Chapter – III

Foreign Institutional Investments and Stock Market – A Review
CHAPTER - III
FOREIGN INSTITUTIONAL INVESTMENTS AND STOCK MARKET – A REVIEW

INTRODUCTION

Chapter – II, Chapter – II, Materials and Methodology of the Study includes Universe, Types and Sources of data, Period of the study, The process and the Tools used, Operational definition and the Chapter scheme have been dealt with. In this chapter, Chapter – III, The Review of Literature and other concepts related to study area have been dealt with.

FINANCIAL MARKET

Meaning

Broad term describing any marketplace where buyers and sellers participate in the trade of assets such as equities, bonds, currencies and derivatives. Financial markets are typically defined by having transparent pricing, basic regulations on trading, costs and fees and market forces determining the prices of securities that trade.

Some financial markets only allow participants that meet certain criteria, which can be based on factors like the amount of money held, the investor’s geographical location, knowledge of the markets or the profession of the participant.\(^1\)

Definition

Markets for sale and purchase of stocks (shares), bonds, bills of exchange, commodities, futures and options, foreign currency, etc., which work as exchanges for capital and credit.\(^2\)

CHARACTERISTICS OF FINANCIAL MARKETS

The characteristics of financial markets are

(i) Financial markets have various segments such as stock markets, bond markets- primary and secondary segments, where investors themselves decide when and where they should invest money. And there is always a scope for instant arbitrage among various markets and types of instruments.
(ii) Financial markets generally have a large volume of transactions and the speed with which financial resources move from one market to another.

(iii) Financial markets are highly uncertain and volatile and very susceptible to panic and the behaviour of a limited group of operators can get generalized and making the markets highly unpredictable.

(iv) Financial intermediaries dominate the financial markets who take investment decisions as well as risks on behalf of their customers and depositors.

(v) Negative externalities are connected with financial markets. A failure in any one section of these markets may affect other section as well, including non-financial markets.

(vi) Domestic financial markets are very much integrated with international financial markets. The failure and vulnerability in a particular domestic market can also have an international impact. Similarly, problems in international markets can affect the functioning of domestic markets.

TYPES OF FINANCIAL MARKETS

The financial markets can be divided into different sub types

a. Capital markets which consist of:
   (i) Stock markets, which provide financing through the issuance of shares or common stock, and enable the subsequent trading thereof.
   (ii) Bond markets, which provide financing through the issuance of bonds, and enable the subsequent trading thereof.

b. Commodity markets, which facilitate the trading of commodities.

c. Money markets, which provide short term debt financing and investment.

d. Derivatives markets, which provide instruments for the management of financial risk.

e. Futures markets, which provide standardized forward contracts for trading products at some future date.
f. Insurance markets, which facilitate the redistribution of various risks.
g. Foreign exchange markets, which facilitate the trading of foreign exchange.04

DEFINITION OF FOREIGN INSTITUTIONAL INVESTMENT

The term foreign institutional investment denotes all those investors or investment companies that are not located within the territory of the country in which they are investing. These are actually the outsiders in the financial markets of the particular company. Foreign institutional investment is a common term in the financial sector of India.

HISTORY OF FII INVESTMENT IN INDIA

Along with Brazil and China, India is one of the fastest growing economies in the world that has seen FII investments. Pending problems of balance of payment crisis that India faced in 1991, the liberalization of the economy was initiated. This also included opening the capital markets and allowing the FII investments. India recorded its highest GDP growth in 2007, when the growth rate was 9%. Since then India has registered high growth rates. According to an OECD (Organization for Economic Cooperation) report, the growth rates would be sustainable at 7.5% as the reforms become more widespread.

In past year, 2010 FII investment in India has grown by leaps and bounds. FII investment was a staggering US $ 30 billion net inflow. This is almost 50% of the worldwide FII investment that was made excluding China. The inflows have also been quite high even in the preceding months of 2011. Barring august when the FII are actually selling, the first six months saw the FII investments being done at large scale and amounted to more than US$ 3.8 billion.

Given this scenario, a number of FII’s India has also seen an astounding growth. The number of FII’s that are registered with SEBI as of July 2011 is 1730. In December, 2010 the number of FII’s that were registered were 1718.05

TYPES OF INSTITUTIONS

The types of institutions that are involved in the foreign institutional investment are as follows:
The economies like India, which are growing very rapidly, are becoming hot favourite investment destinations for the foreign institutional investors. These markets have the potential to grow in the near future.

This is the prime reason behind the growing interests of the foreign investors. The promise of rapid growth of the investable fund is tempting the investors and so they are coming in huge numbers to these countries.

The money, which is coming through the foreign institutional investment, is referred as ‘hot money’ because the money can be taken out from the market at anytime by these investors.

