CHAPTER 2

REVIEW OF LITERATURE

2.1 STUDIES ON CAPITAL MARKET AND THE ECONOMY

2.2 STUDIES ON CAPITAL MARKET IN INDIA

2.3 STUDIES ON FOREIGN PORTFOLIO/INSTITUTIONAL INVESTMENT
CHAPTER 2

REVIEW OF LITERATURE

This chapter reviews literature in the area of capital market and foreign portfolio investment. Studies have been divided into three segments:

i) Studies on capital market and the economy

ii) Studies on capital market in India

iii) Studies on foreign portfolio institutional investment

2.1 Studies on Capital Market and the Economy

Economic literature on capital market has been scanty, till recent times. However, recognizing the role of financial markets in economic growth, researchers started focusing on this area in 1980s and 90s, so much that, currently, economic literature in this field is rich in contributions on capital market and its influence on corporate and economic growth.

Early observations, on the relationship between financial markets and economic growth, came from Gurley and Shaw (1955). Gurley and Shaw found that, as countries develop, self-financed capital development will be increasingly replaced by intermediated debt finance and later, equity markets for raising external funds emerge and develop. The financial structure – mix of financial intermediaries and markets – changes as countries develop.
Empirical evidences support Gurley and Shaw’s view that at low levels of development, commercial banks are the dominant financial institutions and that as economies grow, specialized financial intermediaries and equity markets develop. Studies by Asli Demirguc Kunt and Ross Levine (1996) on the evolution of financial structure in low, middle and high-income countries have brought out empirical evidences in support of the Gurley and Shaw thesis.

In the 1970s major contributions came from McKinnon (1973) and Shaw (1974), who studied the relationship between financial development and economic growth. According to them, government interventions in setting interest rates and allocation of resources, cause distortions in the economy. These distortions caused by governmental interventions in the financial markets adversely affect allocative efficiency and saving and investment in less developed economies. They argue for financial liberalization for the removal of distortions.

Cho (1960) took forward the views of McKinnon and Shaw by introducing the role of the stock market, which was not included in the McKinnon–Shaw analysis. Cho’s important conclusions were:

i. Banks cannot achieve efficient capital allocation due to imperfect credit market information.

ii. Equity markets achieve much superior capital allocation due to superior information.
iii. Therefore development of the equity market is desirable and necessary for complete financial liberalization.

A major drawback of the McKinnon-Shaw-Cho framework is that, it focuses on the allocative function and ignores the impact of the financial market, particularly the stock market on the real economy.

The 1990s saw tremendous growth in literature on capital market and economic growth. Many scholarly works threw light on this contentious issue. The most authoritative study on the relationship between stock market and economic growth came from the World Bank Research Group. This study came in the form of six research papers in a symposium issue on stock markets and economic development (1996)\textsuperscript{vi}.

This World Bank Research Group exhaustively studied the relationship between stock market development and financial intermediaries. The research papers focused on, and studied, the following issues.

Firstly, it constructed more measures of stock market development than any previous study (Robert A Korajczyk. 1996)\textsuperscript{vii}. Further, it compared liquidity, concentration, volatility, institutional development and international integration across 44 industrial and developing countries from 1976 to 1993. The data produced are, indeed, voluminous and valuable.
Secondly, the study investigated the relationship between stock markets and financial intermediaries (Demirguc-Kunt and Levine 1996)\textsuperscript{viii}. Producing evidence to the effect that stock market development leads to better development of banks and non-banking financial intermediaries, the study dispels the fear that stock market development steals banks of their business. The fact that stock market development goes hand in hand with general financial development is emphasized.

Thirdly, the study analyzed the relationship between stock market development and long run economic growth (Levine and Zervos 1996)\textsuperscript{ix}. Evidence relating to the positive association of stock market development with long run growth is brought out using cross-country growth regressions.

