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Financial Disruption and Stock Market Reaction : A Study on Indian Banking Sector and Announcement of Demonetisation

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Abstract

We have used the daily returns data of all the fifty companies listed in NSE Nifty and the thirty-five banks listed on NSE as on the date of the event to evaluate the reaction of stock market to the announcement of demonetisation. The present study uses the event study methodology to achieve this end. To gauge the impact on the banking sector we have created three different portfolios namely All banks, public banks and private banks. Surprisingly the three portfolios show completely different reactions to the announcement of demonetisation. The all bank portfolio shows more pronounced reaction than the Nifty, though the overall trend of movement is similar. However the reaction of the banks in public and the private sectoris starkly different from each other. The public sector banks generate a positive excess return whereas the private sector banks produce hugely negative portfolio returns after the event date.

I. Introduction

A FINANCIAL EVENT that is a departure from the ordinary happenings and drastically different in terms of operations, having widespread consequence on economy is labelled as financial disruption. This can result in a situation where markets stop functioning normally, which is known as market disruption. Market disruption is usually characterised by sudden and large market declines. Physical risks to the stock exchange or irregular trading may cause market disruptions (as in a crash). In any case, the disturbance causes widespread panic and results in a chaotic market. There have been several disruptions in the Indian economy in recent years, with demonetisation being the most significant of it all. In his televised announcement of demonetisation, India's Prime Minister declared that the

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IV. Conclusion

Undoubtedly in the recent times, the declaration of demonetisation has been one of the most controversial and drastic actions taken by any government. It was specifically done to combat counterfeiting, corruption, tax evasion, and terrorist financing. While it will take several years to determine the effects of demonetization, the event study on stock market prices around the announcement date provide an understanding into investors' perceptions about the longer-term impact on different sectors of the economy and various types of businesses.

The comparison of abnormal returns for different sub-samples of firms in the banking sector reveals that it generates more than average excess returns as compared to the fifty stock NIFTY portfolio. Also it was seen that it was only the public sector banks which have contributed to such positive residuals, whereas the private sector banks have been conspicuous by their negative residuals across all event windows. The above discussion provides us with satisfactory explanation of the reasons behind the significantly larger excess returns generated by the public sector banks as compared to the private sector banks. In fact the stock market has been able to process the crucial information much before data regarding the deposits in banking system became available in financial press. Further the market has proved that there are no learning lags and the initial reaction of the stock market proves to be correct as far as reaction of banking sector to announcement of demonetisation is concerned.

We also want to emphasise that this paper is not intended to be a judgement on the efficacy or failure of the government's decision to demonetise. These types of stock market analyses, which are minor attempts to determine the effect of demonetisation, may seem to be of little significance at the moment, but they may fall into place later when a larger picture is addressed after a significant period of time.

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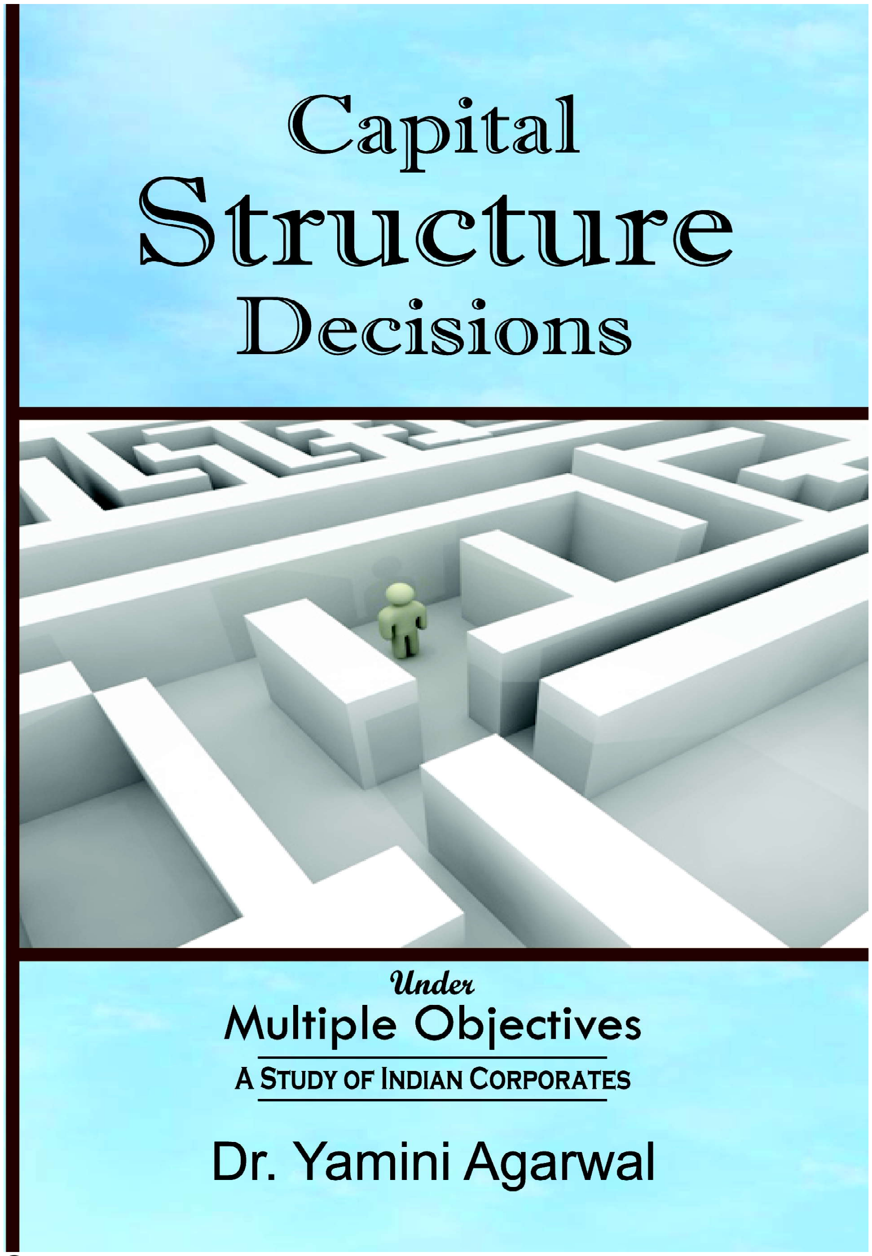
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