Foreign Investment in India: Pain or Panacea? A Study With Reference to BSE and NSE

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INTRODUCTION

One of the outstanding features of globalization in the financial services industry is the increased access provided to non-local investors in several major stock markets of the world. Increasingly, stock markets from emerging markets permit institutional investors to trade in their domestic markets. Indian stock market opened to Foreign Institutional Investors on 14th September 1992, with lots of restrictions. The regulation on them are liberalized and minimized now. Since 1993 has received a considerable amount of portfolio investment from foreigners in the form of FIIs investment in equities. This has become a turning point of Indian stock market. The Government of India announced the policy of the government to permit the FII investment in Indian capital market. SEBI, modified the regulation on 14-11-1995. In order to make investment in India equity market, they wanted to register with Security Exchange Board of India as foreign institutional investors. It is possible for foreigners to trade in India securities without registering as Foreign Institutional investors, but such cases require approval from Reserve Bank of India or the Foreign Institutional Promotion Board. They are generally concentrated in secondary market.

Domestic market alone is not able to meet the growing capital requirement of the country and financing from mutilated institution has lost primary in emerging in the global order .

Portfolio flows often referred to as 'hot- money' are notoriously volatile capital flows. They have also been responsible for spreading financial crisis causing contagion in international market. Eventhough, the FIIs have been playing a key role in the financial markets since their entry into this country. The explosive portfolio flow by FII brings with them great advantages as they are engine of growth, lowering cost of capital in many emerging markets. This opening up of capital markets in emerging market countries has been perceived as beneficial by some researchers while others are concerned about possible adverse consequences.

Clark and Berko (1997) emphasize the beneficial effects of allowing foreigners to trade in stock markets and outline the "base-broadening" hypothesis. The perceived advantages of base-broadening arise from an increase in the investor base and the consequent reduction in risk premium due to risk sharing. Other researchers and policy makers are more concerned about the attendant risks associated with the trading activities of foreign investors. They are particularly concerned about the herding behavior of foreign institutions and the potential destabilization of emerging stock markets.

This study addresses these issues in the context of foreign institutional investors' (FII) trading activities in a big emerging market – India. India liberalized its financial markets and allowed FIIs to participate in their domestic markets in 1992. Ostensibly, this opening up resulted in a number of positive effects. First, the stock exchanges were forced to improve the quality of their trading and settlement procedures in accordance with the best practices of the world. Second, the information environment in India improved with the advent of major international financial institutional investors in India. On the negative side we need to consider potential destabilization as a result of the trading activity of foreign institutional investors. This is especially important in an emerging country that has embarked upon reforms to open up its market.

OBJECTIVES

The objectives of this study were as follows;

(1) To study the role of FII investment in the Indian stock market, (2) To examine the causal relationship between net FII investment and BSE sensex using granger causality test (3) To examine the causal relationship between net FII investment and NSE sensex using granger causality test (4)To examine whether FIIs were a channel of global disturbance into the Indian stock market.

TOOLS: Study was carried out with the help of unit root test, co integration test, causal regression and F statistics for FII investment and index from BSE and NSE

LITERATURE REVIEWS

Gayathri Devi .R in 2003, she conducted study on "Causal Relationship between FIIs and Stock Market: A critical study". It revealed that there was long run relationship between net FII investment and sensex, FII investment did not

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respond the short-run changes or technical-position of the market and they were more driven by fundamentals, and FII investments did granger cause India stock market. "Selen Serisoy Guerin" in 2006, conducted study on "The Role of Geography in Financial and Economic Integration: A comparative Analysis of foreign direct investment, Trade and Portfolio Investment Flows". It found support for the argument that most FDI among Industrial countries were horizontal, whereas most FDI investment in developing countries was vertical and our results indicated that portfolio investment flows compared to FDI, were highly sensitive to change in GDP per capita, this implied that if there was a negative output stock, portfolio investment flows would be more volatile than FDI. A.Julia Priya, D. Lazar and Joseph Jeyapual in 2005, they conducted a study on "Role of Foreign Institutional Investors on stock market development in India", Results revealed that sensex, market capitalization of NSE, Turnover of BSE and NIFTY without market capitalizations were influenced by Foreign Institutional Investors"Suchismita Bose and Dipankor Coondoo" in 2004, they conducted study on "The Impact of FII Regulation in India". These results strongly suggested the liberalization policies had the desired expansionary effect and had either increased the mean level of FII inflows and/or the sensitivity of these flows to a change in BSE returns. Parthapratim Pal in 2004 conducted study entitled as "Recent volatility in stock markets in India and foreign institutional investors. Findings of this study indicated that Foreign institutional investors had emerged as the most dominant investor group in the domestic stock market in India. Particularly, in the companies that constitute the Bombay stock market sensitivity index, their level of control was very high inertia of these flows.

