Impact of Foreign Institutional Investors on the Indian Capital Market

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ABSTRACT

Foreign institutional investment signifies investments made by individual investors or companies in foreign lands. India have been witnessing a surge in FII activity since the opening of its capital markets. Owing to its high growth potential, India has become a favorite destination for FII activity. FIIs, convinced of India's economic progress ad strong corporate earnings, are continuously investing in the country. Fast GDP growth has made India a preferred destination for foreign investors post the 2008 financial crisis. In 2010 itself, India attracted nearly US$ 30 billion of net foreign inflows, which was just under 50 per cent of all inflows into emerging Asian markets, excluding China. Foreign investors have invested Rs 6,460 crore (US$1.45 billion) in Indian stock markets in just five trading sessions of July 2011.In the first six months of 2011, overseas investors infused around Rs 17,000 crore (US$3.82 billion) into the Indian market, including stocks and bonds. In the same period, FIIs made investments of Rs 9,948 crore (US$2.23 billion) in the debt market, with investments in stocks being Rs 2,670 crore (US$ 599.79 million).This paper analyses the role ahead for the Foreign Institutional investors in the present Indian economic Scenario with the focus on the impact on the Indian Capital Market.

Introduction

"Few nations have the growth potential that India already enjoys. India holds the promise of most successful future….."

…Klaus Schwab, Founder & Chairman, World Economic Forum

Until the 1980s, India's development strategy was focused on self-reliance and import substitution. Current account deficits were financed largely through debt flows and official development assistance. There was a general disinclination towards foreign investment or private commercial flows. The broad approach to reform in the external sector after the Gulf crisis was delineated in the Report of the High Level Committee on Balance of Payments (Chairman: C. Rangarajan). It recommended, inter alia, a compositional shift in capital flows away from debt to non-debt creating flows; strict regulation of external commercial borrowings, especially short-term debt; discouraging volatile elements of flows from non-resident Indians (NRIs); gradual liberalization of outflows; and disintermediation of Government in the flow of external assistance. After the launch of the reforms in the early 1990s, Foreign Institutional Investors [FIIs] have been allowed to

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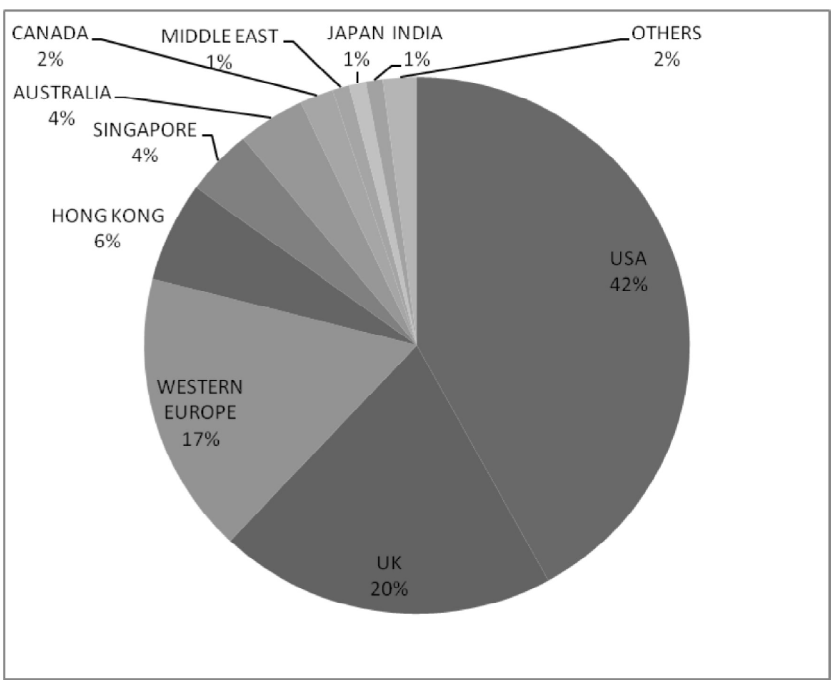
invest in all securities traded on the primary and secondary markets, including shares, debentures and warrants issued by companies which were listed or to be listed on the stock exchanges in India and in the schemes floated by domestic Mutual Funds. Although one cannot expect the FIIs to take an active interest in the developmental concerns of the emerging economies. If there is any benefit that accrues to the emerging economies it will only be incidental. The

main driving force behind the actions of these institutional investors is profit. FIIs tend to invest selectively in companies that achieve good results or show potential for future profitability. This is evident from the financial crisis of 2008.As on March 31, 2011 the net equity investment by FII in India was Rs.1, 46,438 crores with the registration of 1772 Foreign Institutional Investors. Thus in this paper an effort has been made to examine the impact of foreign Institutional Investors on the Indian capital market.

