Do “speculative traders” increase Stock Price Volatility?

Empirical evidence from the Bombay Stock Exchange

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Abstract

In India there existed, until recently, a form of highly leveraged margin trading called the *Badla* system, for certain stocks categorized as group A stocks. In March of 1994, the Securities and Exchange Board of India (SEBI) has effectively banned the facility blaming it for causing “excessive speculation”. We study the effect of *badla* trading on stock return volatility by comparing the daily data from 1992 for group A and a matched sample of group B stocks. After controlling for other factors such as trading frequency, the average price level and the market capitalization of the firms, we find that the residual variance is actually lower for the group A stocks. Also, variance ratio tests indicate, that after accounting for other factors, no differences in the magnitude of price reversals (serial correlation) for both groups of stocks. Hence, SEBI’s decision does not seem justified on economic grounds.