Introduction

The Economic Development of any country depends upon the existence of well-organized financial markets. It is the financial system, which supplies the necessary financial inputs for the production of goods and services, which in turn promote the well being and standard of living of the people of a country. Capital Market are of crucial significance to capital formation as the main function of these markets is the mobilization of savings and their distribution for the industrial investment, thereby stimulating the capital formation and to that extent, accelerating the process of economic growth. There are two broad segments of the financial market viz. the money market and the capital market. The money market deals with short-term debt, whereas the capital market deals with long-term debt and stock (Equity and Preference). Each of these markets has a primary segment and a secondary segment. New financial assets are issued in the primary market; whereas outstanding financial assets are traded in the secondary segment. The components of the Indian Corporate Security Market. When a company wishes to raise capital by issuing securities or other entity intends to raise funds through units, debt instruments or bonds etc. it goes to the primary market, which is the segment of the capital market where issuers exchange securities for long run funds. The primary market facilitates the formation of capital. There are three ways in which a company may raise capital in the primary market: Public Issue, Right Issue and Private Placement.

The secondary market in India, where listed outstanding securities are traded consist of the stock exchanges, which are self-regulatory bodies under the overall regulatory purview of the government and Security Exchange Board of India (SEBI). The government has accorded powers to the SEBI, as an autonomous body, to oversee the functioning of the security market and the operations of the intermediaries: mutual funds, merchant bankers, underwriters, portfolio managers, debentures trustees, bankers to an issue, registrars to an issue, share transfer agents, stock brokers and sub-brokers, Foreign Institutional Investors (FIIs), and rating agencies.

Foreign Institutional Investment
As defined by the European Union, Foreign Institutional Investment is an investment in a foreign stock market by the specialized financial intermediaries managing savings collectively on behalf of investors, especially small investors, towards specific objectives in term of risk, return and maturity of claims.

SEBI’s Definition of FIIs presently includes foreign pension funds, mutual funds, charitable/endowment/university funds, asset management companies and other money managers operating on their behalf in a foreign stock market.

Foreign institutional investment is liquid nature investment, which is motivated by international portfolio diversification benefits for individuals and institutional investors in industrial country. Currently, the following entities are eligible to invest under FII route:

(i) **As FIIs.**

Overseas pension funds, mutual funds, investment trusts, asset management companies, nominee companies, banks, institutional portfolio managers, university funds, endowments foundations, charitable trusts, charitable societies, a trustee or power of attorney holders incorporated or established outside India proposing to make proprietary investment or investment on behalf of a broad-based funds (i.e. fund having more than 20 investors with no single investors holding more than 10 percent of the shares or units of the fund).

(ii) **As Sub-Accounts**

The sub account is generally the underlying fund on whose behalf the FII invests. The following entities are eligible to be registered as sub-account, viz. partnership firms, private company, public company, pension fund, investment trust and individuals.

(iii) **Domestic Entities**

A domestic portfolio manager or a domestic asset management company shall also be eligible to be registered as FII to manage the funds of sub-accounts.

**INDUSTRIAL POLICY of FIIs**
The Government’s liberalisation and economic reforms programme aims at rapid and substantial economic growth, and integration with the global economy in a harmonised manner. The industrial policy reforms have reduced the industrial licensing requirements, removed restrictions on investment and expansion, and facilitated easy access to foreign technology and foreign direct investment.

**Industrial Licensing**

All industrial undertakings are exempt from obtaining an industrial licence to manufacture, except for

1. industries reserved for the Public Sector (Annex I),
2. industries retained under compulsory licensing (Annex II)
3. items of manufacture reserved for the small scale sector and
4. if the proposal attracts locational restriction. For procedure to obtain Industrial Licence.

**Industrial Entrepreneurs Memorandum**

Industrial undertakings exempt from obtaining an industrial license are required to file an Industrial Entrepreneur Memoranda (IEM) in Part ‘A’ (as per prescribed format) with the Secretariat of Industrial Assistance (SIA), Department of Industrial Policy and Promotion, Government of India, and obtain an acknowledgement. No further approval is required. Immediately after commencement of commercial production, Part B of the IEM has to be filled in the prescribed format. The facility for amendment of existing IEMs has also been introduced.

