Role of Foreign Institutional Investors in the Indian Economy

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Abstract

The country's capital market is increasingly influenced by global developments because of the active participation by FIIs (Foreign Institutional Investors) and big corporates' growing appetite for global borrowings. Since the beginning of the liberalization of investment policies, role of FIIs in India has steadily grown in importance. The strong trend towards globalization has brought about significant Developments in the Indian economy. One of them is the tremendous increase in the mobility of capita across national borders. The traditional view is that stock markets are barometers of the economy. It is expected that the markets and their indicators, in the form of indices, reflect the potential of the corporates listed of them and, in the process, the direction and health of the economy. If a country's economy is performing well and expected to grow at healthy rate, the market is usually expected to reflect. An important feature of the development of stock market in India in last fifteen years has been the growing participation of Institutional Investors, both foreign institutional investors and the Indian mutual funds. However, this paper attempts to examine the flow of FIIs in India in particular. It also covers the investment trend of FIIs and the various issues related to the FIIs investment in the domestic market. Foreign investments bring capital into India and lowest cost of capital for a firm. FIIs are responsible for the high level of transparency and corporate governance standards among the corporate sector. Theoretically, FIIs investments bring in global liquidity into the equity market and raise the price-earning ratio and thereby reduce the cost of capital domestically.

Key Words: FIIs, Stock Markets, Fund Flows, Sensex.

FIIs

An FII means an entity established or incorporated outside India, which proposes to undertake investment thought sub-accounts in India. An FII sub-account includes those foreign corporate, foreign individuals, institutions, funds or portfolios established or incorporated outside India on whose behalf investments are proposed to be made in India by an FII. The FII registration is valid for 5 years. After expiry of 5 years, the registration needs to be renewed. Following entities / funds are eligible to get registered as FII:

1. Pension Funds
2. Mutual Funds
3. Insurance Companies
4. Investment Trusts
5. Banks
6. University Funds
7. Endowments
8. Foundations
9. Charitable Trusts/Charitable Societies

They have been allowed to invest in the domestic financial market since 1992; the decision to open up the Indian financial market to FII portfolio flows was influenced by several factors such as the disarray in India's external finances in 1991 and a disorder in the country's capital market. Aimed primarily at ensuring non-debt creating capital inflows at a time of an extreme balance of payment crisis and at developing and disciplining the emerging capital market, foreign investment funds were welcomed to the country.

Given the volatile nature of capital flows to emerging markets seen in the early 1990s and the nature and growth of such flows to India, FII investment in India, obviously called for special regulatory attention. Investment by FIIs in India is jointly regulated by Securities and Exchange Board of India (SEBI) through the SEBI (Foreign Institutional Investors) Regulations, 1995 and by the Reserve Bank of India through Regulation 5(2) of the Foreign Exchange Management Act (FEMA), 1999.The promulgation of legislation pertaining to foreign investment by SEBI in 1995 marked a watershed for FII flows to India, led to a significant increase in the level of FII equity inflows in the pre-Asian crisis period. The SEBI FII Regulations and RBI policies are amended and modified from time to time in response to the gradual maturing of the Indian financial market and changes taking place in the global economic Scenario

Contribution by FIIs

The diversity of FIIs has been increasing over 30 countries registered with SEBI as at March 31st, 2006. Of these 40% originate from US and 20% from UK. Recently FIIs from Japan and continental Europe are increasing their India exposure. FIIs contributed approx. 11% of the total market and approx. 10% of the total market turnover.

The FII inflows into India have been on account of:

- Strong economic fundamentals and attractive valuations of companies
- High quality of corporate governance

- Efficient market mechanisms for settlement and clearing
- Product diversification and availability of active derivatives market

FIIs Registered with SEBI

The following table gives an overview of FIIs registered with SEBI w.e.f 1992-93 to 2005-06.

FINANCIAL YEAR	DURING THE YEAR	TOTAL REGISTEREDATAT THE END OF THE YEAR
1992-93	0	0
1993-94	3	3
1994-95	153	156
1995-96	197	353
1996-97	99	439
1997-98	59	496
1998-99	59	450
1999-00	56	506
2000-01	84	528
2001-02	48	490
2002-03	51	502
2003-04	83	540
2004-05	145	685
2005-06	197	882

Effects of FII on Stock Market

The FIIS are major institutional investors in Indian capital market. Movement in the sensex has clearly been driven by the behavior of foreign institution investors. The presence of foreign institution investor in the sensex companies and their active trading behaviours, their role in determining the share price movements must be considerable. Indian stock markets are known to be known narrow and shallow in the sense that there are few companies whose shares are actively traded. Although there are 4700 companies listed with stock exchange, the BSE sensex incorporates only 30 companies, trading on whose shares are seen as indicative of market activity. This shallowness also means that the FIIs can also affect the behavior of other retail investors, who tend to follow the FIIs when making their investment decision.