The foreign investment market was not so developed in the past. But once the globalization took the whole world in its grip, the diversified global market became united. Because of this the investment sector became very strong and at the same time allowed the foreigners to enter the national financial market.

At the same time the developing countries understood the value of foreign investment and allowed the foreign direct investment and foreign institutional investment in their financial markets. Although the foreign direct investments are long term investments but the foreign institutional investments are unpredictable. The Securities and Exchange Board of India looks after the foreign institutional investments in India. SEBI has imposed several rules and regulations on this investments.

**NEED FOR FII IN DEVELOPING COUNTRIES**

1. *Infrastructure Renewal*

To keep the Indian economy growing the infrastructure sector like power, transport, mining& metallurgy, textiles, housing, retail, social welfare, medical etc. has to be upgraded. After the Enron fiasco, it is difficult to persuade anybody in the
west to take interest in any of these sectors. Hence India is left to its own devices to raise money and build this sector. Borrowing abroad supplemented with Indian resources is the only way open to India. This upgrade is needed prior or in step with the industrial and service exports sector growth. It has to be placed on a higher priority. Only recently a suggestion to use a small portion of India’s foreign reserves met with howl of protests. The protestors in the Indian Parliament did not understand the proposal. Hence the government is stuck to steamroller its proposal through the legislative process or succumb to political pressure and do nothing. The latter is not acceptable. If India finds its own $4 Billion a year for infrastructure then foreign investors will kick in another similar portion. The resulting money will very quickly rebuild the now cumbersome infrastructure.

2. Bridge the technological gap

Developing countries have a very low level of technology. Their technology is not up to the standards and they lack in modern technology. Developing countries possess a strong urge for industrialization to develop their economies and to wriggle out of the low-level equilibrium trap in which they are caught. This raises the necessity for importing technologies from advanced countries. Such technology usually comes with foreign capital.

3. Optimum utilization of resources

A number of developing countries possess huge mineral resources which are untapped and unexploited. Due to lack of technology these countries are not able to use their resources to the fullest. As a result they have to depend on the foreign investment with the help of which technology of the country and that will ultimately lead to the optimum utilization of the resources. India has very huge reserves of mineral resources and to optimize their use or rather for extracting them efficiently and effectively modern technology is required which is possible through foreign investment.

4. Balancing the balance of payment position

In the initial phase of economic development, the underdeveloping countries need much larger imports. As a result the balance of payment position generally turns adverse. This creates gap between earnings and foreign exchange. The
foreign capital presents short run solution to the problem. So in order to balance the Balance of Payment Foreign Investment is needed.

5. Develop the Diverse Market

The Indian market is widely diverse. The country has 17 official languages, 6 major religions, and ethnic diversity as wide as all of Europe. Thus, tastes and preferences differ greatly among sections of consumers. Therefore, it is advisable to develop a good understanding of the Indian market and overall economy before taking the plunge. Research firms in India can provide the information to determine how, when and where to enter the market. There are also companies which can guide the foreign firm through the entry process from beginning to end-performing the requisite research, assisting with configuration of the project, helping develop Indian partners and financing, finding the land or ready premises, and pushing through the paperwork required.  

BENEFITS AND COSTS OF FII INVESTMENTS

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

Benefits

1. Reduced cost of equity capital

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

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

3. Knowledge flows

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

4. Strengthening corporate governance

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

5. Improvements to market efficiency

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

Costs

1. Herding and positive feedback trading

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

2. Bop vulnerability

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

3. Possibility of taking over companies

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

4. Complexities of monetary management

A policymaker trying to design the ideal financial system has three objectives. The policy maker wants continuing national sovereignty in the pursuit of interest rate, inflation and exchange rate objectives; financial markets that are regulated, supervised and cushioned; and the benefits of global capital markets. Unfortunately, these three goals are incompatible. They form the "impossible trinity." India's openness to portfolio flows and FDI has effectively made the country's capital account convertible for foreign institutions and investors. The problems of monetary management in general, and maintaining a tight exchange rate regime, reasonable interest rates and moderate inflation at the same time in particular, have come to the fore in recent times. The problem showed up in terms of very large foreign exchange reserve inflows requiring considerable sterilization operations by the RBI to maintain stable macroeconomic conditions. The Government had to introduce a Market Stabilization Scheme (MSS) from April 1, 2004. With the foreign exchange invested in highly liquid and safe foreign assets with low rates of return, and payment of a higher rate of interest on the treasury bills issued under MSS, sterilization involves a cost. With a rapid rise in foreign exchange reserves and the need for having an MSS-based sterilization involving costs, questions have been raised about the desirability of encouraging more foreign exchange inflows in general and FII inflows in particular. While there is indeed the issue of timing the policy of encouragement appropriately to avoid the pitfalls of throwing the baby with the bath water, there cannot be a turnaround from the avowed policy of gradual liberalization, including the capital account. All modern market economies have evolved policies to reconcile prudent monetary management with the benefits of a liberal capital account. There is no scope for any diffidence in India also moving in the same direction.
PROS AND CONS OF FII FLOWS INTO A COUNTRY

FII flows into a country are associated with several pros and cons.

