During 1980s, the developing countries started liberalizing their economies. There has been a greater emphasis on the development of equity markets as a part of financial reforms. India has also followed this path. With the globalization, financial markets are becoming more and more important every day. A developed stock market is considered crucial to national economic growth as it provides an additional channel along with banks and other financial institutions, for encouraging and thus mobilizing domestic savings. It also ensures improvements in the productivity of investment through market allocation of capital and increases managerial discipline through the market for corporate control. A study by World Institute for Development Economic Research (WIDER, 1990) has argued that the developing countries should liberalize their financial markets in order to attract foreign portfolio equity flow. The huge amount of financial capital available in the developed countries through pension and investment funds could be attracted to the developing countries provided the latter liberalize their markets externally and developed their stock market internally. Capital markets have taken a prominent place in the developing countries financial system during the last decade. The most important measure taken in this regard by developing countries was the opening of their respective stock markets to international investors. This step, taken in the late 1980s or early 1990s, resulted in historically high level of portfolio investment in the emerging markets by global and regional funds. In developing countries like, India there is a great need of foreign capital not only to increase productivity of labour but also to build foreign exchange reserve to meet trade deficits. After opening up the borders for capital movement in 1991, foreign investment in India have grown enormously.

The remarkable economic growth during the past two decades in most of the emerging countries had been stimulated by foreign capital inflows from
developed countries. The post 1990s period witnessed sharp augment in flows of foreign private capital and official development finance lost its predominance in net capital inflows. Most of the developing countries opened their capital markets to foreign investors either because of inflationary pressures, widening current account deficits, exchange depreciation, increase in foreign debt or as a result of economic policy. There was a surge in capital inflows into India too since 1992 as in India, the purchase of domestic securities by FIIs was first allowed in September 1992 as part of the liberalization process that followed the balance of payment crisis in 1990-91. Now days, a significant portion of Indian corporate sector’s securities are held by Foreign Institutional Investors, such as pension funds, mutual funds and insurance companies. These investors are often viewed as sophisticated investors as these institutional investors are better informed and better equipped to process information than individual. As the share of foreign investors in emerging markets has risen, they have influenced the assets prices considerably. Consequently, policymakers have become increasingly concerned about the factors determining international investment, the performance of foreign capital investments, and the impact of foreign investment on local turnover and on the volatility of stock.

Foreign Institutional Investors (FIIs) have been a key part of India’s growth story this decade. The term FIIs is most commonly used to refer the companies that are established or incorporated outside India and are investing in the financial markets of India by registering themselves with the Securities & Exchange Board of India (SEBI). Foreign Institutional Investors have been a major source of funds into the Indian Capital Markets in the past few years. Foreign Institutional Investors are defined under SEBI Regulations as “an institution that is a legal entity established or incorporated outside India proposing to make investments in India only in securities.” FIIs include
overseas pension funds, mutual funds, investment trusts, asset management companies, nominee companies, banks, institutional portfolio managers, university funds, endowments, foundations, charitable trusts, charitable societies, a trustee or power of attorney holder incorporated or established outside India proposing to make proprietary investments on behalf of a broad-based fund (i.e., fund having more than 20 investors with no single investor holding more than 10% of the shares or units of the fund). Foreign Institutional Investment is basically short-term in nature and mostly made in the financial markets. Foreign Institutional Investors (FIIs) are allowed to invest in the primary and secondary capital markets in India through the Portfolio Investment Scheme (PIS) administered by the Reserve Bank of India (RBI). Under this scheme, FIIs can acquire shares/debentures of Indian companies through the stock exchanges in India. The ceiling for overall investment by FIIs is 24 per cent of the paid up capital of the Indian company (20 per cent in the case of public sector banks, including the State Bank of India). The ceiling of 24 per cent for FII investment can be raised subject to (i) approval by the company’s board and the passing of a special shareholder resolution to that effect (ii) certain sector caps imposed by RBI and the Government of India. The RBI monitors the ceilings on FII investments in Indian companies on a daily basis and publishes a list of companies allowed to attract investments from FIIs with their respective ceilings.