Fourthly, the Research Group studied the relationship between stock market development and financing choices of firms (Asli Demurguc Kunt and Vojislov Maksimovic 1996)\textsuperscript{x}. Looking at a sample of 30 industrial and developing economies, they observe that the effect of stock market development on firm’s debt–equity ratios depends on the initial level of stock market development. Improvement in the functioning of stock markets produces a higher debt–equity ratio in firms. Thus, stock market development, while encouraging greater use of equity markets in raising capital, also encourages greater use of bank finance. Stock market development, therefore, increases the quantity of bank loans.
Finally, a theoretical framework is developed (Boyd and Smith 1996) to help explain the important aspects and consequences of Demirgüç–Kunt and Maksimovic findings, on corporate finance and financial market development. A model is constructed, in which, firms finance capital accumulation externally through a combination of debt and equity, and, the level of development of debt and equity markets interacts with physical capital investment decisions.

The research papers presented in this symposium considerably boost our knowledge of the relationship between stock market and economic development. A deficiency of this study by the World Bank Research Group is that the Papers do not study individual country cases. Another deficiency is that the research does not shed any light on when the countries are ready for stock market development.

Researchers have put forward very strong theoretical disagreements with the World Bank’s views on stock market development and economic growth. A prominent work in this category is that of Mayer (1989). Based on studies using corporate balance sheets Mayer made the following observations:

i. Retained earnings are the dominant source of finance in all countries.

ii. There are variations in the retention-earning ratio across countries.

iii. In no country do companies raise substantial amount of finance from the securities market.

iv. Banks are the main sources of external finance in all countries.
v. There is a strong inverse relationship between the proportions of expenditure financed from retentions and bank credit.

vi. Small and medium sized firms, rather than large ones, rely more on external finance.

Mayer’s views, totally at variance with the World Bank’s views, are based on studies using sample of company balance sheets and not on figures for the entire corporate sector.

2.2 Studies on Capital Market in India

In India, the topic ‘Capital Market and Economic Growth’ became an issue of interesting debate, thereby, immensely enriching economic literature. Two schools of thought emerged; one advocating capital market reforms and development and the other skeptical of the same. The first group supporting capital market reforms and recognizing their positive effect on corporate and economic growth continued in the tradition of the World Bank’s views. Prominent representatives of this group are Shah and Thomas. The other group, which is skeptical of stock market development, raised some serious issues regarding the not so positive, and, at times negative effects, of capital market development on savings, investment and economic growth in the Indian context. The prominent representatives of this group are Nagaraj and Ajit Singh. The works of these two representative groups are examined in some detail.
Shah and Thomas (1996)\textsuperscript{xiii} are strong advocates of stock market reform and development. Studying the stock market reform and the banking sector, they reached the following conclusions:

i. The banking system and the stock market compete in two dimensions: to maximize the quality of their information processing and to minimize the transaction costs that they impose upon households.

In the Indian context the stock market is more efficient than the banking system, in both dimensions. The stock market’s superiority in the quality of information processing arises out of its freedom relative to the banking sector, which is subject to a number of controls and constraints. Controls like direct government ownership, entry barriers, high reserve ratios and directives on credit allocation adversely affected the banking system’s ability to process information.

ii. Stock market development plays a key role in strongly assisting reforms in the Banking system.

iii. Efficient stock market would contribute to long-term growth in the real economy through efficient allocation of scarce savings and improving utilization of funds.

iv. Foreign capital inflows have a positive impact on the real economy via lowering the cost of capital and the assets effect.
Regarding the transactions costs, Shah and Thomas conclude that India’s banking system has been suffering from high costs due to labour problems, low level of technology and lack of competition. On the other hand, the transaction costs in the stock market have declined considerably due to the introduction of On Line Trading system, dematerialization of securities etc.

Ajit Singh (1998) examines the growth and evolution of stock markets in India during the 1990s, which, according to him is largely due to internal and external liberalization measures and the general liberal economic ethos created by the reforms. Singh argues that even though the corporate sector considerably benefited from the boom in the stock market by raising huge amounts of capital, including foreign exchange, from the market, the aggregate real economy did not benefit from this. At least in the 1980s, there was no increase in the savings rate in the economy, despite the boom in the stock market. What really happened was a portfolio substitution by households and institutions from bank deposits to financial corporate securities. Singh also argues that it is problematic to attribute variations in corporate investments to variations in resources raised from the stock markets, because, the resources raised from the market essentially replaced the internal resources of the corporations. And Singh does not see any increased productive use of investment resources.