These features of Indian stock markets induce a high degree of instability for four reasons:

- First, increase in investment by FIIs cause sharp price increase. It would provide additional incentives for FII investment and this encourages further investment. And when the correction begins it would have to lead by an FII pullout and can take the form of extremely sharp decline in the share prices.
- Second, as and when FIIs are attracted to the market by expectations of a price increase that tend to be automatically realized, the inflow of foreign capital can result in an appreciation of the rupee. This increases the return earned in foreign exchange, when rupee assets are sold and the revenue converted into dollars. As a result, the investments turn even more attractive triggering an investment twisting that would imply a sharper fall when any correction begins.

- Third, the growing realization by the FIIs of the power they wield in what are shallow markets, encourages speculative investment aimed at pushing the market up and choosing an appropriate moment to exit. This implicit manipulation of the market if resorted to often enough would obviously imply a substantial increase in volatility.

Finally, in volatile markets, domestic speculators too attempt to manipulate markets in periods of unusually high prices.

Monthly FII inflows and BSE Sensex

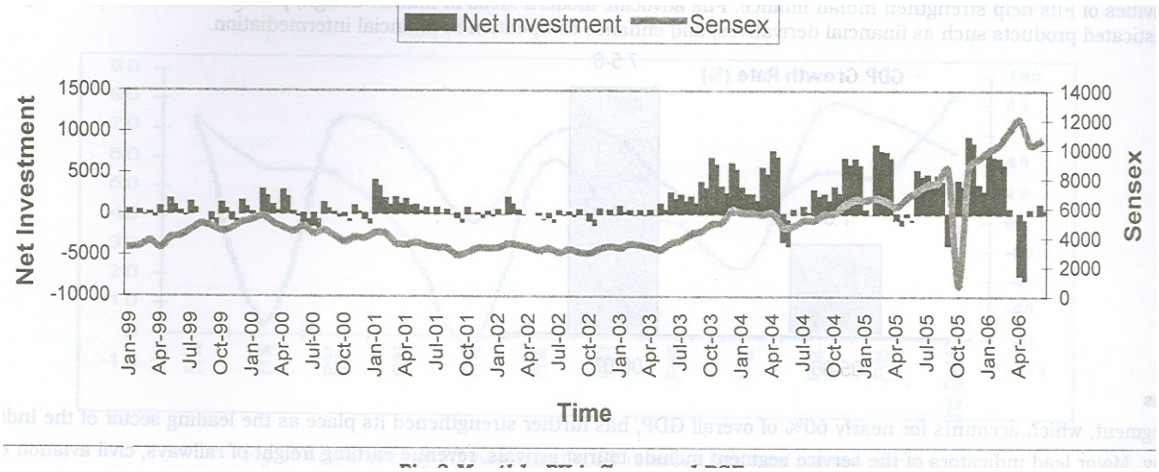

Figure 1: ***Monthly FII inflows and BSE Sensex***

The economic literature is prosperous with research pointing towards the close correlation of the BSE Sensex and FII fund flows. Interestingly, a note by National Stock Exchange "Indian Securities Markets: A review Vol. IV, 2001" observes that FIIs have a disproportionately high level of influence on the sentiments and price trends in the Indian equity market as other market participants perceive the FIIs to be infallible in their assessment of the market and tend to follow decisions taken by FIIs. Such 'herd mentality' displayed by market participants amplifies the role of the FIIs in the Indian stock market. Over the years, as the ceiling for FII investments were relaxed, there has also been a progressive increase in the share of FII holdings in leading Indian companies (and also in the sensex companies). A big role of the FIIs in determining the Sensex level is therefore not out of place.