Industrial undertakings are free to select the location of a project. In the case of cities with population of more than a million (as per the 1991 census), however, the proposed location should be at least 25 KM away from the Standard Urban Area limits of that city unless, it is to be located in an area designated as an “industrial area” before the 25th July, 1991. (List of cities with population of 1 million and above is given at Annexure-V). Electronics, Computer software and Printing (and any other industry which may be notified in future as “non polluting industry”) are exempt from such locational restriction. Relaxation in the aforesaid locational restriction is possible if an industrial license is obtained as per the notified procedure.
The location of industrial units is further regulated by the local zoning and land use regulations as also the environmental regulations.

**FOREIGN DIRECT INVESTMENT**

FOREIGN investment refers to investments made by the residents of a country in the financial assets and production processes of another country. After the opening up of the borders for capital movement, these investments have grown in leaps and bounds. The effect of foreign investment, however, varies from country to country. It can affect the factor productivity of the recipient country and can also affect the balance of payments. In developing countries there has been a great need for foreign capital, not only to increase the productivity of labor but also because foreign capital helps to build up the foreign exchange reserves needed to meet trade deficits. Foreign investment provides a channel through which developing countries can gain access to foreign capital.

Foreign Direct Investment (FDI) is now recognized as an important driver of growth in the country. Government is therefore, making all efforts to attract and facilitate FDI and investment from Non Resident (NRIs) including Overseas Corporate Bodies (OCBs), that are predominantly owned by them, to complement and supplement domestic investment. To make the investment in India attractive, investment and returns on them are freely repatriable, except where the approval is subject to specific conditions such as lock-in period on original investment, dividend cap, foreign exchange neutrality, etc. as per the notified sectoral policy. The condition of dividend balancing that was applicable to FDI in 22 specified consumer goods industries stands withdrawn for dividends declared after 14th July 2000, the date on which Press Note No. 7 of 2000 series was issued.

Foreign direct investment is freely allowed in all sectors including the services sector, except a few sectors where the existing and notified sectoral policy does not permit FDI beyond a ceiling.

FDI for virtually all items/activities can be brought in through the Automatic Route under powers delegated to the Reserve Bank of India (RBI), and for the remaining items/activities through Government approval. Government approvals are accorded on the recommendation of the Foreign Investment Promotion Board (FIPB).
Determinants of Foreign Institutional Investment

Foreign institutional investment can supplement domestic savings and augment domestic investment without increasing the foreign debt of the county. Such investment constitutes non-debt creating financing instruments for the current account deficits in the external balance of payments. The behavior of the FIIs depends on so many factors.

GUIDELINES FOR THE CONSIDERATION OF FOREIGN DIRECT INVESTMENT

The following Guidelines are laid-down to enable the Foreign Investment Promotion Board (FIPB) to consider the proposals for Foreign Direct Investment (FDI) and formulate its recommendations.

1. All applications should be put up before the FIPB by the SIA (Secretariat of Industrial Assistance) within 15 days and it should be ensured that comments of the administrative ministries are placed before the Board either prior to or in the meeting of the Board.

Proposals should be considered by the Board keeping in view the time frame of 30 days for communicating Government decision (i.e. approval of C&IM/CCEA or rejection as the case may be).

3. In cases in which either the proposal is not cleared or further information is required, in order to obviate delays presentation by applicant in the meeting of the FIPB should be resorted to.

4. While considering cases and making recommendations, FIPB should keep in mind the sectoral requirements and the sectoral policies vis-a-vis the proposal(s).
5. FIPB would consider each proposal in totality (i.e. if it includes apart from foreign investment, technical collaboration/industrial licence) for composite approval or otherwise. However, the FIPB’s recommendation would relate only to the approval for foreign financial and technical collaboration and the foreign investor will need to take other prescribed clearances separately.

