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Dynamic Relationship between Foreign Institutional Investments and Movements in Indian Stock Market

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Abstract

Many of the developing countries, including India, restricted the flow of foreign capital till the early 1990s. Later on the serious current account deficit and other development issues have forced these countries to open their doors for foreign investments. In the present Indian scenario Foreign Institutional Investments (FII) has emerged as a major source of capital for emerging market economies including India. The huge investment by the Foreign Institutional Investors (FIIs) is generally considered as the major reason for the movements in the Indian stock market. This paper analyses the dynamic relation between FII and Indian stock market movements. The present study was conducted by taking the daily data of FII flow and market return for a period of 12 years from 1st April 2004 to 31st March 2016. The study with the help of VAR approach and Granger Causality Test reveals that investment activities of FIIs have an impact on the movements of the Indian stock market.

I. Introduction

FOREIGN INSTITUTIONAL INVESTORS (FIIs) means an entity established outside India to make investment in India. It was in September 1992 India opened its market for Foreign Institutional Investments (FII). In the present Indian scenario FIIs are the most dominant player in the Indian equity market. Foreign Institutional Investments is an added advantage to the economy because it adds the investment base and supplements the domestic savings for improving the investment rate. Moreover it is a non-debt creating source of foreign investment. Hence, the Government of India has extended preferential treatment for FIIs especially in the matter of taxation. For example the Indo-Mauritius Double Taxation Avoidance Convention 2000 (DTAC) exempts Mauritius-based entities from paying capital gains tax in India. The immediate impact

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fluctuations in market return is due to FII flow. Thus the analysis of variance decomposition also reveals that impact of market return on FII flows is much higher than the impact of FII flow on market return.

The question whether the FII flow causes the stock market to rise/fall and whether the market return cause FII were addressed by using Granger (1969) causality test. The results are given in the Table IX

Table IX
Granger Causality Test

Null Hypotheses	F Statistics	P - Value
ADR does not Granger Cause PSR	45.313	7E-168
PSR does not Granger Cause ADR	6.30340	0.0019

Source: Test Result

The test results presented in Table VIII reveals that based on the p value (0.000) of F statistics the null hypotheses of ADR (Return) does not Granger Cause PSR (FII) and PSR (FII) does not Granger Cause ARD (Return) is rejected at five per cent level of significance. It means there is bidirectional *causality* between FII flows and the stock market return. It means FII flow cause market return and market return also leads to FII flow.

V. Summary and Conclusion

Indian stock markets have witnessed massive reforms in the past two decades. The arrival of FIIs has led to increase in value of Indian securities which is considered to be undervalued because of low capital availability in the country. Generally the flow of institutional investment is highly correlated with the market returns. This paper examines the dynamic relationship between FII flow and stock returns in Indian securities market. The study is based a period of 12 years from 1st April 2004 to 31st March 2016 using VAR approach and Granger causality test. The analysis based on daily data reveals that FII flows have significant positive impact on the movements in the Indian stock market and market return also has significant positive impact on FII flow. The impulse response function shows that the time profile of the impact of market return on FII flow is more lasting and significant compared to the impact of FII flow on market return. The variance decomposition analysis shows that around 4 per cent of the fluctuations in the market return is explained by FII flow. However, around 24 per cent of the fluctuations in the FII flow is explained by market return. The study supports the existence of positive feedback trading and herding behavior being followed by FIIs in India. The study also found the existence of information revelation hypothesis but there is no evidence that FIIs impose price pressure in the market. The existence of information revelation hypothesis shows that FIIs are having private information and they use it for generating abnormal income from the market. The study also shows the evidence for bidirectional *causality* between FII flows and market return. Based on VAR model, Impulse response, variance decomposition and

Granger causality test the study concludes that the investment activities of FIIs have significant positive impact on stock market movements and market return also has significant positive impact on FII flow. Both FII flows and market movements are mutually reinforce each other but the impact of market return on FII flows is much higher than the impact FII flow on market return.

Notes

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