Pros of FII

1. Enhanced flows of equity capital

FII flows help in financial innovation and development of hedging instruments. Also, it not only enhances competition in financial markets, but also improves the alignment of asset prices to fundamentals.


FII inflows have a greater appetite for equity than debt in their asset structure. The opening up the economy to FII inflows has been in line with the accepted preference for non-debt creating foreign inflows over foreign debt. Enhanced flow of equity capital helps improve capital structures and contributes towards building the investment gap.

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4. Equity market development aids economic development.

By increasing the availability of riskier long term capital for projects, and increasing firms incentives to provide more information about their operations, FII inflows can help in the process of economic development.

5. Improved corporate governance.

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Cons of FII

1. Problems of Inflation

Huge amounts of FII fund inflow into the country creates a lot of demand for rupee, and the RBI pumps the amount of Rupee in the market as a result of demand created.

2. Problems for small investor

The FIIs profit from investing in emerging financial stock markets. If the cap on FII is high then they can bring in huge amounts of funds in the country’s stock markets and thus have great influence on the way the stock markets behaves, going up or down. The FII buying pushes the stocks up and their selling shows the stock market the downward path. This creates problems for the small retail investor, whose fortunes get driven by the actions of the large FIIs.

3. Adverse impact on Exports

FII flows leading to appreciation of the currency may lead to the exports industry becoming uncompetitive due to the appreciation of the rupee

4. Hot Money

“Hot money´ refers to funds that are controlled by investors who actively seek short-term returns. These investors scan the market or short-term, high interest rate investment opportunities. Hot money´ can have economic and financial repercussions on countries and banks. When money is injected into a country, the exchange rate for the country gaining the money strengthens, while the exchange rate for the country losing the money weakens. If money is withdrawn on short notice, the banking institution will experience a shortage of funds.08

MAJOR ROAD BLOCKS IN FOREIGN INVESTMENT

The major obstacle is fortunately a non economic one. Rampant corruption is also said to prevail is, of course, is most common in developing economies, which are on path of reforms.
1. Lack of political stability

It’s not the case that every government may allow the FII to enter into their country. Different government follows different policy framework for FII. One government may follow liberal approach while other may follow the conservative approach. India has emerged as the second most option for FII destination in Asia after china. Incidentally successive government wasted considerable time identifying the desirable sectors where the FII could be encouraged and those where it must be discouraged.

2. Lack of economic stability

FII are the foreign investments and they are always done if the economy of the country supports them. The economy always follows business cycle. Economic prosperity is followed by recession. This is inevitable. During the time when the economy is facing a recession or depression, FII is hard to come because the foreign players do not feel safe to invest. Apart from this there are also many factors that affect the economy adversely and thereby discourage FII.

3. Poor infrastructure

Infrastructure plays a very important role in affecting the decision of the Foreign Institutional Investors whether to invest in a particular country or not. If the infrastructure of the country is poor the Foreign Institutional Investors may not invest in that country as it would affect their returns and at the same time they would invest where the infrastructure is good and returns are good. So initiative should be taken by the government to improve the infrastructure.

4. Corruption cum lack of transparency

Corruption deters several efficient players from investing as they think that the clearance of their proposal is not performance or reputation but under the table dealings. As pointed out by a recent FICCI study only about 29% of the FDI amount approved between August 1991 and January 1999 actually came in. This clearly shows lack of transparency and bureaucracy. The fundamental problem is the government instability to formulate a clear and consistent regulatory framework for FII.
MAJOR DETERMINANTS OF FII FLOWS

The unpredictability of autonomous FII flows, in both scale and direction, has developed a substantial research effort to identify their major determinants. An extensive literature based generally on three approaches – aggregate econometric analysis, survey appraisal of foreign investors opinion, and econometric study at the industrial level – has failed to arrive at the consensus. This can be partly attributed to the lack of reliable data, particularly at the sectoral level, and to the fact that the most empirical work has analyzed FII determinants by pooling of countries that may be structurally diverse. The subject is mainly concerned with examining the factors influencing the destination of the investment, host country determinants, rather than industry specific factors.

1. Market size

Econometric studies comparing a cross section of countries indicate a well established correlation between FII and the size of market (proxied by the size of GDP) as well as some of its characteristics (e.g. average income levels and growth rates.) some studies found GDP growth rate to be a significant explanatory variable, while GDP was not, probably indicating that where the current size of national income is very small, increments may have less relevance to FII decisions than growth performance, as an indicator of market potential.

