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An Analysis on the Effect of Foreign Direct Investment and Foreign Institutional Investment Flows on Indian Stock and Capital Market

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Abstract – Foreign investment was introduced in 1991 under Foreign Exchange Management Act (FEMA). This step was taken to add some source of capital formation in India as other developing economies were already in this practice. As a result inflow of Foreign Capital has become striking measure of economic development in both developed and developing countries Now the developing countries are witnessing changes in the composition of capital flows in their economies because of the expansion and integration of the world equity market. FDI and FII thus have become instruments of international economic integration and stimulation. The Indian stock markets are also experiencing this change. FDI & FII are becoming important source of finance in developing countries including India. It is widely assumed that FDI & FII along with some other external factors such as global economic cues, Exchange rate and Internal factors such as demand and supply, market capitalization, EPS generally drive and dictates the Indian stock market.

Unprecedented globalizations have witnessed double digit economic growth resulting in fierce competition and accelerated pace of innovation. As a result inflow of Foreign Direct investments has become a striking measure of economic development in both developed and developing countries. FDI and FII thus have become instruments of international economic integration and stimulation. Fast growing economies like Singapore, China, Korea etc. have registered incredible growth at onset of FDI. Though US captures most of the FDI inflows, developing countries still account for significant growth of FDI and rise in FII. FDI not only gives access to foreign capital but also provides domestic countries with cutting edge technology, desired skill sets, tools of innovation and other complementary skills. The policies drafted to stimulate the flow of foreign capital in to India provided much needed impetus for India to emerge as an attractive destination for foreign investors. External factors such as global economic cues, FDI & FII, Exchange rate and Internal factors such as demand and supply, market cap, EPS generally drive and dictates the Indian stock market.

Sensex and Nifty were considered as the representative of stock market as they are the most popular Indian stock market indices. Based on 11 years data starting from 2001 to 2011, it was found that the flow of FDI & FII was moving in tandem with Sensex and Nifty. The study concludes that Flow of FDIs and FIIs in India determines the trend of Indian stock market.

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INTRODUCTION

India is the seventh largest and the second most populous country in the world with a history that spans thousands of years. The economic landscape of India underwent a paradigm change when the economy was liberalized in 1991. It also laid the foundation for a strong regulatory network. Indian economy has been one of the stars of global economy in recent years, growing at around 8% consistently. India, today, has a vibrant economy and is recognized as a leader among the emergent countries with a huge potential for growth. India is now initiating the second generation reforms intended for a faster integration of the Indian economy with the world economy. In the present decade India has witnessed unprecedented levels of economic expansion and also seen healthy growth of trade. GDP reflects the potential market size of Indian economy. India witnessed stellar economic performance through the period 2001-10.This was manifested through an average 8.5 - 9 percent GDP growth rates, rising domestic savings and investment levels and the amount of foreign capital flowing into the country. Nations' progress and prosperity is reflected by the pace of its sustained economic growth and development. Investment provides the base and pre-requisite for economic growth and development. Apart from a nation's foreign exchange reserves, exports, government‘s revenue, financial position, available supply of domestic savings, magnitude and quality of foreign investment is necessary for the well-being of a country. United Nations Conference on Trade and Development report on world investment prospects India has been ranked at the third place in global foreign direct investments in 2009 and will continue to remain among the top five attractive destinations for international investors 2010-11. In recent times the FIIs have started selling their investments from the stock market and the impact is clearly seen in the market instability. The 30 share sensitive Index of Mumbai Stock Exchange sensex is down to almost 15% and due to this it affects the growth path of India. It is very easy for FIIs to withdraw from the market. But on the other side if the investment is in FDI then the foreign companies will not liquidate their investments very easily and its impact of withdrawal will take time. Looking to both these impacts we should welcome FDI where we generate more employment at all levels and educate the manpower with more advanced level structure. FDI and FII are in India since long time then why should we oppose FDI in retail. Here are some of the facts to analyse why FDI or FII.

Developed economies consider FDI as an engine of market access in developing and less developed countries vis-à-vis for their own technological progress and in maintaining their own economic growth and development. Developing nations looks at FDI as a source of filling the savings, foreign exchange reserves, revenue, trade deficit, management and technological gaps. FDI is considered as an instrument of international economic integration as it brings a package of assets including capital, technology, managerial skills and capacity and access to foreign markets. The impact of FDI depends on the country‘s domestic policy and foreign policy. As a result FDI has a wide range of impact on the country‘s economic policy. In order to study the impact of foreign direct investment on economic growth, two models were framed and fitted. The foreign direct investment model shows the factors influencing the foreign direct investment in India. The economic growth model depicts the contribution of foreign direct investment to economic growth. Foreign Direct Investment (FDI) is fund flow between the countries in the form of inflow or outflow by which one can able to gain some benefit from their investment whereas another can exploit the opportunity to enhance the productivity and find out better position through performance. The effectiveness and efficiency depends upon the investors perception, if investment with the purpose of long term then it is contributes positively towards economy on the other hand if it is for short term for the purpose of making profit then it may be less significant. Depending on the industry sector and type of business, a foreign direct investment may be an attractive and viable option. Any decision on investing is thus a combination of an assessment of internal resources, competitiveness, and market analysis and market expectations. The FDI may also affect due to the government trade barriers and policies for the foreign investments and leads to less or more effective towards contribution in economy as well as GDP of the economy. One of the main reasons for the FII flows has been an increased recognition of the long-term growth potential of Indian economy. India offers favourable demographics and has quickly established its competitive advantage in many spheres including software. Indian entrepreneurs have been quite successful in launching businesses in India. FIIs have recognised the fact and unlike other countries where FDI has gained predominance, India has seen significant growth in FII investment. Though there could be temporary slowdown or reversals based on interest rate cycles, flow of funds, global contagion etc, over the long term, given the nascence of many Indian businesses and the growth potential, one would see continued inflows. Another reason may be the fact that Indian‘s have the ability to produce goods and services at a lower cost. The scarcity of employment opportunities brings good competition in the labour force and automatically improves the quality and productivity which is highly favourable for foreign corporations. Thus, there is hardly any big company in the entire world who does not have their presence in Indian investment scene. This is the reason that industries like BPO, IT and Manufacturing are steadily rising in India. Therefore, FII investment flow appears to influence and be influenced by the economic growth of India.

To understand the FDI means in Indian context, we have to look into our history, in early 1498 when a Portuguese Vaskodigama arrived at Calicut. He saw the prosperity of Indians. He introduced India in whole world. Later people started to visit India. Portuguese, Dutch, British and French established their premises in India and started trading with Indian people and dynasties. Sir Tomas Roe was the first British who came as the ambassador of British emperor and get the permission of trading in Mughal India. After this they created the ‘East India Company’ and started their business. It was the initial form of FDI in India. Later it got many changes according to the world’s financial status and become more popular word as foreign direct investment. But due to bad experiences of ‘East India Company’ at the time of independence, the attitude towards foreign capital was one of fear and suspicion. This was natural on account of the previous exploitative role played by it in ‘draining away’ resources from this country. The suspicion and hostility found expression in the Industrial Policy of 1948 which, though recognizing the role of private foreign investment in the country emphasized that its regulation was necessary in the national interest. Because of this attitude expressed in the 1948 resolution, foreign capitalists got dissatisfied. But the year-1991 marked a turning point in the economic history of India. In response to the major balance of payment stimulated by the collapse of Soviet Union (U.S.S.R), India’s major trading partner of the era, and hike in oil prices due to Gulf War, the Government of India sought the IMF (International Monetary Fund) to grant a bailout loan of 1.8 billion

US Dollars. IMF agreed to India's request for this bailout loan but demanded it to absorb several reforms into its economic policy in return. Government agreed upon this and absorbed some reforms into the economic policy of India. These reforms are famously referred to as the Economic Liberalization of 1991 in India. Under these reforms, major stress was laid by the government on three areas, namely – Liberalization, Privatization & Globalization. It is for this reason that the Economic Reforms of 1991 are sometimes also referred as the LPG policy of India. Here our subject matter is Globalization, in simple terms; the aim of the globalization was to integrate the Indian Economy with the World Economy, by enabling an unhindered Trade flow, Technology flow and Capital flow across the National and State Borders. For this purpose, several steps were undertaken by the Government of India, one of them was Encouragement to Foreign Investment i.e. FDI & FII

LITERATURE REVIEW

The investment made by Fiis in any capital market has gotten the consideration of specialists to recognize the relationship between the capital market exhibition and net inflow of Fiis. A great number of examination discoveries are accessible demonstrating the volatility movements in the capital market development because of inoculation of Fiis and vice-versa.

Chopra (2002) examines the effect of policy reforms on the FDI in India. The analysis has been carried out with the help of annual data from 1980-2000. The research includes policy related variables such as the degree of openness of the economy, debt-service ratio, foreign exchange rate and GDP as the explanatory variables of FDI inflows in India. Empirical result shows that GDP is an important factor which motivates FDI in the country. A research by Bohn and Tesar (1996) and Brennan and Cao (1997) based on quarterly data of US investments on foreign equity markets found a positive correlation of these flows and local returns on majority of the sample countries. In order to investigate whether FDI announcements provide information to investors, Ding & Sun (1997) studied whether shareholder benefits were a product of their firms' FDI decisions, and whether abnormal returns were attainable by trading shares. Their results showed that an average 2.73% additional return could be observed by investors buying and holding the stock of an announcing firm 21 days around the announcement date.

According to Morgan Stanley (2002) report FIIs strongly influence short-term market movements during bear markets. However, the correlation between returns and flows reduces during bull markets as other market participants raise their involvement reducing the influence of FIIs. Research by Morgan Stanley shows that the correlation between foreign inflows and market returns is high during bear and weakens with strengthening equity prices due to increased participation by other players.

Sivakumar (2003) has further examined the net streams of foreign institutional investment over a time of time and archived different confirms on what amount of the Indian stock market is stabilized or destabilized due the inflows and surges of Foreign Institutional investments.

John Andreas(2004) in his work "The Effects of FDI Inflows on Host Country Economic Growth" discusses the potential of FDI inflows to affect host country economic growth. The paper argues that FDI should have a positive effect on economic growth as a result of technology spillovers and physical capital inflows. A cross section and panel data analysis on a dataset covering 90 countries during the period 1980 to 2002, finds that FDI inflows enhance economic growth in developing economies only but not in developed economies. This paper has assumed that the direction of causality goes from inflow of FDI to host country economic growth. However, economic growth could itself cause an increase in FDI inflows. Economic growth increases the market size of the host country market and strengthens the incentives for market seeking FDI. This could result in a situation where FDI and economic growth are mutually supporting. However, for the ease of most of the developing economies growth is unlikely to result in market – seeking FDI due to the low income levels. Therefore, causality is primarily expected to run from FDI inflows to economic growth for these economies.

Kumar (2006) reported that the development in Indian stock market might be clarified with the heading of trusts glided by foreign institutional gurus. Hence spurred by some fascinating and time fluctuating confirmations with respect to the relationship between Fiis and stock market exhibition, the present study is ordained to inspect the relationship of Fiis and exhibition of Indian stock market.

Bansal and Pasricha (2009) studied the after impact of opening market to FIIs on Indian stock market behavior. They empirically analyze the change of market return and volatility after the entry of FIIs to Indian capital market and found that there is no significant change in the Indian stock market average returns. The volatility got significantly reduced after India unlocked its stock market to foreign investors.

Jayachandran and Seilan (2010) investigate the relationship between trade, Foreign Direct Investment (FDI) and economic growth of India over the period 1970-2007. The results of Granger causality test show that there is a causal relationship between the examined variables. The direction of causality relationship is from FDIs to growth rate and there is no causality relationship from growth rates to FDIs.

Most of empirical studies carried out in the past used multi regression model to study the impact of flow of FDI & FII.

Armstrong et al. (2012) shows that board characteristics significantly affect a firm's financialreporting properties. This suggests that U.S. institutional investors can potentially change a localinvestee's accounting practice by affecting its choice of board members. Further, if U.S.institutional investors make efforts to appoint U.S. directors to the boards of their investees withthe goal of intervening in their accounting practices, these efforts are likely to be most effectiveif the newly appointed board member(s) serves on the audit committee. The choice of externalauditor represents another possible channel through which U.S. institutional investors can affecttheir non-U.S. investees' accounting practice. Prior research (DeAngelo, 1981; Khurana andRaman, 2004; Behn et al., 2008) shows that the big-four auditors play a significant role in shaping the reporting behavior of U.S. firms and so a decision to switch to a big-four auditormay lead to higher comparability. Our next set of hypotheses concerns these underlyingmechanisms through which U.S. institutional monitoring may operate.

DIFFERENCE BETWEEN FDI AND FII

FDI and FII are equally connected to investment in a foreign country. FDI or Foreign Direct Investment is an investment that a parent company builds in a foreign nation. On the different, FII or Foreign Institutional Investor is an investment prepared by an investor in the markets of a foreign country. In FII, the companies just require to get registered in the stock exchange to make investments. However FDI is somewhat different from it as they invest in a foreign country. The FII is too famous as hot money as the investors have the liberty to sell it and take it back. Other than in FDI, this is impossible. In easy language, FII can come in the stock market simply and also withdraw from it without difficulty. Other than Foreign Direct Investment cannot go in and go out that simply. This dissimilarity is what makes countries to select FDI's more than then FIIs. FDI is more favoured to the Foreign Institutional Investor as they are considered to be the mainly valuable type of foreign investment for the entire country.

Foreign Direct Investment simply targets an exact enterprise. It means to increase the enterprises ability or productivity or modify its management control. In FDI, the capital inflow is converted into extra production. The FII investment flows simply into the less important market. It assists in increasing capital ease of use in common rather than enhancing the capital of an exact enterprise. The FDI is considered to be steadier than Foreign Institutional Investor. FDI not just brings in capital but also assists in high-quality governance practises and improved management skills and even technology transfer. While the Foreign Institutional Investor assists in promoting high-quality governance and improving accounting, it does not exist with any other benefits of the FDI. Although the FDI flows into the primary market, the FII flows into less important market. While FIIs are short term investments, the FDI are long-term.

I. FDI is an investment that a parent company makes in a foreign country. On the contrary, FII is an investment made by an investor in the markets of a foreign nation.

II. FII can enter the stock market easily and also withdraw from it easily. But FDI cannot enter and exit that easily.

III. Foreign direct investment targets a specific enterprise. The FII increasing capital availability in general.

IV. The foreign direct investment is considered to be more stable than foreign institutional investor.

RESEARCH METHODOLOGY

Data Collection -

This study is based on secondary data. The required data related to FDI and FII have been collected from various sources i.e. Bulletins of Reserve Bank of India, publications from Ministry of Commerce, Govt. of India. The BSE Sensex and CNX Nifty data is down loaded from the websites of bseindia and nseindia respectively. Daily closing index value are taken and averaged to get the index value for each year, which is considered as more representative figure of index for the entire year rather any one day's/month's closing figure of the index. The present study considers 11 years data starting from 2001 to 2011.

Analytical Tools & Technique -

In order to analyze the collected data the statistical tools such as correlation and Multi regression OLS model is used. Correlation coefficient is a statistical measure that determines the degree to which two variable's movements are associated. Correlation coefficient value ranges from -1 to 1. Negative value of correlation indicates: if one variable increases in its values, the other variable decreases in its value and positive value indicates: if one variable increases in its values the other variable also increases in its value. In the current study to study the linear relationship between variables such as FDI & FII and Sensex & Nifty correlation is applied. The multiple regression analysis is a statistical technique used to evaluate the effects of two or more independent variables on a single dependent variable.

In the current paper attempt is made to study the impact of FDI & FII on Sensex and Nifty. So FDI &

FII are considered as the two independent variables the dependent variable for model 1 is Sensex and Nifty for model 2.

Model Building-

Further, to study the impact of Foreign Direct Investment & Foreign Intuitional Investors on Indian stock market, two models were framed and fitted. Model 1 depicts Sensex as dependent variable; whereas independent variables are FDI and FII. Model 2 depicts Nifty as dependent variable; whereas independent variables are FDI and FII.

The two model equations are expressed below:

BSE SENSEX = a + b_1 (FDI) + b_2 (FII)

CNX NIFTY = a + b_1 (FDI) + b_2 (FII)

FINDINGS

- FII flows in terms of net purchases have shown increasing trend from the year 2001 to year 2013.
- CNX nifty has increased over a period of 13 years from year 2001 to year 2013.
- There is a moderate positive correlation between FII and CNX nifty stock market index. There is a relation between FII and Nifty.
- FII is able to explain 26% variation of the dependent variable Nifty
- There is no significant impact of FII on market index nifty.

CONCLUSION

The flow of FDI & FII accelerated the Indian economy and also gave opportunities to Indian industry for technological up-gradation, gaining access to global managerial skills and practices, optimizing utilization of human and natural resources and global competitive advantage with greater efficiency. Most importantly FDI is central for India's integration into global production chains which involves production by MNCs spread across locations all over the world. From the current study it is evident that there is a strong positive correlation between FDI & sensex and FDI & nifty and moderate positive correlation between FII & sensex and FII.

On the basis of above discussion and data analysis, it is clear that the FII and FDI are influencing the economic development to a greater extent. FDI is preferred over FII investments since it is considered to be the most beneficial form of foreign investment for the economy as a whole. Direct investment targets a specific enterprise, with the aim of increasing its capacity/productivity or changing its management control. Direct investment to create or augment capacity ensures that the capital inflow translates into additional production. In the case of FII investment that flows into the secondary market, the effect is to increase capital availability in general, rather than availability of capital to a particular enterprise. Translating an FII inflow into additional production depends on production decisions by someone other than the foreign investor — some local investor has to draw upon the additional capital made available via FII inflows to augment production. In the case of FDI that flows in for the purpose of acquiring an existing asset, no addition to production capacity takes place as a direct result of the FDI inflow. Just like in the case of FII inflows, in this case too, addition to production capacity does not result from the action of the foreign investor – the domestic seller has to invest the proceeds of the sale in a manner that augments capacity or productivity for the foreign capital inflow to boost domestic production.

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