"Sandhya Ananthanaryanan, Chandrasekhar Krishnamurthi and Nilajan Sen in 2003 conducted a study as "Foreign institutional Investors and Security Returns: Evidence from Indian Stock Exchanges", It found strong evidence consistent with the base-broadening hypothesis.It did not find compelling confirmation regarding momentum or contrarian strategies being employed by FIIs.It supported price pressure hypothesis.

It did not find any substantiation to the claim that foreigners' destabilize the market. J.S. Pasricha and Umesh.C.Singh in 2001, tried to analyze the impact of FIIs investment on Indian capital market. Their study revealed that FIIs are here to stay and have become the integral part of Indian capital market. Their entry has led to greater institutionalization of the market. They have brought transparency in the market operations.S.S.S. Kumar in 2001, attempted in his study to find the effect of FIIs on the Indian stock market. The inference analysis of the paper suggests that FII investments are more driven by market fundamentals rather than by short term changers or technical position of the market. As per K. Seethapathi and V. Subbulakshmi study entitled "Foreign Investment: Need for focus", They concluded that, the flows have to pick up. The political will is to be demonstrated by the government. In addition, the regulators have to identify the reasons for failure in converting approvals into actual investments and those issues are to be addressed immediately. E. Han Kim and Vijay Singal in 1997, they conducted study entitled "Are open market Good for Foreign Investors and Emerging Nations?", Conclusion revealed as: Integrating the emerging stock markets into world markets has had benefits, and will continue to have benefits for both global investor and host countries. The end result of integrated markets is a better allocation of resources, improved productivity of capital, and a higher standard of living.

THEORETICAL REVIEW

Between late 1990 and the middle of 1991, the economy faced severe balance of payment difficulties, coming close to defaulting on its external payment obligations in January and June of 1991. In January 1991, the Government negotiated with the International Monetary Fund (IMF) for loans. What followed was the implementation of the conventional IMF-World Bank prescription of short-term 'stabilization', consisting of devaluation, temporary import compression, fiscal and monetary compression with a rise in interest rates, followed by more long-term 'structural adjustment' measures, seeking to restructure the domestic economy.

The New Economic Policy was an outcome of implementation of the 'structural adjustment' program. The 'economic reforms' or 'economic liberalization' program, which began to be implemented with the announcement of the New Economic Policy (NEP), included wide-ranging changes in industrial policy, trade policy and foreign investment policy, a redefinition of the role of the public sector in the economy and redesigning the architecture of the domestic financial system. By narrowing down the topic, first it concentrates on capital account liberalization.

CAPITAL ACCOUNT LIBERALIZATION

The process of capital account liberalization in India needs to be situated in its wider context, for it was shaped by the reality in the national context and the conjuncture in the international context. In response to the external debt crisis, which surfaced in 1991, the government set in motion a process of stabilization, adjustment and reform.

Economic liberalization and structural reforms sought to increase the degree of openness of the economy through trade flows, investment flows, technology flows and capital flows. The process began the introduction of convertibility on trade as quantitative restrictions on imports, except for with consumer goods were dismantled and tariff levels were reduced. It was combined with a liberalization of the regimes for foreign investment and foreign technology. And restrictions on international economic transactions, including capital movements, were progressively reduced. This process was also influenced by the gathering momentum of globalization which was associated with increasing economic openness in trade flows, investment flows and financial flows.