2. Liberalized trade policy

Whilst across to specific markets – judged by their size and growth- is important, domestic market factors are predictability much less relevant in export oriented foreign firms. A range of surveys suggests a widespread perception that ‘open’ economies encourage more foreign investment. One indicator of openness is the relative size of the export sector.

3. Labour costs and productivity

Empirical research has also found relative labour costs to be statistically significant, particularly for foreign investment in labour intensive industries and for export oriented subsidiaries. In India labour market rigidities and relatively
high wages in the formal sector have be reported as deterring any significant inflows into the export sector in particular. The decision to invest in china has been heavily influenced by the prevailing low wage rate.

4. Political scenario

The ranking of the political risk among FII determinants remains somewhat unclear. Where the host country possesses abundant natural resources, no further incentive may be required, as is seen in politically unstable countries such as Nigeria and Angola, where high returns in the extractive industries seem to be compensated for political instability. In general, so long as the foreign company is confident of being able to operate profitably without undue risk to its capital and personnel, it will continue to invest. Large mining companies, for example, overcome some of the political risks by investing in their own infrastructure maintenance and their own security forces. Moreover, these companies are limited neither by small local markets nor by exchange rate risks since they tend to sell almost exclusively on the international, market at hard currency prices.

5. Infrastructure

Infrastructure covers many dimensions, ranging from roads, ports, railways and telecommunication systems to institutional development (e.g. accounting, legal services, etc.) studies in china reveal the extent of transport facilities and the proximity to major ports as having a positive significant effect on the location of FII within the country. Poor infrastructure can be seen, as both, an obstacle and an opportunity for foreign investment. For the majority of the low income countries, it is often cited as one of the major constraints. But foreign investors also point potential for attracting significant FII if host country government permits more substantial foreign participation in the infrastructure sector.

6. Incentives and operating conditions

Most of the empirical evidence supports the notion that specific incentives such as lower taxes have no major impact on FII particularly when they are seen as compensation for continuing comparative disadvantages. On the other hand, removing restrictions and providing good business operating conditions are
generally believed to have a positive effect. Further incentives such as granting of equal treatment to foreign investors in relation to local counterparts and the opening up of markets (e.g. air transport, retailing, banking,) have been reported as important factors in encouraging FII flows in India.

7. Dis-investment policy

Though privatization has attracted some foreign investment flows in recent years, progress is still slow in majority of low income countries, partly because the divestment of the state assets is a highly political issue. In India for example, organized labour has fiercely resisted privatization or other moves, which threaten existing jobs workers rights. A number of structural problems are constraining the process of privatization. Financial markets in most low income countries are slow to become competitive; they are characterized by the inefficiencies, lack of debt and transparency and the absence of regulatory procedures. They continue to be dominated by government activity and are often protected from competition. Existing stock markets are thin and illiquid and securitized debt is virtually non-existent. An underdeveloped financial sector of this type inhibits privatization and discourages foreign investors.09

POLICY MEASURES TO ATTRACT FII

The Government of India has introduced many policy measures to attract FII:

1. Automatic approval

Automatic approval up to a specified limit is allowed in 34 specified high priority, capital intensive and high technology industries. Foreign investment has been allowed in exploration, production and refining of oil and marketing of gases.

2. The Foreign Investment Promotion Board (FIPB)

FIBP has been set up to process applications in cases not covered by automatic approval.

3. A Foreign Investment Implementation Authority (FIIA)

FIIA was established in august 1999 within the Ministry of Industry in order to ensure the approvals for Foreign Investment (including NRI investment) are
quickly translated into actual investment inflows and that proposals fructify into projects. In particular, in case where FIBP clearance is needed, approval time has been reduced to 30 days. Foreign companies have been allowed to use their trade marks on domestic sales from 14 May 1992.

4. **Provisions of the Foreign Exchange management act (FEMA) should be liberalized**

   This is through an ordinance dated on 9 January 1997 as a result of which more than 40% of foreign equity is also treated on par with fully owned Indian company.

5. **Disinvestment on equity**

   Disinvestment on equity by foreign investors has been allowed at market rates on stock exchanges from 15 September 1992 with permission to repatriate the proceeds of such Disinvestment.

**FACILITATION OF FOREIGN INVESTMENT IN INDIA**

1. Foreign investment can be done in the Automatic Route up to 100 per cent without need for any approvals. The investor has to keep the Reserve Bank of India informed.

2. The sectors not open to foreign investments are retail trade, housing and real estate, agriculture and lottery and gambling.

3. There are maximum limits on foreign investment. Some of these are being increased.

4. Prior approval of the government is needed for those cases, which need industrial license and those involving investment beyond the maximum limits. Such cases are cleared by the Foreign Investment Promotion Board in a transparent, efficient, time-bound and predictable manner.

5. The Department of Industrial Policy and Promotion is the nodal agency for information and assistance to foreign investors. It also gives information on projects available for foreign investors and contains online applications for clearances.