Nevertheless, Singh compliments the government for its prudent handling of portfolio capital inflows and ensuring that no loss was suffered on
that count to the economy, in spite of large inflows. Singh’s conclusion is that despite all the extraordinary growth achieved by the stock market, as far as the real economy was concerned, it has just been a sideshow.

In conclusion, Singh sounds a note of warning that as the market for corporate control develops with mergers, takeovers, acquisitions and divestments becoming common place, the situation will worsen and the real economy will be harmed by these developments. According to Singh, the market for corporate control is a ‘bridge too far’ at the present level of development of the Indian economy.

A comprehensive empirical work came from Nagaraj (1996)\textsuperscript{iv}. Nagaraj’s study examines the long-term trends in India’s capital markets and the structural changes that have taken place in the country’s saving pattern. Examining important indicators like the amount of capital raised, share of equity in total capital mobilized, share of financial saving in Gross Domestic Savings, Gross Fixed Capital Formation, corporate GFCF as percentage of GDCF, corporate profitability etc., Nagaraj comes to the following conclusions:

i. In India, the growth of the capital market was in fact financial disintermediation, which involved portfolio substitution by households and institutions from bank deposits to stock market instruments.

ii. There is no correlation between growth rate of capital mobilization and aggregate saving rate, and corporate physical investment and value added.
iii. The positive correlation between the annual growth rate of capital raised externally and the corporate fixed capital formation, which existed previously, has become statistically insignificant in the 1980s.

iv. There is a long-term decline in the contribution of internal finance to corporate fixed investment, despite a fall in the ratio of corporate tax to gross profit.

v. The growth rate of real value added in the corporate manufacturing sector in the 1980s was lower than that of registered manufacturing sector as a whole suggesting that the small corporate firms, which did not have access to stock market funds, were able to grow at a faster rate than the larger corporate firms.

Nagaraj’s findings regarding corporate GFCF as a percentage of GDCF and corporate GFCF as a percentage of GDP, as statistically insignificant, are actually not as insignificant as he suggests. Both these indicators as percentages more than doubled in the 1980s and early part of 1990s when compared to 1960s and 1970s. Furthermore, if the spurt in capital mobilization through the capital market is due to portfolio substitution of bank deposits with corporate securities, then, there should have been a corresponding decline in the growth of bank deposits. There is no evidence to this effect in Nagaraj’s findings.

Parantab Basu and Mathew R Morey (1998) analyzed the impact of economic reforms (since 1984) on stock market prices in India. They employed
the non-parametric variance ratio tests spanning over the period 1957 to 1996. The study showed that from mid 1980s, equity prices in India behaved like a ‘random walk’ suggesting that the market obeyed Fama’s Efficient Market Hypotheses, till the securities scam of 1991–92.

Lalitha (1995) examined the new issue market with special reference to public issues by the private corporate sector in 1998. Public issues were analyzed on the basis of (a) type of industry (b) size of firm (c) age of the firm and (d) size of issue. The study examined the factors, especially policy initiatives by the government, like introduction of new securities, raising of interest rates on debentures etc., that influenced public issues. The study pointed to the need for spreading the ‘equity cult’ throughout the country.

Patil (2007) examined the current state of the Indian capital market tracing its evolution and growth in the reform era starting in early nineties. Patil draws attention to the fact that before reforms Indian capital market was really backward in most respects. To quote him: “During the early part of the nineties the ranking of the Indian capital market with reference to the standard global indices relating to efficiency, safety, market integrity etc., was not flattering. With reference to the risk indices, in particular, the Indian capital market was one of the worst as it figured almost at the bottom of the league.” After the initiation of capital market reforms as part of the economic reforms in the country, the Indian capital market was completely transformed and today it
ranks among the best markets. Again to quote Patil: “From the point of view of both adoption of modern information technology tools in trading and settlement mechanisms also the efficiency of capital markets, not only India ranked in the top league, but it is considered way ahead of many developed country capital markets.” According to Patil this transformation was made possible by reforms such as setting up of the NSE, the SEBI, Depositories, On Line Trading, Rolling Settlement and the opening up of the market to FIIs.