The approach to capital account liberalization in India was much more cautious. What was liberalized was specified. Everything else remained restricted or prohibited. The contours of liberalization of the capital account were, in large part, shaped by the salutary lessons of the external debt crisis which surfaced in early 1991 and brought India close to default in meetings its international obligations. The balance of payments situation, then, was almost unmanageable. The vulnerability was accentuated by two factors: it became exceedingly difficult to roll-over short-term debt in international capital markets and there was capital flight in the form of withdrawals from deposits held by non-resident Indians. This experience dictated the parameters of capital account liberalization. It prompted strict regulation of external commercial borrowing especially short-term debt. It led to a systematic effort to discourage volatile capital flows associated with repatriable non-resident deposits. Most important, perhaps, it was responsible for the change in emphasis and the shift in preference from debt creating capital flows to non-debt creating capital flows. To some extent, the liberalization that was introduced was also influenced by the perceived needs of the economy: financing the current account deficit, mobilizing resources for investment and attracting international firms. But capital account convertibility remained, fortunately, in the realm of rhetoric. The Mexican crisis in late 1994 was, ironically enough, a blessing in disguise for India. It was not just an early warning signal. It dampened the enthusiasm of those who advocated capital account liberalization with a big bang. It lent support to those who questioned the wisdom of capital account convertibility that would have been premature in every sense. The contours of capital account liberalization in India were determined by these factors.

In sketching these contours, it is necessary to distinguish between different forms of private capital inflows and outflows, as there are important differences between these categories in the nature and the degree of liberalization. A complete description would mean too much of a digression. For our purpose, it would suffice to consider the contours of liberalization in the following categories of capital account transactions:

- Direct investment,
- Portfolio investment, and
- Non-resident deposits.

Foreign Direct Investment

It is defined as a long-term investment by a foreign direct investor in an enterprise resident in an economy other than that in which the foreign direct investor is based. The FDI relationship consists of a parent enterprise and a foreign affiliate which together form a transnational corporation (TNC). In order to qualify as FDI, the investment must afford the parent enterprise *control* over its foreign affiliate.

The liberalization of the policy regime for direct foreign investment began in July 1991 with two major decisions. First, direct foreign investment with up to 51 per cent equity was to receive automatic approval in selected high priority industries subject only to a registration procedure with the Reserve Bank of India. Second, a Foreign Investment Promotion Board was constituted to consider all other proposals for direct foreign investment where approval was not constrained by pre-determined parameters and procedures. In effect, this created a dual route for inflows of direct foreign investment. The approval was automatic, within the specific parameters, from the Reserve Bank of India, while all other inflows were subject to approval through the Foreign Investment Promotion Board. The access through the automatic route has been progressively enlarged over time. Needless to add, outflows associated with direct foreign investment are not subject to any restrictions, but this was so even in the era of capital controls.

Foreign Portfolio Investment (FPI)

Portfolio investment represents passive holdings of securities such as foreign stocks, bonds, or other financial assets, none of which entails active management or control of the securities' issuer by the investor; where such control exists, it is known as foreign direct investment.

The liberalization of the policy regime was extended to portfolio investment in September1992. To begin with, foreign institutional investors such as pension funds or mutual funds were allowed to invest in the domestic capital market subject simply to registration with the Securities and Exchange Board of India. Guidelines issued by the Reserve Bank of India permitted such foreign institutional investors to invest in the secondary market for equity subject to a ceiling of 5per cent (subsequently raised to 10 per cent) for individual foreign institutional investors in a single Indian firm with an overall limit at 24 per cent of equity (later relaxed to 30 per cent of equity at the option of the firm) for total foreign institutional investment in a single Indian firm. Foreign portfolio investment further classified into

1. FIIs 2. ADR/GDR, and 3. Offshore funds.

Foreign Institutional Investors (FIIs)

One who propose to invest their proprietary funds or on behalf of "broad based" funds or of foreign corporates and individuals and belong to any of the under given categories can be registered for FII.

• Pension Funds • Mutual Funds • Investment Trust • Insurance or reinsurance companies • Endowment Funds • University Funds • Foundations or Charitable Trusts or Charitable Societies who propose to invest on their own behalf, and • Asset Management Companies • Nominee Companies •Institutional Portfolio Managers •Trustees • Power of Attorney Holders • Bank

Access was provided to foreign institutional investors in the secondary market for debt. Soon thereafter, foreign institutional investors were also allowed investment or placement in the primary market, subject to approval from the Reserve Bank of India, with a maximum limit of 15per cent of the new issue. It was some time before foreign institutional investors were permitted investment in government securities in the primary and secondary markets. This came in 1996-97 and was subject to the ceiling for external commercial borrowing. Subsequently, in 1998-99, foreign institutional investors were also permitted to invest in treasury-bills. There is no reserve requirements stipulated for, or taxes imposed on, these capital inflows. It also needs to be said that foreign institutional investors are allowed to repatriate the principal, the capital gains, the dividends, the interest and any other receipt from the sale of such financial assets, without any restriction, at the market exchange rate. The income tax rate for dividends on such portfolio investment for foreign institutional investors is 20 per cent, which is much lower than the corporate income tax rate for domestic or foreign firms. But foreign institutional investors are subject to a higher short-term capital gains tax at 30 per cent compared with 20 per cent for domestic investors, while the long-term capital gains tax is the same at 10 per cent. Sales of such financial assets for the purpose of repatriation are absolutely unrestricted, provided the sales are through stock exchanges. However, disinvestment through any other route, or in any other form, requires approval from the Reserve Bank of India.