6. The Board should examine the following while considering proposals submitted to it for consideration:
   (i) Whether the items of activity involve industrial licence or not and if so the considerations for grant of industrial licence must be gone into;
   (ii) Whether the proposal involves technical collaboration and if so:- (a) the source and nature of technology sought to be transferred.
   (iii) Whether the proposal involves any mandatory requirement for exports and if so whether the applicant is prepared to undertake such obligation (this is for items reserved for small scale sector as also for dividend balancing, and for 100% EOU/EPZ units);
   (iv) Whether the proposal involves any export projection and if so the items of export and the projected destinations;
   (v) Whether the proposal has concurrent commitment under other schemes such as EPC Scheme etc.
   (vi) In the case of Export Oriented Units (EOUs) whether the prescribed minimum value addition norms and the minimum turn over of exports are met or not;
   (vii) Whether the proposal involves relaxation of locational restrictions stipulated in the industrial licensing policy;
   (viii) Whether the proposal has any strategic or defence related considerations, and
   (ix) Whether the proposal has any previous joint venture or technology transfer/trademark agreement in the same or allied field in India, the detailed circumstance in which it is considered necessary to set-up a new joint venture/enter into new technology transfer (including trade mark), and proof that the new proposal would not in any way jeopardize the interest of the existing joint venture or technology/trade mark partner or other stake holders.
REVIEW OF LITERATURE

Rao, Murthy and Rangnathan (1999), conducted a study of developed market by taking the data for a period of 8 years (1990 to 1998). They suggest that FIIs investments would help the stock markets directly through widening investor base and indirectly compelling local authorities to improve the trading system. In their study they analyzed the investment exposure of the five US-based India specific funds that suggested a close resemblance between FII investment and trading pattern at the BSE. On behalf of that they interpreted that net FII investment influences stock prices in India as it traces the relationship to the sectoral level. They found that heavy emphasis of FIIs was on computer software and consumer goods industry. The other finding was that the FIIs are having a strong presence in the Indian Mutual Funds segment.
Banaji, J. (2000), emphasized on the fact that the capital market reforms like improved market transparency, automation, dematerialization and regulations on reporting and disclosure standards were initiated because of the presence of the FIIs. He opined that FII flows could be considered both as the cause and the effect of the capital market reforms. The market reforms were initiated because of the presence of FIIs and this in turn has led to increased inflows. The Government of India gave preferential treatment to FIIs till 1999-2000 by subjecting their long term capital gain to lower tax rate of 10 percent while the domestic investors had to pay higher long-term capital gains tax. The Indo-Mauritius Double Taxation Avoidance Convention 2000 (DTAC), exempts Mauritius based entities from paying capital gains tax in India- including tax on income arising from the sale of shares.

Kumar, S.S.S (2000), made an investigation regarding the stability of the foreign institutional investors in India between January 1990 to March 1998 at BSE and found that the volatility in return of Indian stock market before opening for FIIs was 41.05 percent where as the volatility after opening up was 22.66 percent. The study also checked the significance of the difference in both periods (pre and post entry) by applying the F-test and inferred that volatility of the Indian stock market has reduced after the arrival of FIIs.

Chakrabarti (2001) has perceived a regime shift in the determinants of FII following the Asian financial crisis. He used the data of BSE for a period of 6 years from May 1993 to Dec. 1999. By applying the Granger Causality Test on the data he found that in the pre-Asian crisis period, any change in FII had a positive impact on equity returns, but it found a reverse relationship in post Asian crisis period. The study points out that the change in FII is mainly due to change in equity returns.

Froot, O’Connell and Seasholes (2001), also experienced the existence of price pressure along with persistence of flows. For the purpose of analysis the study classified the FIIs flow into two parts expected flows and unexpected flows and on the basis of that classified data the analyst concluded that FIIs do not seem to be at an informational disadvantage, they seem to experience an informational advantage. Secondly, the impact of the unexpected sales by the FIIs on the respective market returns was considerably high. This shows that the market was very sensitive to the FIIs trading, especially sales, which the policy makers should take into account. On the basis of degree of association between unexpected sales and respective market returns they found that BSE was more vulnerable to instability due to trading by FIIs as the impact of unexpected
sales at BSE (21.9 percent) reduce the stock price considerably when compared to that of NSE (11.4 Percent)

Pasricha and Singh (2001), evaluated the impact of FIIs on stock market volatility between April 1998 to March 2000 on BSE and NSE both. They found that FIIs have always remained net investors in the country except during 1998-99 and their investment has been steadily growing since their entry in the Indian market. They are here to stay and have become the integral part of Indian capital market. Although their (FIIs) investment in relation to market capitalization is quite low, they emerged as market movers. The market had been moving, in consonance with their investment behavior. However, their entry has led to a greater institutionalization of the market and their activities have provided depth to it. FIIs have also contributed towards making Indian market modern and comparable with international standards. Their entry has brought transparency and simplicity in the market operations.