2.3 Studies on Foreign Portfolio/Institutional Investment

Since Foreign Portfolio Investment is a recent phenomenon, literature on the same has been scanty till recent times. However with financial globalization and the explosion of FPI since early nineties the topic has attracted lot of scholarly attention. Bekaert and Harvey (2002) studied the impact of financial liberalization on capital flows and the consequent market volatility. From the analysis of data for 16 emerging markets, they found that capital flows increased substantially after liberalization. It was found that, on an average, capital flows increased tenfold in the five years after liberalization compared to the five years preceding liberalization. Of course, the market volatility increased after the capital flows. But, this should be expected in a market economy. The notable favourable consequence of the capital flows was that in all emerging markets, the cost of capital declined after the capital flows. The decline in cost varied between 5 and 75 basis points. Decline in the cost of capital is investment
and growth promoting and therefore eminently desirable for developing countries. However, increasing capital flows has always been associated with increasing concerns regarding volatility and vulnerability.

Regarding volatility and the criticisms flowing from that, Bekaert and Harvey (2000)xx feel the criticism rather strange. Developing and emerging economies start with very little capital flows and after liberalization experience sudden increase in capital flows. This is bound to increase volatility. But it has been found that volatility increased immediately after liberalization and later subsided. Of course, it is a fact that portfolio capital flows are far more volatile than FDI.

An interesting issue in portfolio capital flows is whether “capital flows are causes or consequences of stock price movements”. Scholars have attempted to grapple with this ‘chicken to egg issue’. One argument is that foreign investors have a ‘cumulative informational disadvantage’ vis-à-vis local investors and therefore returns lead capital flows. However there are evidences to the contrary. Froot, O’Connel and Seasholes (2001)xxi found from their analysis using daily data for 44 countries that capital flows lead price changes. They found that a one basis point change in portfolio flows result in a 40 basis point change in stock prices.

Stiglitz (1998)xxii has been a prominent critic of hasty financial liberalization. He argues that developing countries are far more vulnerable to
volatility in capital flows. Volatility in capital flows wrecked havoc with the financial and real sectors of the economy of the South East Asian countries during the South East Asian currency crisis of 1997-98. The consequences were devastating for these economies. Therefore Stiglitz argues for greater control and regulation of capital flows for developing countries.

An insightful probe into the financial and economic imbalances caused by capital flows into emerging markets came from Christoffersen and Errunza (2000)\textsuperscript{xiii}.

The authors examined in detail the causes of financial crisis in recent times, particularly in the nineties. According to the authors, the imbalances in the internal and external accounts, asset bubbles, inappropriate exchange rate policies, imprudent and excessive external borrowing by the public and private sectors, less developed capital markets and banking sector, crony capitalism, information problems and lack of political reforms contributed to the crisis. External factors that contributed to the crisis were identified as moral hazard from political availability of multilateral financing, expectation of sovereign bail outs, under estimation of credit and foreign exchange risks by domestic and international investors, difficulties in the export sector from loss of competitiveness and currency speculation that exacerbated panic in exchange and asset markets.
The authors made several proposals for reform which included:

i. Timely, accurate and full disclosure of information to assess the economic and financial health of the nation.

ii. Reform of the banking system on the basis of the Basle norms.

iii. Flexible fiscal, monetary and exchange rate policies.

iv. Capital market liberalization with safeguards.

v. A new global financial architecture based on a democratic and open system.

Durham (2004)xxiv studied the effects of FDI and Equity Foreign Portfolio Investments (EFPI) on economic growth using data on 80 countries for the period 1979-1998. The important conclusion of the study is that the effects of FDI and EFPI depend on the ‘absorptive capacity’ of host countries with particular respect to financial and institutional development. Previous studies ignored this crucial aspect and treated emerging economies as a homogeneous group. This study, therefore, focuses on institutions as well as financial development indicators that mediate the flow of funds to productive enterprises.