6. The Various state governments in India offer competitive incentives and attractions to foreign investors.
POTENTIAL FOR INVESTMENT IN INDIA

1. Expansion of various transport facilities

a) Roads

The Government is focusing on expansion and modernization of roads and has opened this up for private sector participation. 48 new road projects worth US$ 12 billion are under construction. Development and upgradation of roads will require an investment of US$ 24 billion till 2008. Private sector participation in road projects will grow significantly.

b) Railways

The railway sector will need an investment of US$ 22 billion for new coaches, tracks, and communications and safety equipment over the next ten years.

c) Airways

Upgradation and modernization of airports will require US$ 33 billion investment in the next ten years.

d) Waterways

There is potential for investment in the expansion and modernization of ports. The government has taken up a US$22 billion 'Sagarmala' project to develop the Port and Shipping sector under Public-Private Partnership. 100 percent FDI is permitted for construction and maintenance of ports. The government is offering incentives to investors.

2. Better power facilities

The Ministry of Power has formulated a blueprint to provide reliable, affordable and quality power to all users by 2012. This calls for investment of US$ 73 billion in the next five years. The gap between demand and production of power is around 10000MW. Opportunities are there for investment in power generation and distribution and development of non-conventional energy sources.

3. Urban projects need investments

There is potential for investment in urban infrastructure projects. Water supply and sanitation projects alone offer scope for annual investment of US$ 5.71 billion.
The entire gamut of exploration, production, refining, distribution and retail marketing present opportunities for FDI.

4. Exploration of mineral reserves

India has an estimated 85 billion tones of mineral reserves remaining to be exploited. Potential areas for exploration ventures include gold, diamonds, copper, lead zinc, cobalt silver, tin etc. There is also scope for setting up manufacturing units for value added products.

5. Develop Telecom IT sector

The telecom market, which is one of the world's largest and fastest growing, has an investment potential of US$ 20-25 billion over the next five years. The telecom market turnover is expected to increase from US$ 8.6 billion in 2003 to US$ 13 billion by 2007. Mobile telephony has started growing at the rate of 10-12 million subscribers per year. The IT industry and IT-enabled services, which are rapidly growing, offer opportunities for FDI.

6. Service sector opportunities

India has emerged as an important venue for the services sector including financial accounting, call centres, and business process outsourcing. There is considerable potential for growth in these areas.

7. For R & D and healthcare sector development

Biotechnology and Bioinformatics, which are in the government's priority list for development, offer scope for FDI. There are over 50 R&D labs in the public sector to support growth in these areas. The Healthcare industry is expected to increase in size from its current US$ 17.2 billion to US$ 40 billion by 2012.

8. Positive future of automobile industry

The Indian auto industry with a turnover US$ 12 billion and the auto parts industry with a turnover of 3 billion dollars offer scope for FDI. The government is encouraging the establishment of world-class integrated textile complexes and processing units. FDI is welcome.
9. **Agricultural sector**

While India has abundant supply of food, the food processing industry is relatively nascent and offers opportunities for FDI. Only 2 percent of fruits and vegetables and 15 percent of milk are processed at present. There is a rapidly increasing demand for processed food caused by rising urbanization and income levels. To meet this demand, the investment required is about US$28 billion. Food processing has been declared as a priority sector.

10. **Promotion of exports**

The Government has recently established Special Economic Zones with the purpose of promoting exports and attracting FDI. These SEZs do not have duty on imports of inputs and they enjoy simplified fiscal and foreign exchange procedures and allow 100% FDI.

11. **Development of Tourism industry**

The travel and tourism industry which has grown to a size of US$ 32 billion offers scope for investment in budget hotels and tourism infrastructure.

**PROSPECTS FOR INDIAN PERSPECTIVE “FDI OR FII”**

FDI usually is associated with export growth. It comes only when all the criteria to set up an export industry are met. That includes reduced taxes, favourable labour law, freedom to move money in and out of country, government assistance to acquire land, full grown infrastructure, reduced bureaucratic involvement etc. IT, BPO, Auto Parts, Pharmaceuticals, unexplored service sectors including accounting; drug testing, medical care etc are key sectors for foreign investment.

Manufacturing is a brick and mortar investment. It is permanent and stays in the country for a very long time. Huge investments are needed to set this industry. It provides employment potential to semi-skilled and skilled labour.

On the other hand the service sector requires fewer but highly skilled workers. Both manufacturing and service sector foreign investment are needed in India. Still high end manufacturing in auto parts and pharmaceuticals should be India’s target.
The FII (Foreign Institutional Investor) is monies, which chases the stocks in the marketplace. It is not exactly brick and mortar money, but in the long run it may translate into brick and mortar. Sudden influx of this drives the stock market up as too much money chases too little stock. In last four months an influx of about $1.5 Billion has driven the Indian stock market 20% higher.