Foreign institutional investment can be beneficial to developing countries like India because of its risk-sharing characteristics and effects on resource mobilization and allocation. With financial integration, developing countries have become increasingly attractive destinations for international investors who are seeking a higher return than what is available in the developed economies. Stock markets of developing countries have become more, although not fully, integrated with world financial markets, and this
increased integration implies a lower risk-adjusted cost of capital, which is possible by diversifying the risk. The correlation between returns of emerging markets (developing markets) with developed markets is lower than the return available in the developed economies, the risk-return profile of the portfolio can be improved. This has created the prospects of a more efficient worldwide allocation of savings and investment than was possible earlier, when domestic investment in most countries was constrained by domestic savings. Thus, big financial investors in the developed countries, while diversifying their risk, find developing countries a more attractive destination. Since 1992, the Government of India declared the opening of the domestic market to foreign institutional investors. Since then, Foreign Institutional Investment (FII) has steadily grown as the primary source of portfolio investment in India. Reflecting high economic growth as well as favorable corporate performance, this tendency has become more significant since the arrival of FIIs in the Indian capital market. The surge of FII inflows is said to have affected the Indian economy, and specially the secondary market, given the dominant role of equity in FII inflows and the relative thinness of the capital market. In fact, the Bombay Stock Exchange (BSE) SENSEX 30, the leading index in the principal market, has shown a significant upward movement since net FII flows began to increase. FII flows are considered to increase the domestic investment without increase in foreign debt. FII flows can raise stock prices, lower cost of equity and stimulus investment by Indian firms and lead to improvements in securities market design and corporate governance. Thus, FIIs increase the depth and breadth of the market; expand securities business, and their policy of focusing on fundamentals of the shares and thus enable efficient pricing of shares. However, market pundits often attribute fall of the stock market to the flow of funds by FIIs. FIIs are known to rush out at the slightest hint of trouble in the host country leaving an
economic crisis, like Mexico in 1994 and India in 2008. Thus, FIIs exacerbate small economic problems in a country by making large and concerted withdrawals. And, they can be held responsible for spreading financial crisis - causing ‘contagion’ in international markets. Foreign Institutional Investors (FIIs) were permitted to invest in all the listed securities traded in Indian capital market for the first time in September, 1992. As per the RBI, Report on Currency & Finance (2003-04), since 1991 there has been continuous move towards the integration of the Indian economy with world economy. Since then the regulations with regard to FIIs investment has become more liberal. As a result of abolishment of barriers to capital inflows in the form of FIIs investment, India attracted huge amount of foreign capital particularly from developed countries. The cumulative net investment by FIIs in Indian stock market since 1993 has crossed Rs. 292473.60 crores (US$ 50 billion) at the end of March 2008. International capital inflows have both positive as well as negative impact on the health of the recipient economy. On the positive side, these capital inflows raise the level of economic development by augmenting the domestic investment and widen financial intermediation. But these capital inflows also pose several threats to the domestic economic and financial system of the recipient economy like inflation, appreciation in exchange rate, overheating of the economy and possibility of sudden withdrawal. FIIs investment is volatile by nature and is often termed as ‘hot money’. The speed and the volume of current inflows have caught the market by surprise. India’s capital account outlook remains optimistic, but some market watchers feel that the current pace of equity FII inflows may not be sustainable. Once the major IPOs are completed, valuations may come into investor focus, leading to a lull in equity inflows. In the light of huge and growing FIIs investment inflows to India, appropriate policy formulation is the need of the hour which will help in reducing the impact of possible threats and maximizing the
benefits from the same to enhance economic and financial development. This in turn calls upon for the need to estimate the determinants of FIIs investment. Available empirical evidence suggests that FIIs inflows by and large are determined by the performance of stock markets and macroeconomic aggregates of the host country. Thus, FIIs investment is pulled toward an economy with sound macroeconomic factors, high returns, lesser risk and growing stock markets in terms of rising market capitalization and turnover. FIIs, give due consideration to risk-return characteristics in the home (source) country while investing in emerging markets. The profit booking tendency of FIIs depends on the difference in the home country risk-return and host country risk return. Besides this, official policies of the host and home country i.e. degree of financial liberalization, also determine the size of FIIs inflows.