Sources of Foreign Institutional Investment

Foreign Institutional investment is used to denote an investor mostly in the form of an institution or entity, which invests money in the financial markets of a country different from the one where the institution or entity was originally incorporated. FII is frequently referred to hot money for the reason that it can leave the country at the same speed at which it comes in. In India SEBI has prescribed norms to register FIIs and also to regulate such investments flowing through in the form of FIIs.

Chart No: 1 Sources of Foreign Institutional Investment



Source : www.sebi.com

The above chart clearly depicts major portion of FIIs come from USA [42%], followed by UK [20%], Western Europe [17%], Hong Kong[6%], Singapore [4%], Australia [4%], Canada [2%], middle east countries [1%], and other countries contribute 2% of investment.

Purpose of the study

Foreign Institutional investors invest their money in India and the domestic investors are able to get benefit out of it. In the year 2008-2009,because of the global crisis FIIs withdrew their money from capital market because of profit motive and destabilized and damaged the capital market by which domestic investors were also affected to a large extent. FII depends upon number of variables operating in an economy like interest rate, inflation rate, exchange rate and also the global economic environment and its favorability towards the host country.

Literature Review

Rajesh Chakrabarthi (2001) found that FII flows are highly correlated with equity returns and FIIs do not seem to be at informational disadvantages in India when compared to the local investors. Paramita Mukherjee, suchismita Bose and Dipankor Coodoo (2002) found that FIIs activities exert strong demonstration effect and thus drive the domestic stock market in India, evidence from causality test suggests that FII flows to and from Indian market tend to be caused by return by domestic equity market and not the other way round. Amita Batra(2003) confirmed that the trading behavior and biases of FIIs do not appear to have a destabilizing impact on the equity market. Kulwant Rai and N.R Bhanmurthy (2003) suggested that stabilizing the stock market volatility and minimizing the ex-ante risk would help in attracting more FII inflows which would have positive impact on the real economy. S.S.S.Kumar (2006) examined the role of FII in Indian stock market and found that the market movement can be explained using the direction of the funds flow from the investors. Shromon (2007) mentioned spectacular rise of the Sensex over the past few months and it also shows how volatile FII flows are. It is almost impossible to predict whether FIIs will be net sellers or net buyers tomorrow. The study also indicates there is no rigid relationship between FIIs and SENSEX in the market. K.P.Prabheesh (2008) established the existence of bidirectional causality between FII flows and stock returns and also indicated that FII flows are driven by the stock returns. Kumar Sundaram (2009) emphasizes that there was no casual relationship between the nominal exchange rate and the stock returns and FII does not have a unit root at conventional level and it also gives positive directional Granger causality results. P.K.Mishra, K.B.Das, B.B.Pradhan (2010) examined the causality between FII inflows and real economic growth in Indian economy. The analysis provides the evidence of bi-directional causality running from net FII flows to real economic growth and reveals that the real economic growth of India both determines and determined by the volume of portfolio institutional investments in the country.

The review of literature reveals that only few studies have been carried out by constituting all the variables which influences the flow of FII in to the Indian economy. Hence an attempt has been made to study nature and its influence in the Indian capital market in the present scenario.

Objectives

The Main objectives of this paper is

1. To analyze the nature and extent of Foreign Institutional Investment in India

2. To study the relationship between Foreign Institutional Investment and stock Indices

Hypothesis

Null Hypothesis (Ho): BSE SENSEX and S&P CNX NIFTY Indices does not rise with the increase in the Foreign Institutional Investment.

Alternate Hypothesis (H): BSE SENSEX and S&P CNX NIFTY Indices rise with the increase in the Foreign Institutional Investment.