The study constructs six capital absorptive variables and frames regression equations. The complete cross sectional analysis covers data on 62 non-OECD (Organisation of Economic Co-operation and Development) and 21 high income countries for at least one absorptive capacity regression. The study concludes that the effects of FDI and EFPI on growth depend on the absorptive
capacity of host countries and this in turn depends on the institutional and financial absorptive variables. The study concludes that all in all, the data do not suggest that FDI and EFPI have an unmitigated positive effect on economic growth. Therefore, Durham suggests that while ‘leaving financial markets alone is not a good way to encourage them’, unfettered capital flows do not necessarily enhance growth.

Suhejla Hoti (2004) evaluated the significance of 30 published empirical papers in the international capital flows literature according to established statistical and econometric criteria. The study compared the trends and volatilities in international capital flows for nine representative developing countries for the period 1977-2001. The nine developing countries namely Argentina, Brazil, Hungary, Indonesia, Mexico, Pakistan, Philippines, Russia and Slovenia were selected as representative of Latin America, Asia and Eastern Europe.

Three descriptive statistics, namely, Mean, Standard Deviation (S.D) and Co-efficient of Variation were calculated. The S.D was taken as an indicator of the risks associated with fluctuations in a particular financial variable over time. C.V was used for comparison of S.D associated with different means.

The study showed that Indonesia had the most variable FDI, followed by Argentina, Brazil and Philippines. Russia had the least variability in FDI, followed by Slovenia, Pakistan and Mexico. The variability in FPI differed from
that of FDI, with Indonesia being most variable, followed by Russia, Argentina
and Pakistan. The least variability in FPI was shown by Hungary followed by
Slovenia, Philippines and Mexico. The most variable countries in total were
Indonesia, Russia, Argentina and Brazil while the least variable were Hungary,
Slovenia, Pakistan and Mexico.

Liljeblom and Loflund (2005) investigated the determinants of foreign
equity investment flows into the Finnish stock market during its deregulation in
the early 1990s. They focused on informational differences in influencing
foreign equity investment. They found that stocks held by foreign investors
deviated clearly from the Finnish market portfolio. They found evidence of
stock induced effects as well as effects of potential informational barriers.
Foreign investor portfolios were tilted towards low dividend yield stocks. This
was caused by additional withholding tax on dividends. A preference for large
cap, liquid stocks with a strong profitability record was also found. However
they did not find evidence of any informational disadvantage or advantage for
foreign investors.

Woochan Kim and Shang-Jin Wei (2002) studied the trading
behaviour of foreign portfolio investors in Korea before and during the currency
crisis. They found that investors in different categories have different trading
patterns. These differences in trading behaviour are due to differences in
information. The Korean branches of foreign institutions or foreign individual
investors engaged less in positive feedback trading (hence less herding) than their non-resident counterparts. The authors recognize that even though the impact of foreign investors on Korean stock prices was negligible, its impact could increase in emerging markets in the days to come due to increasing liberalization of capital flows into emerging markets.

Brink and Viviers (2003)xxviii studied the obstacles in attracting investments into Southern Africa. The study starts by emphasizing the fact that Southern Africa has been isolated from international financial markets and the process of financial globalization; the only exemption being South Africa and Mauritius. The authors feel that this deficiency has to be removed since official development assistance is declining fast. Recognizing the fact that ‘hot money flows’ can be potentially destabilizing – both financially and economically – the authors feel that the potential dangers can be avoided through sound policy. The study mainly focused on the obstacles in attracting portfolio investments into Southern Africa.

Analyzing the composition of international financial flows the authors reach the following conclusions:

i. The financial flows into and out of the Southern African region are dominated by flows from and into South Africa. South Africa accounted for 98.3 percent of the region’s direct investment abroad, 99.9 percent of
FPI abroad and 86.5 percent of total foreign investment assets in the region.

ii. If South Africa’s figures are excluded, grants are the most important source of foreign capital to the region as a whole. However grants show a downward trend.

iii. The second largest category of investment into the region is FDI. However the quantum of FDI is insufficient to compensate for the shortfall in grants.

The study identified the underdevelopment of financial markets as the major obstacle in attracting FPI. Other obstacles identified were: macroeconomic instability, interest rate structures, exchange rate risk, exchange control, tax structures, inadequate availability of information and underdeveloped telecom infrastructure.

