study was to obtain information about the financial market structure of Bangladesh, India, Pakistan by applying Granger Causality Analysis to the relationship of trading volume and stock returns volatility in the period 1980–2012. The study then examines some of the stock market regulations that have been proposed in South Asia to attenuate stock market volatility, which have usually included proposals to limit volatility by imposing temporary trading halts, limiting the legal leverage available to investors in financial assets, altering exchange trading practices to accommodate volume, and by raising the transactions costs of financial trading.

1. INTRODUCTION

Financial market volatility is the volatility shown to the financial market by any asset worth or index in a specific period. Financial market volatility expressed as financial asset yield variability is an important measurement used in the determination of risk of investments in the financial market. Therefore, there has been increasing interest recently in studies related to volatility, which have the same meaning as the concepts of risk and uncertainty, which have an important place in traditional financial theory. When financial markets are effective markets, changes in asset prices and yield of the financial markets reflect the changes in the basic variables of the economy. When the financial markets are not effective, two conditions will arise.

The first is that agents external to economic factors start to affect financial market volatility, such as wrong financial policies and irrational behavior of investors. The second is that this volatility created

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in the financial markets starts to affect the real economy. In both situations, the volatility observed in
the financial markets is an independent indicator of the economic balance and requires intervention
by policy-makers. The volatility, which is initially an internal variable, over time starts to affect
the economy as a dependent external variable. Financial market volatility showed an increase in general
after the 1980s. The most significant reason for this was the increase in worldwide financial liberaliza-
tion after the 1980s. In this context, the collapse experienced in the USA in October 1987 is extremely
noteworthy. Increased financial market volatility is highly significant in respect of both the market inves-
tors and the policy-makers. When increased volatility means increased risk for investors, the situation
arises where investors may review their investment decisions. In the same way, as a result of increased
volatility, policy-makers may fall into the idea that the increased volatility of the financial markets will
damage the economy by reflecting the real economy. At the same time, the policy-makers may think
that increased financial volatility may damage the financial institutions and the regular functions of the
financial market. In this situation, structural and organizational changes may be required to be made by
the policy-makers for the market to function more regularly and to increase the flexibility of the mar-
et. Therefore, the determination of the causes of the waves experienced in the financial markets and
particularly in the stock markets and predictions made by the best modeling are of great importance in
respect of both investors and policy-makers.

In recent studies, it has been accepted that there is a connection between the general state of the economy
and the financial markets. Especially in developing markets, the general macroeconomic variables of
the economy have an effect on securities prices. In financial markets experiencing high volatility, lower
risk resources are generally seen as Treasury bonds and foreign currency. Therefore, modeling of the
volatility in the financial markets is extremely important in the formation of healthy markets be able to
provide depth and flow of resources in the financial markets. When financial market volatility is spoken
of, the focus is generally on stock market volatility, which can be considered an indicator of the pricing
of stocks not being effective and the financial markets not functioning adequately. There are two reasons
why volatility in the stock market has become so important in recent years. The first is that stock market
volatility is closely related to the performance of option and derivatives markets, and the second is the
financial crisis experienced in the USA on 19 October 1987. At that time, stock prices fell by 40% on
average and the fall of 508 points on the Dow Jones Index was a record-breaking crash. This volatility
damaged economy transfer channels and caused serious crises in the financial markets. Just as there are
negative aspects to stock market volatility, so there can also be said to be positive aspects. Therefore,
both the positive and negative directions of stock market volatility should be well considered. Sometimes
what can be characterized as positive can also be expressed as negative when volatility is looked at from
a different angle. In this sense, with high volatility of stock prices, just as it has been emphasized that
the stock may rise excessively, so it can also fall dramatically. Thus, investors with highly volatile stocks
may make large profits and when prices fall, may lose large amounts. On the other hand, manipulation
to protect investors who are active in the market from volatility risks is one of the negative aspects of
volatility and damages the market.

While that is the negative aspect of volatility, that high returns can be provided in the short-term by
long-term investment means is the positive aspect of volatility. Volatility in the stock market provides
increased possibility of accumulation in the short-term without investors having to wait for a long pe-
riod and thus the transfer of these accumulated funds to the market increases demand. Although there is
general agreement among economists on how stock volatility should be measured and the factors affect-