Khanna, Sushil (2002), discussed the impact of FII inflows on the Indian economy and concluded that there is no evidence that the entry of FIIs have reduced the cost of capital to the Indian corporate sector nor have they helped the corporate sector to shift from their dependence on internal resources and funds from public sector development banks to the capital markets. The overall cost of the economy of increased short-term capital flows has been substantially higher than any current potential benefits.

The review of the literature is that the opening up of capital market for foreign institutional investors in emerging market countries has been perceived beneficial by some researchers while others have expressed concerned about the possible adverse consequences. For instance, the research studies of Banerjee and Sarkar (2006); Badhani (2005); Biswas, Joydeep (2005); and Rao, Murthy and Rangnathan (1999) found clear evidence of benefits of such flows in the form of equity market development, capital market integration, lower cost of capital and increased return etc. In contrast, Rakshit, Mihir (2006), Moel (2000) etc. points towards its adverse impact on the share market return on Investment. The present research is aimed to put at rest the debate regarding the impact of FII flows on emerging stock market return.
Indian stock market which has been able to attract both FDI and FIIs in a significant manner, particularly in recent years, is taken as a representative of emerging markets to conduct this study. It needs re-mention here that the impact of FIIs on the stock return in India has been studied by taking both daily and monthly data on the respective variables. The reference period for the former data set is 22 years started from January 1986 to ending on December 2007. ARMA model has been applied to analyze the data. In the former data set, FIIs investment was taken as a dummy variable so as to find the significance of difference in stock return as a result of their entry. The analysis will be made by taking real value of the FIIs monthly investments as one of the regressors in the case of latter data set. The descriptive statistics of various series used in ARMA Model during pre and post FIIs entry. The second part is devoted to the daily basis data analysis to determine the pre and post effect of FIIs on share market return.

**Objectives Of Study:**

This study was undertaken primarily to measure the impact of foreign institutional investor’s investment on the Indian stock market. More specifically, the present study was aimed to achieve the following objectives:

1) To bring out the impact of FIIs investment on the return of Indian stock market;

2) To assess the impact of FIIs on the volatility of the stock market in India;

3) To examine whether arrival of FIIs have affected trading volume and market capitalization of Indian stock market;

4) To identify the determinants of FIIs investment and assess their impact on FII flows in Indian economy; and

5) To suggest policy guidelines regarding FII flows to India on the basis of findings emerging from this study.
HYPOTHESIS

In the absence of adequate empirical evidence, the emergence of FIIs in stock market has been a debatable issue over the posh lobby of the Parliament to common man. While it is generally held that FII flows benefit the economies of recipients’ countries, policy makers worldwide have been more than a little uneasy about such investment. FII flows often referred, as “hot money” is notoriously volatile compared to other forms of capital flows. Investors are known to pull back portfolio investments at the slightest hint of trouble in the host country often leading to disastrous consequences to its economy.

The two main bodies of theories exist in the literature about the relationship between FIIs investment and underlying stock market and both are contradictory to each other. These are:

1) A ‘Destabilizing forces’ hypothesis, that predicts volatility due to the FIIs inflows.

2) A ‘Non-destabilization’ hypothesis that FIIs have no impact on stock market volatility.

Even about the impact of the FIIs flows on stock market return, there are two views:

1) A ‘Positive Feed Back Trading’ hypothesis that says FIIs enter the market when there are some positive signals of higher stock return and withdraws when they perceive some negative information.

2) A ‘Base broadening’ hypothesis suggests that the expansion of the investor base by including foreign investors leads to increased diversification followed by reduced risk and consequently lowering the required risk premium. Thus there is a permanent increase in the equity share price through risk pooling which is the signal of higher returns.