Ram Mohan (2006) examined the trends in FII in emerging markets in general and in India in particular. According to Ram Mohan in mature economies institutional investors have replaced banks as the primary custodian of people’s savings. These institutional investors are: mutual funds, insurance firms, pension funds and hedge funds. These institutional investors who command huge resources are diversifying their portfolios through investments in debt and equity in emerging markets.

Huge capital flows into emerging markets via FII have substantially augmented the foreign exchange reserves of these countries. They have also
boosted the stock markets of these countries. Also the presence of FIIs improved the standards of disclosure of companies and thereby contributed to improving corporate governance. On the flip side, Ram Mohan draws attention to the concern in emerging markets regarding the possible volatility that can be caused by hot money inflows and outflows on the financial markets and the real economy. While accepting the fact that FIIs have replaced domestic mutual funds as the major investors and prime movers of the market, Ram Mohan dispels fears that FII investment can be destabilizing. In emerging markets capital outflows became a problem only in Malaysia and Indonesia during the currency crisis of 1997. In India FII investment has been steady and positive with modest volatility so far. According to Ram Mohan the real problem caused by variations in FII inflows is not stock market volatility but the difficulties posed in the management of money supply and exchange rate.

Rao et al (1999) studied the trends in Foreign Institutional Investment in the Indian Stock Market. The study begins by drawing attention to the changes in the nature and magnitude of capital flows to developing economies in recent times. Official Development Assistance which dominated the capital flows in the decades immediately following the Second World War gave way to private capital transfers starting with the eighties and gathering momentum in the nineties. Capital flows more than tripled from $100.8 billion in 1990 to $308.1 billion in 1996. During this period private capital flows increased from
$43.9 billion to $275.9 billion. All main components of private capital transfers, viz., commercial loans, FDI and FPI increased substantially.

After briefly examining the favourable and unfavourable impact of FPI on the domestic economy, the authors analyzed the importance of different types of foreign portfolio investment. Thereafter the study examined the countrywide distribution of FIIs registered with the SEBI and the shares of different categories of companies in the market value of investments. The study also examined the exposure of five India specific U.S. funds drawing attention to the changing sectoral importance during the period 1996 to 1998. Based on the study the authors conclude that FII investments considerably influence stock prices in India.

Rathod (2007) xxxi studied the role of PE (Private Equity) Funds in the Indian stock market. According to Rathod developed, mature markets are increasingly getting saturated with low GDP growth and mediocre stock market returns. On the other hand, growth rates have shot up in developing markets like China and India and the consequent high levels of corporate profitability and its apparent sustainability for long periods of time are attracting PE funds on a massive scale to emerging markets. This seems to be a new trend in global financial markets.

Rathod distinguishes between different forms of investors such as FIIs, PE Funds and Hedge Funds. FIIs usually invest in listed public companies. But
PE Funds mainly invest in unlisted companies. PE Funds invest through a negotiated process since the price of the stock is unknown in the absence of stock market listing. Private equity can be treated as synonymous with ‘venture capital’, ‘management buy out’, ‘mazzanine capital’ and ‘angel investing’.

Rathod identified the following factors as the drivers of PE Funds in India.

i. India’s huge reservoir of trained, scientific, technical and managerial human resource.

ii. Growing entrepreneurship and increase in M&A (Mergers and Acquisitions) activities in India with India Incorporated’s huge appetite for global acquisition.

iii. Stringent IPO norms in India.

iv. High level of sustained GDP growth.

v. Avenues for lucrative exits by PE Funds as evidenced by the highly profitable exit of Warburg Pinces from Bharti through block deals.

An erudite critique of PE Funds came from Chandrasekher (2007)xxxii. Chandrasekher draws attention to the phenomenal growth of PE Funds in recent times and their probable negative impact on emerging economies via acquisition of domestic companies by foreign companies using the PE route. As and when FDI norms are relaxed, PE Funds can sell the stocks they own to foreign companies or take over specialists through block deals. This will weaken the domestic corporate sector.
Chandrasekher traces the emergence and growth of PE Funds globally. According to him this can be traced to two factors viz.,

i. the desire of pension funds in the developed world to invest their burgeoning resources.

ii. burgeoning petro dollar resources of banks caused by high oil prices.