Methodology

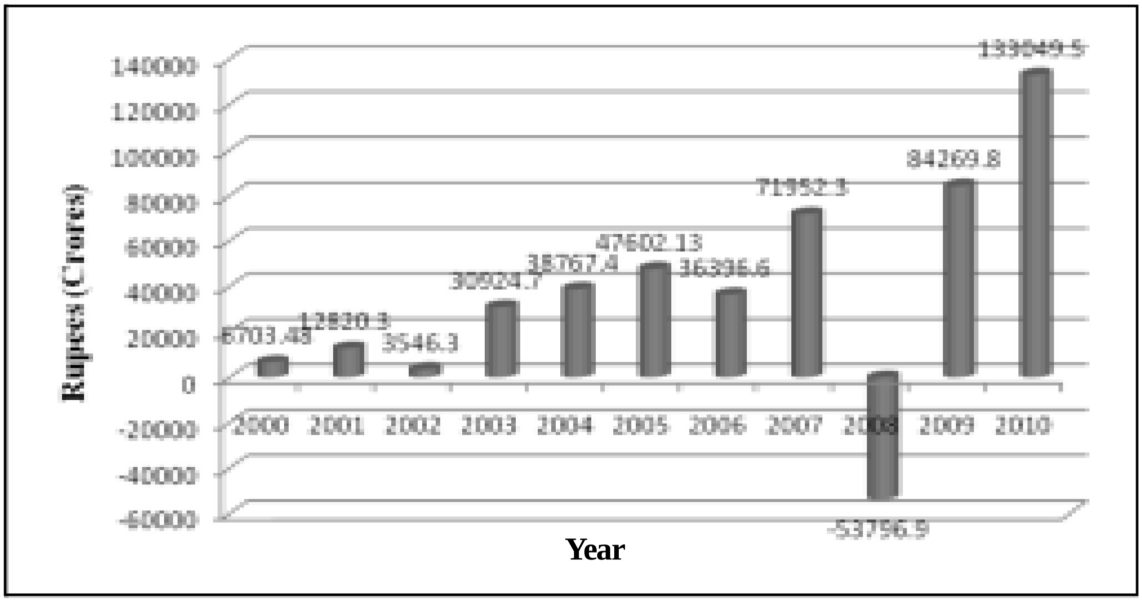
The study pertains on Secondary data. Secondary data is collected from BSE for BSE SENSEX, NSE for S&P CNX NIFTY and From SEBI Bulletin. The period of study taken for analysis is from 2000 to 2010.A simple linear relationship has been shown between two variables using correlation and regression as the data analysis tools. In the analysis FII is taken as Independent variable and SENSEX and NIFTY are taken as dependent variable.

Analysis

Table No: 1 Net Investment and Cumulative of FII from 2000 to 2010

Year	Gross Purchase (Crores)	Gross sale (Crores)	Net Investment (Crores)	Cumulative Investment ($Mn)
2010	765,509.90	632,461.00	133,049.50	29,320.79
2009	626,428.60	542,158.10	84,269.80	17,639.21
2008	719,079.50	772,876.10	-53,796.90	-13,335.90
2007	816,430.50	739,495.93	71,952.30	17,360.40
2006	473,610.90	437,213.90	36,396.60	7,985.20
2005	287,183.10	239,582.40	47,602.13	10,966.30
2004	185,562.10	146,791.00	38,767.40	9,398.36
2003	94,393.70	64,060.40	30,924.70	6,666.49
2002	46,454.10	42,878.10	3,576.30	772.80
2001	51,315.50	38,513.90	12,820.30	7,766.40
2000	75,313.90	68,611.10	6,703.48	1,794.90

Chart No. 2 : Net Investment by Foreign Institutional Investors



Foreign Institutional Investors made entry into the Indian capital market during 1992.The data taken for study from 2000-2010 also reveals their movement in the Indian capital market. In all the years their Gross Purchases was higher when compared to Gross Sales. Only in the year 2008 when Global crisis hit the market gross purchases was Rs.719059.5 crores when compared to their Gross sales Rs.772876.10 crores, also their net investment was -53796.90 crores. Where in they pulled off immediately from the market. So only they are also referred to as hot money.

Statistical Analysis

For the purpose of statistical analysis we have considered 11 years data from 2000 to 2010 of FIIs net investment, BSE SENSEX, NSE S&P CNX NIFTY. Statistical analysis is carried out to find the association between FIIs and SENSEX, NIFTY during the study period. Since the data was taken for 11 years the internal and extraneous factors have been changing overtime which might have impact on the capital market. In this study correlation and regression was used taking FII as Independent variable and SENSEX and NIFTY as dependent variable.