Global Depositary Receipt:

Global Depositary Receipt : A negotiable certificate held in the bank of one country representing a specific number of shares of a stock traded on an exchange of another country. American Depositary Receipts make it easier for individuals to invest in foreign companies, due to the widespread availability of price information, lower transaction costs, and timely dividend distributions. Also called European Depositary Receipt.

The option of portfolio investment was also made available to domestic corporate entities from September 1992. Indian firms were allowed access to international capital markets through global depository receipts or Euro convertible bonds which converted debt into equity after stipulated period. This access, however, was not automatic. Individual applications, drawn up inconformity with the general guidelines of the government, were subject to approval. This process remains unchanged.

Offshore Funds:

An offshore fund is a collective investment scheme domiciled in an Offshore Financial Centre, for example British Virgin Islands, Luxembourg, Cayman Islands or Dublin.

Similar facilities for portfolio investment were subsequently extended to Offshore funds, non-resident Indians (as individuals) and overseas corporate bodies, only for investment in shares or debentures through stock exchanges, on the same terms as foreign institutional investors, but subject to a ceiling of 5 per cent for individual non-resident Indians or overseas corporate bodies in a single Indian firm.

Among the various components of portfolio investment, FII comprises the bulk of portfolio inflows. The main objective of foreign institutional investors is to minimize risk and maximize returns by diversifying their portfolios internationally. Major determinants of investment decisions of FII are country and region specific.

Portfolio flows often referred to as 'hot- money' are notoriously volatile capital flows. They have also responsible for spreading financial crisis causing contagion in international market. Evan though, the FIIs have been playing a key role in the financial markets since their entry into this country. The explosive portfolio flow by FII brings with them great advantages as they are engine of growth, lowering cost of capital in many emerging market. This opening up of capital markets in emerging market countries has been perceived as beneficial by some while others are

concerned about possible adverse consequences.
Among the most active FIIs are Morgan Stanely Asset Management, jardine Fleming, Capital International, J. Henery schorder, templeton, Warburg Pinkers, Internatioanl Alliance and Quantum fund.