Of the two factors mentioned above, the explosion of pension funds is truly mind boggling. The assets of autonomous pension funds in the U.S. rose from $ 786 billion in 1980 to $ 4.8 trillion in 1995 and further to $ 8 trillion in 2004 (OECD 2001 and 2003). With investible resources rising by this magnitude, these entities were keen to enter new areas and invest in new asset classes. Public pension funds invest about 8 percent of their funds in PE Firms and corporate pension funds invest around 7 percent. Side by side with this phenomenal increase in PE Funds corpus, the regulatory guidelines allowing them to invest in emerging markets were liberalized. The regulatory regime, both in developed and developing markets, facilitated PE investment.

Chandrasekher focuses on the areas of concern arising from PE investment. According to him the very nature of the business organization is not transparent unlike registered FIIs. PE Funds are often limited partnerships: the PE Firm acts as the general partner that manages the Fund and the investors are limited passive partners. The general partners are entitled to management fee as well as share of profits, while the limited partners are entitled to only share of
profits. Global experience is that PE firms, more often than not, do not align the interests of investors and managers of funds. Since managers are entitled to a fee (as a percentage of the total size of funds) plus share of profits, the fee should have declined with increase in the size of funds, argues Chandrasekher. This has not happened. Thus the interests of investors have not been safeguarded, particularly when the funds do not perform well.

Another criticism put forward by Chandrasekher is that of lack of transparency. Chandrasekher quotes Paul Myners, former chairman of Marks and Spencer who said: “We are seeing public companies go private and they go from being transparent and accountable into a dark box.”

Coming to the Indian experience, Chandrasekher traces the growth of PE Funds in India in recent times. He draws attention to the increasing role of PE Funds in M&A deals struck in India. The total number of M&A deals struck in India increased from 467 ($18.3 billion) in 2005 to 782 ($28.2 billion) in 2006. Of this, 203 involved private equity. This trend is increasing at an accelerating rate. The major factor driving this trend is the process of liberalization. Liberalization keeps alive the hope of liberalization of FDI Limits. Private equity firms wait for this relaxation and when it comes they exit from the investment through block deals. This has the potential to facilitate the takeover of domestic companies by foreign companies and Chandrasekher warns that this is not in India’s national economic interests.
Chandrasekher’s study, though erudite and thought provoking, appears to be needlessly alarmist. While warning of the possible takeover of domestic companies by foreign companies, the author conveniently ignores the fact that the takeover of foreign companies by Indian companies (typified by the takeover of Corus by Tata Steel) is the major trend now.

Rishit (2007) presented a critique of the approach and recommendations of the 2004 Government of India Expert group on foreign institutional flows. The expert group was set up to ‘suggest measures for encouraging foreign institutional flows’. While recognizing the fact that FII flows have strengthened India’s Balance of Payments position, Rishit cautions against unbridled encouragement of highly volatile and potentially destabilizing FII flows in the absence of empirical evidence proving the beneficial impact of such flows on economic growth.

Rishit questions the government’s policy assumption that FII flows are always investment and growth promoting. Citing the fact that for many years during the post-reform period in India the country’s capital account had been in excess of current account deficit, Rishit argues that a part of the foreign capital was used for acquiring capital assets abroad and not for bridging the investment-saving gap. So long as the current account is in surplus, as was the case during 2000-04, FII flows cannot be investment and growth promoting.
This argument of Rishit is indeed, fool proof. But it breaks down in the context of current account deficit, which is the case since 2004.

Rishit further questions the Expert Group’s views on the following grounds:

i. Even when there is an investment-saving gap, other types of foreign capital, e.g., FDI, ADRs / GDRs or long term borrowing may be superior to FII. The reason is that when capital inflow is directly linked to investment demand (which FII is not), a greater part of capital inflow is translated into investment and there is no problem of deficiency of aggregate demand.

ii. There is no coherent macro economic model behind the Expert Group’s analysis and recommendations. Also, there is no appraisal of the optimal scale of capital inflows or the relative merit of FII vis-à-vis other forms of capital inflows.

iii. Even though the recommendations of the expert group for checking the vulnerability of capital are sensible, the package as a whole is inadequate to meet the objective.