Table No: 2 Analysis of Net Investment by FIIs, SENSEX and NIFTY

Year	Net Investment	NIFTY	SENSEX
2000	6,703.48	1263.55	3972.12
2001	12,820.30	1059.05	3262.33
2002	3,576.30	1093.5	3377.28
2003	30,924.70	1879.75	5838.96
2004	38,767.40	2080.5	6602.69
2005	47,602.13	2836.55	9397.93
2006	36,396.60	3966.4	13786.91
2007	71,952.30	6138.6	20286.99
2008	-53,796.90	2959.15	9647.31
2009	84,269.80	5169.45	17464.81
2010	133,049.50	6134.5	20509.09

The above table shows the net investment by FIIs, Sensex and Nifty from 2000 to 2010.During the year 2000 net investment was 6703.48 crores nifty was 1263.55 points and was 3972.12 points.Net FIIs Sensex and nifty grew positively over the years and achieved Rs.71952.3 crores during 2007 then it experienced a sudden drift of negative investments during 2008 to the tune of Rs.-53796.9 crores. In the same period Sensex and nifty was also at the low of 2959.15 points and 9647.31 points. During the next year the market showed a positive movement as the net FIIs and Sensex and nifty was on the raising front.

Empirical Analysis

Table No: 3 Regression model for FIIs

	Correlation with FII	R Square	Standard Error	Significance
NSE NIFTY	0.723	0.522	1413.56	0.12
BSE SENSEX	0.722	0.521	4838.71	0.12

The above table exhibits the correlation and regression values of the independent variable FIIs on the dependent variables of SENSEX and Nifty. Correlation helps to measure the degree of relationship between the variables. Correlation of Foreign Institutional Investment and NSE nifty is 0.723 and that of Foreign Institutional Investment and BSE SENSEX is 0.722.In both the cases it shows positive correlation.

R Square is the coefficient of simple determination. It expresses the extent of variation in the dependent variable as explained uniquely or jointly by the independent variables. The value of r square ranges from 0 to 1.Small values indicate the model does not fit the model well. From the table No:3 the value of R square for FII and Sensex is 0.522,implying that 52.2% of the change in dependent variable was explained by the independent variable. With regard to FII and NIFTY R square was 0.521 and it reveals that 51% of change in dependent variable was explained by the independent variable.

Hence the Null hypothesis(Ho).i.e., BSE SENSEX and S&P CNX NIFTY Indices does not rise with the increase in the Foreign Institutional Investment, is rejected and the Alternate Hypothesis (H): BSE SENSEX and S&P CNX NIFTY Indices rise with the increase in the Foreign Institutional Investment, is accepted.

The above analysis shows that SEXSEX and NIFTY are highly dependent on FIIs. It is also evident from the following

Table No: 4 Movement of FII, SENSEX and NIFTY

Year	Net Investment	NIFTY	SENSEX
2010	133,049.50	6134.5	20509.09
2011 Up to September	10,533.8	4943.25	16453.76

From the above table it is evident that as Net Investment by Foreign Institutional Investors are rising both SENSEX and NIFTY are also rising also from the empirical analysis only 52% of Foreign institutional investment are influenced by NIFTY and SENSEX and other 48% of investment are influenced by other macro-economic variables such as inflation rate, exchange rate, interest rate, policies framed by Indian Government and the like factors.

Findings

- FIIs tend to buy and sell stocks in bulk and trend to create major withdrawal effects when they leave. So only FIIs are referred to as 'Hot Money', given the tendency reverse direction in response to adverse market sentiments influencing large capital outflows.
- It was also found that FIIs flourished in the capital market over the period of study from 2000 to 2010.except during the year 2008 there was a negative impact on FIIs (Table No:1)
- Foreign Institutional Investment and movement of SENSEX and Nifty are closely correlated in India. The Movement of FII has significant influence on the influence on the movement of stock market indices when there is an upward trend in the FIIs due to greater buying, SENSEX and NIFTY also raises on the other hand.(Table No:3 and 4).
- The high degree of volatility can be attributed to Foreign Institutional Investments.

Suggestions

The outlook for India among the world nations is good. Industries are performing remarkably good in all sectors. The stock market is at a record high. After analyzing the nature and performance of foreign institutional investors and their influence in the Indian capital market SEBI can still be more cautious in regulating the flow of Hot Money. The Indian Government and SEBI can check the volatility of FIIs, and also more priority can be given to long term sources of funds.

Conclusion

With the economic outlook improving worldwide, global majors are investing in India, which is ranked the most attractive country for retail investment for emerging markets. From our study on the impact of foreign institutional investments on the capital market we came to know they have got substantial effect over the stock indices. They also have the potential of influencing the process of economic development of India through the positive impacts on macro- economic fundamentals of the country. Therefore, the policy makers should provide the FIIs with more opportunities and reasons to invest in Indian markets by suggesting and implementing prudential norms.

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