Foreign Institutional Investors in India

India opened her doors to foreign institutional investors in September, 1992. This event represents a landmark event since it resulted in effectively globalizing its financial services industry. Initially, pension funds, mutual finds, investment trusts, Asset Management Companies, nominee companies and incorporated/institutional portfolio managers were permitted to invest directly in the Indian stock markets. Beginning 1996-97, the group was expanded to include registered university funds, endowment, foundations, charitable trusts and charitable. Since then, FII flows which form a part of foreign portfolio investments have been steadily growing in importance in India. Other than in the year 1998, the net flows have been positive. The nuclear tests and East Asian crisis did slow down the flows but as stated by Gordan and Gupta (2003), their effects were short lived. That the percentage of total net turnover of BSE, the share of average of FII sales and purchases increased from 2.6 percent in 1998 to 5.5 percent in 2002. The cumulative net FII investment in India as on August 2003 is approximately $17400 million. As of August 2003 net FII investment was 9 percent of the BSE market capitalization which is small compared to the size of the market. However, in the words of Banaji (2002), it is not the market capitalization that matters but what is important is the level of the free float, that is, the shares that are actually publicly available for trading. With floating stock in the Indian market being less than 25 percent, about 35 percent of the free float available has been bagged by FIIs - despite the fact that they invest in just a few highly liquid stocks.
Though India receives hardly 1 percent of the FII investments in emerging markets, the portfolio flows to India have been less volatile when compared with that of many other emerging markets (Gordan and Gupta, 2003). FIIs by adopting a bottom-up approach seem to invest in top-quality, high growth, large cap stocks (Gordan and Gupta, 2003). Sytse et al. (2003) provide empirical evidence that foreign institutional investors in India, invest in large, liquid companies which enable them to exit their positions quickly at relatively lower cost and also that the foreign institutional owners have a larger impact than foreign corporate owners when performance is measured using stock market valuation criterion.
India is one of the fastest growing economies in South Asia, promising a growth of over 9 percent, second only to China, it would not be a surprise to see increased FII flows to India in the future. FIIs are now looking at the economy as a whole, with the macro-economic factors also playing their role in attracting foreign investors. Factors like a strong currency, key reforms in the banking, power and telecommunications sector, increased consumer spending and stable policies are expected to play a major role in attracting FIIs to India. The Securities Exchange Board of India (SEBI) along with the Institute of Chartered Accountants of India (ICAI) jointly monitor the markets and announces the regulatory measures thus making the Indian companies more transparent and more disciplined.
According to the April 2005 report on corporate governance by CLSA Emerging Markets, India ranks fourth with a score of 55.6 percent. Banaji (2000) emphasizes 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. But FII flows can be considered both as the cause and the effect of capital market reforms. The market reforms were initiated because of the presence of FIIs and this in turn has lead to increased flows.
The Government of India gave preferential treatment to FIIs till 1999-2000 by subjecting their long term capital gains 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. This gives an incentive for foreign investors to invest in Indian markets taking the Mauritius route. Consequently, we now see investments coming from Mauritius while there were none before 2000.
The country wise distribution of the FIIs registered in India, with majority of them coming from USA and UK. Chakrabarti (2002) and Rao et al. (1999) point out the fact that due to existing inter-linkages, the source of the FII investment might not be the country from where the institution operates. Nevertheless, the figure gives us an idea of the country wise distribution of the FIIs in India. So as to encourage long term investments in the Indian market, Budget 2003 proposed that investors who buy stocks of listed companies from March 1, 2003 be exempt from paying tax on the gains they make on their investments, provided they hold them for more than one year. With so much to benefit from, the FII investment in India is likely to increase in the future.

Regulation on FII

Investment by FII was 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 market (a watershed for FII flows) to India; this 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.

In order to trade in Indian equity market, foreign corporation need to register with SEBI as Foreign Institutional Investors. Without registration they can invest, but cases require the approval from RBI. They are generally concentrated in secondary market. FIIs are allowed to invest in

a) Securities in primary and secondary market including shares, debentures and warrant of companies, unlisted, listed or to be the listed in India.

b) Units of mutual funds c) Dated government securities d) Derivative traded in a recognized stock market and

e) Commercial papers

FIIs can invest their own funds as well as invest on behalf of their over seas clients registered as such with SEBI. These client accounts that the FII manages are known as 'sub accounts'. FII sub accounts include those foreign corporate, foreign individual, institution funds or portfolio established or incorporated outside India.

FIIs may issue deal in or hold off share derivative instrument such as participatory notes (PN). The entities that can subscribe to the PN are : a) Any entity incorporated in a jurisdiction that requires filing of constitutional or other documents with a registrar of companies or comparable regulatory agency or body under the applicable companies legislation in that jurisdiction; b) Any entity that is regulated, authorized or supervised by a central bank, such as the Bank of England, or any other similar body provided that the entity must not only be authorized but also be regulated by the aforesaid regulatory bodies; c) Any entity that is regulated, authorized or supervised by a securities or futures commission, such as the Financial Services Authority or other securities or futures authority or commission in any country , state or territory ; d) Any entity that is a member of securities or futures exchanges such as the New York Stock Exchange or other self-regulatory securities or futures authority or commission within any country, state or territory provided that the aforesaid mentioned organizations which are in the nature of self- regulatory organizations are ultimately accountable to the respective securities financial market regulators.

Investment limit

As per the September 1992 policy permitted foreign institutional investment registered FII could individually invest in a maximum of 5% of a company's issued capital and all FIIs together up to a maximum of 24%. From November 1996 they were allowed to make 10 percentage investment in debt securities subject to the specific approval from SEBI as a separate category of FIIs or sub accounts as 100% debt fund investment. Such investment were subjected to the fund specific ceiling prescribed by SEBI and had to be within overall ceiling US 1.5 $. The investment was however, restricted to the debt instrument of companies listed or to be listed on the stock exchanges. In 1997, the aggregate limit on investment by FIIs was allowed to be raised from 24% to 30% by then board of directors of individual companies by passing a resolution in their meeting and by special resolution to that effect in the company's Board meeting. In June 1998, the 5% individual limit was raised to 10%.In March 2000, the ceiling on aggregate FII portfolio investment increased to 49%. Finance minister announced on February 28, 2002 that foreign institutional investors can invest in a company under the portfolio investment rout beyond 24% of the paid up capital of the company with the approval of the general body of the share holders by a special resolution.

Benefits and costs of FII investments

The terms of reference asking the Expert Group to consider how FII inflows can be encouraged and examine the adequacy of the existing regulatory framework to adequately address the concern for reducing vulnerability to the flow of speculative capital do not include an examination of the desirability of encouraging FII inflows. Yet, for motivating the consideration of the policy options, it is useful to briefly summarize the benefits and costs for India of having FII investment. Given the Group's mandate of encouraging FII flows, the available arguments that mitigate the costs have also been included under the relevant points.

Benefits

Reduced cost of equity capital

FII inflows augment the sources of funds in the Indian capital markets. In a commonsense way, the impact of FIIs upon the cost of equity capital may be visualized by asking what stock prices would be if there were no FIIs operating in India. FII investment reduces the required rate of return for equity, enhances stock prices, and fosters investment by Indian firms in the country.

Imparting stability to India's Balance of Payments

For promoting growth in a developing country such as India, there is need to augment domestic investment, over and beyond domestic saving, through capital flows. The excess of domestic investment over domestic savings result in a current account deficit and this deficit is financed by capital flows in the balance of payments. Prior to 1991, debt flows and official development assistance dominated these capital flows. This mechanism of funding the current account deficit is widely believed to have played a role in the emergence of balance of payments difficulties in 1981 and 1991. Portfolio flows in the equity markets, and FDI, as opposed to debt-creating flows, are important as safer and more sustainable mechanisms for funding the current account deficit.

Knowledge flows

The activities of international institutional investors help strengthen Indian finance. FIIs advocate modern ideas in market design, promote innovation, development of sophisticated products such as financial derivatives, enhance competition in financial intermediation, and lead to spillovers of human capital by exposing Indian participants to modern financial techniques, and international best practices and systems.

Strengthening corporate governance

Domestic institutional and individual investors, used as they are to the ongoing practices of Indian corporates, often accept such practices, even when these do not measure up to the international benchmarks of best practices. FIIs, with their vast experience with modern corporate governance practices, are less tolerant of malpractice by corporate managers and owners (dominant shareholder). FII participation in domestic capital markets often lead to vigorous advocacy of sound corporate governance practices, improved efficiency and better shareholder value.

Improvements to market efficiency

A significant presence of FIIs in India can improve market efficiency through two channels. First, when adverse macroeconomic news, such as a bad monsoon, unsettles many domestic investors, it may be easier for a globally diversified portfolio manager to be more dispassionate about India's prospects, and engage in stabilising trades. Second, at the level of individual stocks and industries, FIIs may act as a channel through which knowledge and ideas about valuation of a firm or an industry can more rapidly propagate into India. For example, foreign investors were rapidly able to assess the potential of firms like Infosys, which are primarily export-oriented, applying valuation principles that prevailed outside India for software services companies.

Costs

Herding and positive feedback trading

There are concerns that foreign investors are chronically ill-informed about India, and this lack of sound information may generate herding (a large number of FIIs buying or selling together) and positive feedback trading (buying after positive returns, selling after negative returns). These kinds of behavior can exacerbate volatility, and push prices away from fair values. FIIs' behavior in India, however, so far does not exhibit these patterns. Generally, contrary to 'herding', FIIs are seen to be involved in very large buying and selling at the same time. Gordon and Gupta (2003) find evidence against positive-feedback trading with FIIs buying after negative returns and vice versa.

BoP vulnerability

There are concerns that in an extreme event, there can be a massive flight of foreign capital out of India, triggering difficulties in the balance of payments front. India's experience with FIIs *so far*, however, suggests that across episodes like the Pokhran blasts, or the 2001stock market scandal, no capital flight has taken place. A billion or more of US dollars of portfolio capital has never left India within the period of one month. When juxtaposed with India's enormous current account and capital account flows, this suggests that there is little evidence of vulnerability so far.