Rishit concludes by recognizing that, of late, capital flows are used for financing the investment-saving gap. But the author calls for further probing into the linkages between capital inflows and domestic economic activity. Furthermore, Rishit feels that measures relating to FII should be considered as an integral part of a policy package encompassing all types of external capital.
Mukherjee et al (2002) examined the relationship of daily FII inflows to the Indian equity market with two types of variables: one representing daily market return and its volatility and the other representing macroeconomic variables like short term interest rates, index of industrial production etc. According to the authors, FII inflows to and from the Indian market tend to be caused by returns in the domestic market and not the other way round as commonly believed. To quote them: “The regression analysis in various stages, reveals that the returns in the Indian equity market is indeed an important factor that influences FII flows into the country. While the dependence of net FII inflows on the daily return in the domestic equity market is suggestive of foreign investors’ return chasing behaviour, the recent history of market return and its volatility in international and domestic stock markets have some significant effect as well. However, while FII sale is significantly affected by the performance of the Indian equity market, FII purchase is not responsive to this market behaviour. Looking at the role of the betas of the Indian equity market with respect to the S&P (Standard and Poor) 500 and MSCI (Morgan Stanley Capital Index) indices, it is concluded that FIIs do not seem to use the Indian equity market for the purpose of diversification of their investments”.

Gordon and Gupta (2003) examined the factors determining portfolio flows. These factors were classified into global and domestic. Global factor is the LIBOR (London Inter Bank Offer Rate) which is inversely related to portfolio inflows. Among domestic factors the crucial ones are: lagged stock
market returns, rating downgrades and Rupee depreciation. Regarding the macro economic fundamentals Gordon and Gupta found that they were significant determinants.

Soros (2004)xxxvi argues for intervention of international financial authorities to rescue the global capitalist system from the grave crisis which it is facing. (Soros was writing during the East Asian Currency crisis of 1997). According to Soros the global economy characterized by free trade in goods and services and free movement of capital across national boundaries have led to a situation where interest rates, exchange rates and stock prices in various countries are intimately interrelated, and global financial markets exert tremendous influence on economic conditions. Market volatility and currency crisis of the last two decades have produced far reaching economic and political consequences. The development of the global economy has not been matched by the development of the global society. International law, international institutions and financial markets are far from perfect. Financial markets are inherently unstable.

Soros criticizes the global capitalist system on two main grounds: one, the defective market mechanism, particularly the instabilities of the financial markets and two, the failure of the ‘non-market sector’ of society. By non-market sector he means the collective interests of society, that is, the social values that do not find expression in markets. To stabilize and regulate the
global economy Soros argues for a global system of political decision making and intervention of international financial authorities.

This review of literature clearly reveals the fact that many studies have been undertaken in the field of capital market in general, Indian capital market in particular and foreign portfolio investment. Studies on capital market dates back to the 1950s and the literature has been enriched by interesting research and debates. Indian capital market started attracting scholarly attention only after the initiation of economic reforms in India in general and capital market reforms in particular. Two schools of thought emerged in India; one, favouring capital market reforms and development and the other skeptical of the same. Foreign portfolio investment, being a phenomenon of recent origin, started attracting the attention of researchers only from the early nineties onwards. With the phenomenal development of the capital market and explosive growth of foreign portfolio investment in emerging markets, this area is increasingly attracting the attention of scholars. However, in spite of many studies undertaken in the field of capital market, Indian capital market and foreign portfolio investment separately, there is no study on the impact of foreign institutional investment on the Indian stock indices and major macro economic aggregates. In the context of the substantial increase in foreign portfolio investment into India in recent times, its arguably favourable impact on stock prices and other macro economic indicators and its much feared potential to cause market volatility and crisis, an in depth research into the same is very
relevant. Therefore, there is a clear research gap here. The present study would hopefully fill this research gap.

Notes and References:


