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FOREIGN INSTITUTIONAL INVESTORS AND THE STOCK MARKET MOVEMENTS: THE CASE STUDY OF THE INDIAN STOCK MARKET

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Abstract: Since the beginning of liberalization FII flows to India have steadily grown in importance. There is a prevalent feeling that FII activities exert a strong demonstration effect and thus drive the stock market. As a starting point, in this paper we explores the relationship of FII flows to the Indian stock market with Sensex (BSE, BSE-100), NSE Index and their returns on a daily data set for the period from April 2016 to December 2018. By applying Granger causality we see that FII inflows are correlated with the return in the Indian stock market and the former is more likely to be the effect than the cause of the Indian stock market return.

INTRODUCTION

The portfolio investment flows from industrial countries have become increasingly important for developing countries after 1991. The Indian situation has been no different. India has been gradually emerged as an important destination of global investor's investment in emerging equity markets. A significant part of this portfolio flow to India comes in the form of Foreign Institutional Investors' (FIIs) investments, mostly in equities. Today India has a share of about 20 percent in the total global investment in all emerging equity markets together and the outstanding FII investment in India stood at around Rs.69000 crore, as on end-March, 2019.

While it is generally held that portfolio flows benefit the economies of recipient countries, policy makers worldwide have been more than a little uneasy about such investments in the wake of the Asian crisis. The portfolio flows – often referred to as "hot money" – are 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. They have been blamed for exacerbating small economic problems in a country by making large and concerted withdrawals at the first sign of economic weakness. They have also been responsible for spreading financial crises – causing "contagion" in international financial markets. Due to these reasons, international capital flow and capital controls have emerged as importanpolicy issues in the Indian content as well.

It is essential to study the extent to which FIIs investments cause destabilization and damages by withdrawing from the equity market. It is in this context that a careful examination of the nature of foreign institutional investment (FII) flow into an economy is important, as it may help identify the strength of various factors (including macroeconomics ones like level of production, interest rate etc.) that are likely to affect such flows, the possible impact as well as for predicting the chances of their sudden reversals.

OBJECTIVE

The broad objective of the present paper is to gain a better understanding of the nature and determinants of

FII flows. Towards this we first take a look at the FII investment flow data to bring out the feature of these flows. Afterwards we study the relationship between flows and the stock market returns in India with the close look at the issue of causality.

ORGANIZATION OF THE STUDY

The paper has been divided into three sections. In the first section we discuss briefly about the importance of and the factors behind portfolio flows to emerging markets. In the second section we provide an overview of the nature and sources of portfolio flows in India, pointing out their main characteristics. The third section probes into the possible determinants of FII flows in India. In the fourth section we conclude with a summary of findings.

INTERNATIONAL PORTFOLIO FLOWS TO EMERGING MARKETS

International capital flows to emerging markets is a very good phenomenon, which began at a reasonable scale in the early 90s. On the theoretical side, the case for liberalization of international capital flows is built around a few basic tenets – viz., (a) free capital movements facilitate efficient allocation of global savings, channeling resources to countries where they will be most productive and thereby increasing growth and welfare globally; (b) access to foreign capital markets enable investors to achieve a higher degree of portfolio diversification, thus allowing them to obtain higher returns at lower risk; (c) full convertibility for capital account transactions complement the multilateral trading system which broadens the channels through which countries obtain trade and investment finance on much easier terms; and (d) liberalization improves macroeconomic performance as it subjects governments to greater market discipline and penalizes unsound monetary and fiscal policies. On the practical side, on the other hand, the surge in international portfolio investment over the past decade or so has been triggered by a number of parallel developments. First, institutionalized of savings in the USA and the developed world since the 1980s placed a massive and increasing volume of funds under the management of professional portfolio managers, who for tactical reasons tend to prefer a widely diversified portfolio spread out internationally. Second, there has been a trend towards financial liberalization both in developing countries and countries in transition thus allowing global fund managers to reach the financial markets of these countries. Third, developments in the information technology have immensely lowered the cost of international trading in securities and made information dissemination on a near real time basis possible. Fourth, a remarkable expansion of capital markets in emerging economies has taken place due mostly to the widespread privatization of formerly state-owned enterprises. However, the very elements that facilitated the inflow of foreign capital into developing countries have also meant that foreign capital can now be withdrawn from these countries far more quickly.