Where FDI is a bit of a permanent nature, the FII flies away at the shortest political or economical disturbance. The late nineties economic disaster of Asian Tigers is a key example of the latter. Once this, money leaves and it leaves ruined economy and ruined lives behind. Hence FII is to be welcomed with strict political and economical discipline. Thus it can be said that India should welcome, FDI as well as FII and work hard to retain both.

### SWOT ANALYSIS OF FOREIGN INSTITUTIONAL INVESTMENTS

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<tr>
<th><strong>Strengths</strong></th>
<th><strong>Weakness</strong></th>
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<tbody>
<tr>
<td>1) Provides the most important resource i.e. is finance.</td>
<td>1) Focuses more on developing countries.</td>
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<td>2) Contributes to the economic growth of the country.</td>
<td>2) Hampering the progress due to anytime withdrawal.</td>
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<td>3) Balances the balance of payment position.</td>
<td>3) Provides only short term opportunities.</td>
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<td>4) Provides more returns than in domestic countries.</td>
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<td>5) Develops relationship between two countries.</td>
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<th><strong>Opportunities</strong></th>
<th><strong>Threats</strong></th>
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<td>1) Better infrastructure.</td>
<td>1) Anytime withdrawal of investments.</td>
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<td>2) Exploitation of resources to the maximum.</td>
<td>2) Investments made in Foreign countries poses threat to the Indian companies.</td>
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<tr>
<td>3) Better technology available.</td>
<td>3) Increased returns.</td>
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**Strengths:**

1. Provides most important resource i.e. finance

   To start any business and to make the idea to be actually implemented it needs finance. The FIIs brings the inflow of money into the country. Many projects that require funding is done with the help of FIIs. Today in this world, the Finance is
the only resource, which has the capability to be easily transferred from one place to another, and hence providing as a base for business opportunities. Free flow of capital is conducive to both the total world welfare and to the welfare of each individual.

2. **Contributes to the economic growth of the country**

When FIIIs enters the domestic country they bring in the money and acts as the facilitator of the business development. As money comes into the country, it provides various benefits to the leading sectors and ultimately results into the development of various sectors. For example, in India, the I.T sector is the most booming sector and has shown signs of improvement thus attracting the FIIIs.

3. **Balances the balance of payments**

In the initial phase of economic development, the underdeveloped countries need much larger imports. As a result, the balance of payment position generally turns adverse. This creates a gap between earnings and foreign exchange. The foreign capital presents a short-term solution to the problem. So in order to balance the Balance of Payment, Foreign Investment is needed.

4. **Provides more returns than in domestic countries**

FIIIs provide more returns to the investors as compared to the domestic country. This is one of the most important strengths of FIIIs. The main reason is that the countries in which the Foreign Institutional Investors invest their money, provide more opportunities and many benefits. So investors invest in foreign countries rather than in the domestic countries.

5. **Develops relationship between two countries**

Due to FIIIs, the investors from different countries come into picture and various people also come into contact with each other. This develops a sense of relationship between different people and develops a nice intra-cultural atmosphere.
Weaknesses

1. Focuses more on developing countries

   The main weakness of foreign institutional investments is that they provide opportunities to only the developing and developed countries. The Foreign institutional investor focuses on the developing countries rather than on the underdeveloped countries and because of this the underdeveloped countries remain underdeveloped. So this drawback of the FIIs should be improved upon by making their investments in the under developed countries.

2. Hampering the progress due to anytime withdrawal

   The FIIs do not provide any guarantee i.e. the Foreign institutional investors can anytime withdraw their money when they want to so this makes the nature of the FIIs unpredictable and ultimately hampering the progress of the economy of that country. The very good example of this is the mass withdrawal of the FIIs in the far eastern countries like Malaysia, Indonesia etc in 1996-97.

3. Provides only the short term opportunities

   FIIs provide only the short term opportunities i.e. they do not provide the long term opportunities as they are very much supple in nature and thereby limiting its scope to short term opportunities. As far as the market seems to be good the FIIs are attracted and after that they are not predictable. So FIIs are bound to provide only the short term opportunities.

Opportunities

1. Better infrastructure

   Better infrastructure is available only when there is adequate finance available and this comes with the help of FIIs. Infrastructure covers many dimensions, ranging from roads, ports, railways and telecommunication systems to institutional development (e.g. accounting, legal services, etc.) studies in china reveal the extent of transport facilities and the proximity to major ports as having a positive significant effect on the location of FII within the country. Poor infrastructure can be developed with the help of the foreign investment. Foreign investors also point potential for attracting significant FII if host country government permits more substantial foreign participation in the infrastructure sector.
2. Exploitation of resources to the maximum

The major resources i.e. manpower, material and machines can be utilized to its fullest so as to get the maximum benefit out of it. Through FIIs, the reserves or the resources that are untapped because of the lack of funds can be exploited. Potential areas for exploration ventures include gold, diamonds, copper, lead zinc, cobalt silver, tin etc. There is also scope for setting up manufacturing units for value added products.

3. Better technology available

Technology is the main aspect on which the growth of the country is determined. Developing countries has a very low level of technology. Their technology is not up to the standards and they lack in modern technology. Developing countries possess a strong urge for industrialization to develop their economies and to wriggle out of the low-level equilibrium trap in which they are caught. This raises the necessity for importing technologies from advanced countries. Such technology usually comes with foreign capital.

Threats

1. Anytime withdrawal of investments

The FIIs are more flexible in nature i.e. unlike FDI they are not guaranteed. Foreign Institutional Investors can withdraw at any time they want. Foreign Direct Investment is for a fixed period and the investments could not be withdrawn until a specified period. The recent example was the net outflows of the money from the stock market that affected the whole economy and its consequences are very much appalling resulting into posing threats to the economy.

2. Investments made in Foreign Companies poses threat to Indian companies

Many MNCs have their set up in India and these MNCs provide a stiff competition to the domestic industries. The Foreign Institutional Investors invest their money in these MNCs and they are equipped with the latest technology to provide products at cheaper rates. Moreover, the Indian labourers are opposing the use of modern technology as the company downsizes the number of workers that substitutes the modern technology.
3. Increased returns results in outflow of money

Increased returns can pose a threat to the domestic country as the money flows out of the country and this may affect the economy of the domestic country. The returns that the Foreign Institutional Investors are getting are very much high and this returns they take to their home country and this leads to the outflow of money from domestic country to the foreign country.\(^{10}\)

**ROLE OF FIIS IN INDIAN CAPITAL MARKET**

The recent spat over the tax authorities issuing notices to foreign institutional investors (FIIs) which take advantage under the Indo-Mauritius Double Taxation Avoidance Agreement, has once again drawn attention to the role that FII investment is playing in the capital markets in India. This article endeavours to place the overall picture in perspective.

The Union Government allowed the entry of FIIs in order to encourage the capital market and attract foreign funds to India. Today, FIIs are permitted to invest in all securities traded on the primary and secondary markets, including equity shares and other securities listed or to be listed on the stock exchanges. The original guidelines were issued in September 1992. Subsequently, the Securities and Exchange Board of India (SEBI) notified the SEBI (Foreign Institutional Investors) Regulations, 1995 in November 1995.

Over the years, different types of FIIs have been allowed to operate in Indian stock markets. They now include institutions such as pension funds, mutual funds, investment trusts, asset management companies, nominee companies, incorporated/institutional portfolio managers, university funds, endowments, foundations and charitable trusts/societies with a track record. Proprietary funds have also been permitted to make investments through the FII route subject to certain conditions.

The SEBI is the nodal agency for dealing with FIIs, and they have to obtain initial registration with SEBI. The registration fee is $10,000. For granting registration to an FII, the SEBI takes into account the track record of the FII, its professional competence, financial soundness, experience and such other criteria as may be considered relevant by SEBI. Besides, FIIs seeking initial registration with SEBI will
be required to hold a registration from an appropriate foreign regulatory authority in the country of domicile/incorporation of the FII. The broad based criteria for FII registration have recently been relaxed. An FII is now considered as broad based if it has at least 20 investors with no investor holding more than 10 per cent of shares/units of the company/fund.

The SEBI's initial registration is valid for five years. The Reserve Bank of India's general permission to FIIs will also hold good for five years. Both will be renewable. There are approximately 500 FIIs registered with SEBI, but not all of them are active.

The RBI, by its general permission, allows a registered FII to buy, sell and realize capital gains on investments made through initial corpus remitted to India, subscribe/renounce rights offerings of shares, invest in all recognized stock exchanges through a designated bank branch and appoint domestic custodians for custody of investments held.

FIIs can invest in all securities traded on the primary and secondary markets. Such investments include equity/debentures/warrants/other securities/instruments of companies unlisted, listed or to be listed on a stock exchange in India including the Over-the-Counter Exchange of India, derivatives traded on a recognized stock exchange and schemes floated by domestic mutual funds. A major feature of the guidelines is that there are no restrictions on the volume of investment - minimum or maximum - for the purpose of entry of FIIs. There is also no lock-in period prescribed for the purpose of such investments.

Further, FIIs can repatriate capital gains, dividends, incomes received by way of interest and any compensation received towards sale/renouncement of rights offering of shares subject to payment of withholding tax at source. The net proceeds can be remitted at market rates of exchange.