Possibility of taking over companies

While FIIs are normally seen as pure portfolio investors, without interest in control, portfolio investors can occasionally behave like FDI investors, and seek control of companies that they have a substantial shareholding in. Such outcomes, however, may not be inconsistent with India's quest for greater FDI. Furthermore, SEBI's takeover code is in place, and has functioned fairly well, ensuring that all investors benefit equally in the event of a takeover.

Complexities of monetary management

A policymaker trying to design the ideal financial system has three objectives. The policy maker wants continuing national sovereignty in the pursuit of interest rate, inflation and exchange rate objectives; financial markets that are regulated, supervised and cushioned; and the benefits of global capital markets. Unfortunately, these three goals are incompatible. They form the "impossible trinity." India's openness to portfolio flows and FDI has effectively made the country's capital account convertible for foreign institutions and investors. The problems of monetary management in general, and maintaining a tight exchange rate regime, reasonable interest rates and moderate inflation at the same time in particular, have come to the fore in recent times. The problem showed up in terms of very large foreign exchange reserve inflows requiring considerable sterilization operations by the RBI to maintain stable macroeconomic conditions. The Government had to introduce a Market Stabilization Scheme (MSS) from April 1, 2004.

With the foreign exchange invested in highly liquid and safe foreign assets with low rates of return, and payment of a higher rate of interest on the treasury bills issued under MSS, sterilization involves a cost. With a rapid rise in foreign exchange reserves and the need for having an MSS-based sterilization involving costs, questions have been raised about the desirability of encouraging more foreign exchange inflows in general and FII inflows in particular. While there is indeed, the issue of timing the policy of encouragement appropriately to avoid the pitfalls of throwing the baby with the bath water, there can not be a turnaround from the avowed policy of gradual liberalization, including the capital account. All modern market economies have evolved policies to reconcile prudent monetary management with the benefits of a liberal capital account. There is no scope for any diffidence in India also moving in the same direction.

CONCLUSION

The liberalization policies had the desired expansionary effect and had either increased the mean level of FII inflows and/or the sensitivity of these flows to a change in BSE returns and /or the inertia of these flows. On the other hand, the restrictive measures aimed at achieving greater control over FII flows also did not show any significant negative impact on the net inflows, it had found that these policies mostly render FII investment sensitive to the domestic market returns and raise the inertia of the FII flows.

Foreign institutional investors had emerged as the most dominant investor group in the domestic stock market in India. Particularly, in the companies that constitute the Bombay stock market sensitivity index, their level of control was very high. Data on shareholding pattern showed that the FIIs were currently the most dominant non-promoter shareholder in most of the sensex companies and they also controlled more tradable shares of sensex companies than any other investor groups .The sensex, market capitalization of NSE, Turnover of BSE and NIFTY without market capitalizations were influenced by Foreign Institutional Investors.FIIs investment was not across the shares listed in the stock exchange but instead it was concentrated on the top few company's shares. Though there was a role by FII on Indian stock market. It was to be taken very cautiously because their influences were on the very few shares in the stock market, which influenced the indicator included in the study but which might not help the Indian economy to grow The influence of FIIs on the movement of sensex became apparent after general election in India, during this period sensex experienced its worst single-day decline in its history and in the three month period between April to June 2004, it declined by about 17 percent. Moreover, this study also showed that even sharp changes in sensex did not necessarily indicted a significant alteration of actual shareholding pattern of different investor groups even in sensex companies. The activities of foreign institutional investors in emerging economies following the opening-up of the capital account were not simply positive for these countries but could also exert adverse effects. The reasons were derived from asymmetric distributions of information between local and foreign investors and between fund holders and managers. Foreign institutional investors could be assumed to have relatively little information on specific developments in emerging markets so that 'diluted information' and 'illusive competition' could result. Their influence on these markets was likely to worsen the relative position of local investors which leads to 'unbalanced diversification'. Moreover, due to their incentives they were likely to amplify occurring imbalances or even trigger financial shocks leading to what they call 'obscure risks' and 'booming contagion'. There was long term relationship between net FII investment and sensex, FII investment did not respond to the short-run changes or technical-position of the market and they were more driven by fundamentals, and FII investments did granger cause Indian stock market. The FIIs investments are highly concentrated in terms of their market value in very small number of companies. There seemed to be a clear distinction in the FIIs shareholding in nifty and non-nifty companies. There was a wide gap between the actual investments by FIIs and the investments allowed as per the cap.The gap in their investments existed both in nifty and non-nifty companies

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