That the BSE Sensex is closely correlated with trend of FII inflows is clearly brought out from the above fig. it is evident that the equity markets were more or less in a steady state till around April 2003 when FII inflows per month tended to follow a normal historical trajectory. The upswings in the FII inflows from around May 2003 have also led to quantum jumps in the BSE Sensex. But despite the general upward trajectory of the BSE sensex there have been some months of correction and such correction and such corrections occurred in months with negative FII flows. Little doubts therefore that the BSE Sensex fell by around 14% in May 2006 compared to April 2006 after FIIs turned net seller to the extent of US$ 1.6 billion in that month.

Advantages of FII investment

- **Enhance flow of equity capital**
  FIIs are well known for a greater appetite for equity than debt in their asset structure. In pension funds in the UK and USA bad 68% and 64%, respectively, of their portfolio in equity in 1998. thus, opening up the economy to FIIS in the line with accepted preferences for non-debt creating foreign inflows over foreign debt because of this preference for equities over bonds, FIIs can help in compressing the yield differential between equity and bonds and improve corporate capital structure.

- **Managing uncertainty and controlling risks**
  FIIs promote financial innovation and development of hedging instruments. FIIs as professional bodies of asset managers and financial analysts, not only enhance competition in the financial markets, but also improve the alignment of asset prices to fundamentals.

- **Improving capital markets**
  FIIs enhance competition and efficiency in the capital markets and aids economic development by the viability of riskier long term capital for projects and increasing firm's incentives to supply more information about them, the FIIs can help in the process of economic development.

- **Improved corporate governance**
  Bad corporate governance makes equity finance a costly option. Incentives for shareholders to monitor firms and enforce their legal rights are limited, and individuals with small-holdings often do not address the issue since others can free-ride on their endeavor. What is needed is large shareholders with leverage to complaint their legal rights and overcome the free-rider problem.

- **Knowledge flows**
  The activities of FIIs help strengthen Indian finance. FIIs advocate modern ideas in market design, promote innovation, development of sophisticated products such as financial derivatives, and enhance competition in financial intermediation.

- **Services**
  This segment, which accounts for nearly 60% of overall GDP, has further strengthened its place as the leading sector of the Indian economy. Major lead indicators of the service segment include tourist arrivals, revenue earning freight of railways, civil aviation etc. services Sector. Because of liberalization, Indian service sector is outperforming,

  The main thrust to industrial growth has come from the services sector. Services contribute to 41 per cent of the GDP. Rapidly, the quality and complexity of the type of services being marketed is on the rise to match worldwide standards. Whether it is financial services, software services or accounting services, this sector is highly professional and provides a major impetus to the economy. Interestingly, this sector is populated with average of players who cater to a niche market.

India is fast becoming a major force in the Information Technology sector. According to the National Association of Software and Service Companies (NASSCOM), over 185 Fortune 500 companies use Indian software services. The world's software giants such as Microsoft, Hughes and Computer Associates who have made substantial investments in Indian are increasingly tapping this potential. A number of multi-nationals have leveraged the relative cost advantage and highly skilled manpower base available in India, and have established shared services and call centers in India to cater to their worldwide needs.

The software industry was one of the fastest growing sectors in the last decade with a compound annual growth rate exceeding 50 per cent. Software service exports increased from US$ 4.02 billion in 1999-2000 to US$ 6.3 billion in 2000-01, thereby registering a growth of 57 per cent. India's success in the software sector can be largely attributed to the industry's ability to cultivate superior knowledge through intensive R&D efforts and the expertise in applying the knowledge in commercially viable technologies.

Conclusions

A number of studies in the past have observed that investments by FIIs and the movements of Sensex are quite closely correlated in India and FIIs wield significant influence on the movement of Sensex. There is little doubt that FII inflows have significantly grown in importance over the last few years. In the absence of any other substantial form of capital inflows, the potential ill effects of a reduction in the FII flows into the Indian Economy can be severe. Investment by FIIs directly in the Indian stock market didn't bring significantly large amount compared to the GDR issues. GDR issues, unlike FII investments, have the additional advantage of being project specific and thus can contribute directly to productive investments. FII investments seem to have influenced the Indian stock market to a considerable extent. Results of this study shows that not only the FIIs are the major players in the domestic stock market in India, but their influence on the domestic market is also growing. Data on trading activity of FIIs and domestic stock market turnover suggest that FIIs are becoming more important at the margin as an increasingly higher share of stock market turnover is accounted for by FII trading. Moreover, the findings of this study also indicate that Foreign Institutional Investors have emerged as the most dominant investor group in the domestic stock market in India.

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