The present study makes an attempt to trace out the development and promotion of Indian capital market after the liberalization of the Indian economy, when foreign Institutional investments were to allowed enter in Indian capital market. The arrivals of the foreign institutional investments have mainly influenced the promotion of the Indian capital market. The impact of FIIs investment on the major indices including BSE Sensex and NSE Nifty, the volume of investment has been quite significant. The study has been divided into five chapters as follows:

The first chapter is a brief introduction of foreign institutional investors. It also reviews the available literature on the subject, research gap, describes the need and significance of the study, sets out the objectives of the study, hypotheses and research methodology of the study.

The second chapter of the study deals with an outlook of foreign institutional investments in the Indian economy after the liberalization. Since 1990-91, the Government of India embarked on liberalization and economic reforms with a
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view of bringing about rapid and substantial economic growth and move towards globalization of the economy. As a part of the reforms process, the Government under its New Industrial Policy revamped its foreign investment policy recognizing the growing importance of foreign direct investment as an instrument of technology transfer, augmentation of foreign exchange reserves and globalization of the Indian economy. Simultaneously, the Government, for the first time, permitted portfolio investments from abroad by foreign institutional investors in the Indian capital market. The entry of FIIs seems to be a follow up of the recommendation of the Narsimhan Committee Report on Financial System. From September 14, 1992 with suitable restrictions, Foreign Institutional Investors were permitted to invest in all the securities traded on the primary and secondary markets, including shares, debentures and warrants issued by companies which were listed or were to be listed on the Stock Exchanges in India. The chapter also deals with the market design, registration process, and prohibitions on investment of FIIs in India according to the regulatory body of Indian capital market and an outlook of Indian government on different reforms in different sectors of the Indian economy includes streamlining of procedures, raising of permissible equity limits in different sectors where FIIs are allowed to invest. It also includes the expected gains of the FIIs in Indian capital market as in terms of enhanced flow of equity capital, improving the corporate governance in the firms, reducing cost of equity, improving market efficiency and providing stability to balance of payments, whereas some disadvantages of FII investments also discussed like increasing volatility and capital outflows, price rigging, money laundering and possibility of taking over the companies or backdoor control.

The third chapter provides a brief account of the developmental history of the Indian capital market. The facts emerging from the chapter are that Capital market being the most important segments of the financial market plays a
significant role in providing finance to the government and corporate sectors. Capital market is important for raising funds for capital formation and investments and forms a very vital link for economic development of any country. The capital market provides a means for issuers to raise capital from investors (who have surplus money available from saving for investment). Thus, the savings normally flow from household sector to business or Government sector, which normally invest more than they save. A vibrant and efficient capital market is the most important parameter for evaluating health of any economy. The chapter also describes the major functions of the capital market, various forms of investment instruments which are available to investors and major entities involved in the capital markets.

The fourth chapter analyses the impact and role of the foreign institutional investments on the Indian capital market. To study such role of FII s in development of Indian capital market, the following hypotheses have been tested and a trend analysis of FI investment has also been done.

**Ho1.** Null hypothesis: There is no significant impact of FII s in the promotion of Indian capital market.

**Ho2.** Null hypothesis: There is no significant impact of FII s investment on BSE Sensex.

**Ho3.** Null hypothesis: There is no significant impact of FII s investment on NSE Nifty.

**Ho4.** Null Hypothesis- There is no significant difference in respect to FII s investment in debt and equity in Indian capital market.