The performance of emerging equity markets during the past decade has indicated that investment in these markets can provide global investors with attractive absolute returns as well as some scope to diversify their portfolios. In fact, global investors reaped such benefits in the first half of the 1990s, but the gains disappeared between 1995 and 2001 with the reversal of performances of these markets relative to their matured counterparts. Such performance reversals have ushered in tactical investors such as a hedge fund (which tries to achieve high absolute returns essentially by exploiting the high volatility of returns in these markets through market timing). Such speculative and opportunistic behaviour of these tactical investors has contributed to the volatility of FII inflows into emerging markets. Even though global investors allocate a small portion of their total assets to equities in these markets to track a world or regional equity index and also as a means to diversify the portfolio held by them. Although this allocation is estimated to be a meager 5 percent of the total assets of global investors, in absolute terms this investment has now crossed the US dollar 100 billion level (which is larger than the total market capitalization of many individual emerging equity markets). The share that individual emerging markets get of such investments is often sizeable in relation to their total market capitalization.

As a result FII flows to the secondary equity market do not have any direct link with the level of real investment in the economy. It is only by enhancing the efficiency and liquidity of capital markets that such

a flow can contribute to growth. Securities markets in developing countries are typically both narrow and shallow. Therefore, FII participation may, a *priori*, induce considerable instability in these markets. The effect of such mobile capital inflows can, however, be quite complicated and therefore are highly controversial. In fact, country experiences differ considerably. Some studies found clear evidence of benefits of such flow in the form of equity market development, capital market integration, lowering cost of capital, and hence tend to question policy concerns regarding resource mobilization, market co-movements, contagion and volatility expressed by some policy makers and academics to be largely unwarranted. The causes of the instability and volatility of short-term portfolio capital flows to emerging markets are often related to the way in which investment funds are managed in order to confront uncertainty. It has been alleged that international portfolio investors seek liquidity and use 'quick exit' as a means of containing downside risk, thus making frequent marginal adjustments to their portfolios. Further, shifts in the portfolio composition of global investors are largely ascribed to changes in their perceptions of country solvency rather than to variations in underlying asset value. A common conclusion from research, however, is that institutions sometimes panic, disregard fundamentals and spread crisis even to countries with strong fundamentals. The literature also notes that individuals, too, can contribute to this destabilization process by fleeing from funds, particularly mutual funds and forcing fund managers to sell when fundamentals do not warrant such sale.

Empirical results of the effect of FII activities on the volatility of return are rather divided; some studies do not find that foreign investors have any destabilizing impacts on stock prices. Evidences to the contrary showing that foreign investors cause higher volatility in the market compared to domestic investors or that stocks in which foreign investors mainly trade experience higher volatility compared to those in which they do not show much interest also exist. These studies also show that volatility caused by FII jumped significantly around the crises period.

FIIS FLOWS TO THE INDIAN EQUITY MARKET

India opened its stock markets to foreign investors in September 1992 and has, since 1993, received considerable amount of portfolio investment from foreigners in the form of Foreign Institutional Investor's (FII) investment in equities. This has become one of the main channels of international portfolio investment in India for foreigners. In order to trade in Indian equity markets, foreign corporations need to register with the Securities and Exchange Board of India (SEBI) as FIIs. The SEBI definition of FIIs presently includes foreign pension funds, mutual funds, charitable/endowment/ university funds etc. as well as asset management companies and other money managers operating on their behalf. The Investments by all registered FIIs / sub accounts in primary or secondary markets under portfolio investment scheme is subject to a ceiling of 24% of paid up share capital of a company. The limit can be extended up to 49% sectorial cap if the general body of the company approves it. The limit does not include investments made by FIIs outside the portfolio investment route i.e. through the direct investment approval process. Investments made offshore through purchases of GDRs, ADRs and Foreign Currency Convertible Bonds excluded.

The overall investment limit is monitored by RBI. When the aggregate investment level reaches 22% in a company, in case of 24% limit, RBI gives a caution notice. Subsequently all purchases have to be done by prior approval of RBI. The approval is given on a first – cum – first served basis. For companies with FIIs investment limit of 49%, this caution notice is given at 47%.

On the basis of availability of investment opportunities, the global investors continuously adjust investment portfolio and thereby tracking returns in all possible markets. Following this logic, we have chosen to examine the relationship between FIIP and BSE Sensex, BSE 100 Sensex and NSE Index as well as their return values. As regards the data frequency, we have chosen to use daily data since April 2016 to December2018. A set of daily data should be more appropriate for examining the nature of causality. Daily returns in BSE Sensex, BSE 100 Sensex and NSE are calculated on the basis of day to day variations in their values.

The FII inflows and contemporaneous stock returns are strongly correlated in India. These positive correlations have often been held as evidence of FII actions determining Indian equity market returns. However, correlation itself does not imply causality. A positive relationship between portfolio inflows and stock returns is consistent with at least four distinct theories: (1) the "omitted variables" hypothesis ; (2) the "downward sloping demand curve" view ; (3) the "base – broadening" theory ; (4) the "positive feedback strategy" view.