In the above-mentioned two cases, the former hypothesis states that the FIIs enter in the foreign market to reap the benefits and thereafter they withdraw their money and that increases the volatility in the underlying stock market. The later hypothesis in each case is based on the belief that introduction of the FIIs leads to more complete market, enhance information flow and thus improves the investment choices for investors, enhances the transparency in the market, put no impact on the volatility and due to low cost of investment the return increases.

Because of the above stated interpretations about the impact of FIIs on the underlying stock market, various studies have been carried out to lay at rest the debate of which hypothesis
are held in reality. In this part, we have made an attempt to reexamine the results offered by the existing studies regarding the impact of FIIs on the underlying stock market so as to draw a conclusion near to the reality.

**RESEARCH METHODOLOGY**

To achieve the various objectives of the study, we utilized the secondary data on various parameters pertaining to stock markets and economy of both India and US. These parameters include daily as well as monthly opening and closing index value, trading volume and market capitalization. The reference period for the study ranges from January 1986 to December 2007.

**Data Base and Sources**

As National stock exchange was incorporated in November 1992 and FIIs were also allowed to invest in Indian stock market in September 1992 so it was not appropriate to consider the NSE data for the above mentioned purpose. Accordingly, daily basis closing BSE Sensex was taken to calculate the return of the Indian stock market for the study period. Beside the FIIs, some other variables such as Risk in the Return of Domestic Market, Return of the US Market, Risk in Return of US Market, Exchange Rate US $ v/s Indian Rupee, Growth Rate of the Economy represented by Index of Industrial Production, Indian Interest Rate, Federal Bank Interest Rate were also considered to explain the return behavior of the Indian stock
market with response to FIIs investment. Further, analysis based on monthly data has also been carried out to determine the impact of the FIIs investment on the stock market return and volatility.

**Tools, Sample & Methods Used**

This study is descriptive and experimental in nature as the effect of certain events or actions have been observed in it objectively and by distinguishing the effect of extraneous variables. This type of research design is appropriate for this study as it aims to measure the effect of certain policy initiative (Stock Market Liberalization). For this purpose pre and post control techniques have been used. The results of the study are based on the secondary data, which have been collected from the various websites such as [www.bseindia.com](http://www.bseindia.com), [www.nseindia.com](http://www.nseindia.com), [www.moneycontrol.com](http://www.moneycontrol.com), [www.stls.frb.org](http://www.stls.frb.org), [www.rbi.org.in](http://www.rbi.org.in). Beside websites mentioned above various publications of SEBI, Bombay Stock Exchange, National Stock Exchange and Reserve Bank of India. PROWESS database maintained by CMIE (Centre for Monitoring Indian Economy) have also been important sources of data related to study.

To analyze the pre and post impact of FII investment on underlying market return and volatility the daily data from January 1986 to December 2007 has been collected. However, to determine FIIs impact on trading volume and market capitalization of the stock market monthly data have been used for the period from January 1993 to August 2007. To identify the determinants of foreign institutional investments in Indian stock market, the daily data for the period ranging from April 1999 to December 2006 was taken. The daily data regarding FII investments were not available for time period before April 1999. Hence, the study period is restricted for the aforesaid duration.

A detail presentation of the data series and sources of variables considered for the study will show in table format in thesis along with procedure of developing various series of requisite data.

To assess the impact of FIIs flows into Indian stock market on the return offered by the market is one of the primary objectives of the present study. The research methods including selection of variables and models used are objective specific. The research tools applied under the study are explained as follows:
1) For analyzing the return on the Bombay Stock Exchange, Auto regressive Moving Average (ARMA) model has been used. ARMA is a commonly used econometric technique for forecasting of interrelated time series. The emphasis of this model is not on constructing a single equation or simultaneous equation models but on analyzing probabilistic or stochastic properties of economic time series on their own under the philosophy let the data speak for themselves. The following factors have been taken to specify the regression equation.

- Risk in the Return of Domestic Market
- Return of the US Market (S & P 500)
- Risk in Return of US Market
- Exchange Rate US $ v/s Indian Rupee
- Growth Rate of the Economy Represented by Index of Industrial Production
- Indian Interest Rate (3months Treasury Bill Rate)
- Federal Bank Interest Rate (3 months Treasury Bill Rate)

As the main motive was to determine the impact of the foreign institutional investment on the India’s stock market return, FIIs net investment was also taken as a explanatory variable.