In fact, liberalization and reforms have the potential to change the complexion of economy and the Indian capital market is no exception to this phenomenon. On Sep 14, 1992, the Govt. of India announced guidelines regarding investment in the primary and secondary markets by foreign institutions. FII s could trade in all securities after obtaining SEBI registration.
They could sell the shares at market rates and repatriate the proceeds without a lock-in-period. Since the economic reforms in 1991, Indian economy has been increasingly integrated into the global economy and hence, Foreign Institutional Investment (FII) is largely open to the India’s equity, debt and derivatives markets. It is clear from the past investments data that there is an increase in net investments by FIIs till 2002 in which year such flow experienced a break. After 2002, FII flow shows a steep ramp. Again there was a small decrease in net investments in the year 2006. But there was a steep increase in the year 2007. The net FII increased to Rs. 66179.6 crores (including debt investments by the FIIs) till March 2008. This was the best period in the Indian capital market during which stock prices were increased and the market witnessed a Bull Run. And, FII investment treated as ‘Hot Money’ that ‘Fuel the Market Run’. In January 2008, the US financial crisis came into light with sub-prime effect, which led the major financial companies to post heavy losses. In September 2008, this crisis worsened with some of the companies had to file for bankruptcy and some had to take financial aids from government to continue their business operations. This crisis had significant impact on FII investment in India, as investors all over the world lacked confidence on the market. The crisis in confidence resulted in the selling of equities of Rs. 47,706.3 crores in April 2008-March 2009 by FIIs which comes to around 15% of net investment of Rs. 2, 84,942 crores as on 1st January 2008 of last eight years. This had significant impact on India’s stock market. When FIIs started withdrawing money from the financial market, the domestic investors became fearful and they also withdrew money from the market. Thus, the Sensex which touched above 21,000 mark in January 2008, plunged as below as 8160 mark in March 2009. In fact, major falls in stock market witnessed heavy withdrawal of money by FIIs. This indicated a relationship between FIIs’ equity investments and the stock market performance in India.
After a long spell of growth, the Indian economy experienced a downturn. Industrial growth shrunk; inflation remained at double-digit levels; the current account deficit widened; foreign exchange reserves depleted; the rupee depreciated; and the Sensex crashed. All of these developments were not unrelated to the financial crisis in the markets of the developed countries, which affected India also in many ways. The most immediate effect was an outflow of foreign institutional investment from the equity market. Faced with the need to retrench assets in order to cover losses in their home countries and seeking havens of safety in an uncertain environment, foreign institutional investors (FIIs) were major sellers in Indian markets in the financial year 2008-09.

The fifth and final chapter draws conclusions based on different chapters of the thesis and presents recommendations and suggestions for the improvement of foreign institutional investments operations in the Indian capital market. Few but most important observations and recommendations are as follow:

i. On the basis of empirical study it is found that there is a significant difference in respect to FIIs investment in debt and equity in Indian capital market. Although FIIs were allowed in debt in year 1997, but they have been found to be more interested in equity rather in debt as FIIs have mainly invested in equity in the whole period of this study.

ii. It is also found that the movement in stock indices fluctuations is not caused by FIIs investment alone. For the whole period of study (1993 to 2009) only 27.7% of the changes have happened in stock indices of BSE Sensex due to FIIs investment and 28.3% of the changes have happened in NSE Nifty due to FIIs investment. So, we can say that the FIIs are not wholly responsible for changes in stock indices of Indian capital
market and thus FIIs are aiding in the promotion of Indian Capital market.

iii. The Market capitalization and the Net FIIs investment are positively correlated where market capitalization of BSE Sensex and the net FI investment is 0.683 at a significant level of 1 percent and NSE Nifty and Net FIIs investment i.e. 0.532 at a significant level of 5. Thus both the markets are positively correlated. Therefore, there is significant impact of FIIs in the promotion of Indian capital market.

iv. The investment in the economy should be enhanced in the face of rising demand for investible resources. This can be done by encouraging more FI inflows into the country particularly given the advantage that FI is a form of non-debt creating inflows and thus does not increase the country’s debt liabilities.

v. The fact is that developing country like India has its own challenges arising out of the very state of their social, political and economic development. To attract portfolio investments and retain their confidence, the host country has to follow stable macro-economic policies.

vi. The ability of Government to prevent and reduce financial crises also has a great impact on the growth of capital flows. Steps to address these crises should include strengthening banking supervision, requiring and ensuring more transparency in international financial transactions, ensuring adequate supervision and regulations of financial markets.