The "omitted variables" view is the classic case of spurious correlation – that the correlated variables, in fact, have no causal relationship between them but are both affected by one or more other variables missed out in the analysis. The "downward sloping demand curve" view contends that foreign investment creates a buying pressure for stocks in the emerging market in question and causes stock prices to rise much in the same way as suddenly higher demand for a commodity would cause its price to rise. The "base – broadening" argument contends that once foreigners begin to invest in a country, the financial markets in that country are now no longer moved by national economic factors alone but rather begin to be affected by foreign market movements as well. As the market itself is now affected by more factors than before, its exposure to domestic stocks declines. Consequently the 'risk' of the market itself falls, people demand a lower risk premium to buy stocks, and stock prices rise to higher levels. Finally the 'positive feedback view' asserts that if investors 'chase' returns in the immediate past (like the previous day or week) then aggregating their fund flows over the month can lead to a positive relationship in the contemporaneous monthly data.

For any type of investor, domestic or foreign, market return is generally the prime driver of equity investments. However when it comes to the case of foreign investment in a thin equity market like that of India, there is a prevalent feeling that FII activities exert a strong demonstration effect and thus drive the stock market. In order words, some believe that the day to day FII trading in Indian market, rather than being influenced by the market return, induces the daily market return to be what it is. As a starting point we examine the nature of pair – wise causality between daily measures of FII inflows and the corresponding BSE Sensex, BSE Sensex Returns, BSE 100 Sensex Returns, NSE Index and NSE Index Returns at 1,2,3,4 and 5 lags. The results are given in the Table – 1.

TABLE-1

Pairwise Granger Casualty Test

Sample: 04/01/2016 **12/31/2018**

Null Hypothesis	Lags Considered				
	1	2	3	4	5
Panel-1					
BSE Sensex does not Granger cause FIIP	0.0000	8.3E-15	2.4E-11	8.2E-11	9-0E-09
FIIP does not Granger cause BSE Sensex	0.00049	0.10289	0.28457	0.39388	0.48611
Panel-2					
BSE Sensex Return does not Granger cause FIIP	0.01093	0.00271	0.00277	0.00367	0.00405
FIIP does not Granger cause BSE Sensex Return	0.17256	0.24825	0.38569	0.54128	0.68470
Panel-3					
BSE 100 Sensex does not Granger cause FIIP	0.00000	3.8E-15	1.2E-15	4.0E-11	3.8E-09

FIIP does not Granger cause BSI 100 Sensex	0.00261	0.22320	0.50595	0.62618	0.72104
Panel-4					
BSE 100 Sensex Return does not Granger cause FIIP	0.07138	0.30030	0.42513	0.56290	0.62049
FIIP does not Granger cause BSE 100 Sensex Return	0.20367	0.38955	0.51388	0.65692	0.77243
Panel-5					
NSE Index does not Granger cause FIIP	0.00000	3.9E-14	1.0E-10	4.1E-10	3.9E-08
FIIP does not Granger cause NSE Index	0.00055	0.11252	0.33817	0.46997	0.58638
Panel-6					
NSE Index Return does not Granger cause FIIP	0.05253	0.25388	0.37686	0.52176	0.59338
FIIP does not Granger cause NSE Index Return	0.16533	0.30182	0.44290	0.58566	0.71267

The results in Table -1 clearly suggest that causation runs from BSE Sensex, BSE Sensex Returns, BSE 100 Sensex, NSE Index and NSE Index Returns to FII inflows and not the other way. This lends further credence to the supposition that FII inflows to India are mostly in response to contemporaneous returns in the Indian stock markets rather than FII inflows being the cause of returns in the national markets.

CONCLUSION

The study shows the predominance of the Indian equity market return as the prime mover of the FII inflow into India. This suggests that the rate of FII inflows into the country would be governed mostly by the performance of the domestic equity market and / or foreign investor's expectation about this performance. In other words, FII flows to and from India are significantly affected by return in the domestic equity market, the latter is not influenced by variations in these flows in the sense of Granger causality. While the dependence of net FII flows on daily return in the domestic equity market-at a day's lag to be more specific-is suggestive of foreign investor's return chasing behavior, their decisions seem to get affected also by the recent history of market return as depicted from other lags' and it's volatility in international and domestic market returns as well.

The FII inflows can be extremely volatile because a drop of return in the Indian equity market may result in sudden massive withdrawals of FII which may result in quiet disturbing consequences on the country's economy, unless an appropriate stabilization mechanism is built into the domestic economic system.

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