2) For analyzing the instability various instability measures can be used. The study undertakes a comparative analysis of stock return volatility before and after stock market liberalization in India. In order to achieve aforementioned objective, the stock return has been calculated on basis of daily data of closing index Many econometrics models assume that the variance as a measure of uncertainty is constant. Financial time series such as stock returns or exchange rates exhibits volatility clustering. This means that large changes in time series tend to be followed by large changes and small changes by small changes. The technical term given to the behavior is called autoregressive conditional heteroscedasticity (ARCH). Bollerslev (1986) generalized the ARCH process by allowing the conditional variance to be a function of past observations as well as of recent news named as GARCH model. Following the introduction of ARCH and GARCH, there have been numerous refinements of the approach to model volatility to better capture the stylize characteristics of the data.
3) For analyzing Impact of FIIs on Trading Volume and Market Capitalization. The monthly data for a time period of 15 years from January 1993 to August 2007 were used to measure the impact of FIIs on trading volume and market capitalization. The data of the Trading Volume and market capitalization have been taken from the website of the Reserve Bank of India. The impact of foreign institutional investors purchases and sales of the securities at BSE Ltd. on the market capitalization and trading volume has also examined. For this purpose we have taken the monthly data of the purchase and sale of the securities for the same time period. The development of stock market is a complex and multi-faced concept.

There are various indicators of judging stock market development. One common used measure is the Value Traded Ratio (VR), which is total value of shares traded on a country’s stock exchanges as a percent of GDP. The second measure is the value share traded as a percent of market capitalization. This turnover ratio (TR) measures the trading relative to the size of the stock market. The third indicator, the market capitalization (MR), which is market capitalization of listed shares in a stock exchange as a percent of GDP, measures the size and expansion of the market. The value traded and turnover ratios are considered as the indicators of liquidity.

**Scope of the Study**

The study pertains to India, which is one of the fast growing markets in the world. India is an appropriate case for conducting such a study, as portfolio investment has become the dominant path of foreign investment in the Indian economy. India liberalized its financial market and allowed FIIs to participate in their domestic markets in 1992. The opening up of the market resulted in a number of positive effects. First, the stock exchanges had to improve the quality of their trading and settlement procedures in line with the best practices of the world. Second, the transparency and information flows improved on account of the entry of FIIs in India. However, people are also sensing negative effects in the form of potential destabilization because of the bulk buying and selling activity of FIIs.

The Bombay Stock Exchange (BSE) and National Stock Exchange (NSE) are two leading stock exchanges of India. The foreign institutional investors are investing in these markets. So both of these markets have been taken to study the determinants of the
foreign institutional investment in India. The National Stock Exchange was launched in 1992 and FIIs were also permitted to invest in Indian market in September 1992. Because of this the reference period for the study to investigate the impact of FIIs on stock market in India has been taken from January 1986 to December 2007. However, due to its non-existence the data on NSE prior to 1994 was not available. Hence, it was not appropriate to take National Stock Exchange data to ensure the impact of foreign institutional investors on stock market return and volatility. Therefore, to determine the impact of FIIs on Indian stock market (i.e. on return and volatility) Bombay Stock Exchange has been considered. The time period of the study varies with the various objectives of the study.

**Significance of the Study**

The present study is an addition to the existing body of knowledge as very scanty work is available in this area of research in case of India. As we know that the BSE Sensex has touched new heights. That is mainly due to foreign institutional investment. Our finance Minister P. Chidambram stated during an interview to ‘Economic Times’ that, this boom is not harmful for our economy and not supposed to decline in near future. Now the question arises why is it so? Why are the foreign institutional investors coming to India? What will be the impact of this boom on Indian stock market? To find out the answer of these questions and to know another aspects related to foreign institutional investment, the study is structured. The present study is an attempt to find out the impact of foreign institutional investment on Indian stock market and to highlight the procedural and legal aspect related to foreign institutional investment in India. The study will also contain the trends of foreign institutional investment in India and with the help of the data an attempt was made to determine the factors determining the flow of FIIs in India.