All secondary market operations would be only through the recognized intermediaries on the Indian stock exchanges, including OTCEI. Forward exchange cover can be provided to FIIs by authorized dealers both in respect of equity and debt instruments, subject to prescribed guidelines. Further, FIIs can lend securities through an approved intermediary in accordance with stock lending schemes of SEBI.11
REASONS TO INVEST IN INDIA

Some of the major reasons to invest in India:

1. It is one of the largest economies in the world, fourth largest economies in terms of purchasing power parity.

2. Strategic location- access to the vast domestic and south Asian market.

3. Large and rapidly growing consumer markets up to 300 million people constitute the market for branded consumer goods- estimated to be growing at 8% per annum.

4. Demand for several consumer products is growing at over 12% p.a.

5. Skilled manpower and professional managers are available at competitive cost.

6. One of the largest manufacturing sectors in the world, spanning almost all areas of manufacturing activities.

7. One of the largest pools of scientists, engineers, technicians and managers in the world.


9. Developed banking system- commercial banking network is over 63000 branches supported by a number of national and state level financial institutions.

10. Well developed R&D infrastructure and technical and marketing services.


12. English is widely spoken and understood.

13. Foreign brand names are freely used.

14. No income tax on profits derived from export of goods.

15. Complete exemption from customs duty on industrial inputs and corporate tax Holiday for five years for 100% export oriented units and Export Processing Zones.
A corporation must also decide where in India to set up. India has 28 unique states, each with their own problems and benefits. The most popular hubs for investment in India are Mumbai, Maharashtra, Bangalore, Karnataka and New Delhi. Thus benefits make India a competitor for foreign investment.\textsuperscript{12}

**FII TREND IN INDIA**

Portfolio investments in India include investments in American Depository Receipts (ADRs), Global Depository Receipts (GDRs), Foreign Institutional Investments and investments in offshore funds. Before 1992, only Non-Resident Indians (NRIs) and Overseas Corporate Bodies were allowed to undertake portfolio investments in India. Thereafter, the Indian stock markets were opened up for direct participation by FIIs. They were allowed to invest in all the securities traded on the primary and the secondary market including the equity and other securities/instruments of companies listed to be listed on stock exchanges in India.

**VOLATILITY OF FOREIGN INSTITUTIONAL INVESTMENT ON STOCK MARKET**

In the Indian stock markets movement of the stock depends on the limited number of stocks. As FIIs purchase and sell these stocks there is a high degree of volatility in the stock market. If any set of development encourages outflow of capital that will increase the vulnerability of the situation in the stock market.

**IMPACT OF FIIs ON STOCK MARKET**

a. While analysing a stock, the percentage of FII holding is an important factor to be noted. When % holdings of FIIs increases in a stock its stocks price goes up and when it drops, its share price comes down. However, readers should not take that as a negative remark. If an FII invests in a company, it also means that they see growth potential in that company.

b. If the number is too large then it’s easier for the individual entities to move out of a stock which would make stock price of the company very volatile and risky. So, investing in a company which has smaller number of FIIs could be a safer investment option.
c. A fundamentally sound company which has a consistent and stable FII shareholding would be an ideal candidate for investment. When some FIIs exit from a good stock, its price actually falls thus giving a good chance to invest in it. However be sure to check the reason for the FIIs exiting the stock. If it is due to change in the fundamentals of the company, it is a negative sign.\textsuperscript{13}

**INDIA’S FUTURE**

The future of the India is bright and moreover due to FIIs the economy will gain a swing in the future in short run as well as long run. India is a pool of various resources, their effective utilization is possible only with the investments and in large sum. The prosperity of India will soon be visible in the near future. By evolving the strategy to improve the competitive position in these areas, overall level of competitiveness can be raised thereby enhancing the export potential of the country.

Thus, India could take a proactive initiative in seeking an international discipline on investment incentives with a built in exception based on the level of industrialization. Soon India will be leading country.\textsuperscript{14}

**CAPITAL MARKET**

A capital market is a market for securities (debt or equity), where business enterprises (companies) and governments can raise long-term funds. It is defined as a market in which money is provided for periods longer than a year, as the raising of short-term funds takes place on other markets (e.g., the money market). The capital market includes the stock market (equity securities) and the bond market (debt). Financial regulators, such as the UK's Financial Services Authority (FSA) or the U.S. Securities and Exchange Commission (SEC), oversee the capital markets in their designated jurisdictions to ensure that investors are protected against fraud, among other duties.\textsuperscript{15}

Capital markets provide a channel for allocation of savings to those who have a productive need for them. The securities market has two interdependent and inseparable segments: (i) primary market and (ii) secondary market.
(i) PRIMARY MARKET

Primary market provides an opportunity to the issuers of securities, both Government and corporations, to raise resources to meet their requirements of investment. Securities, in the form of equity or debt, can be issued in domestic/international markets at face value, discount or premium. The primary market issuance is done either through public issues or private placement. Under Companies Act, 1956, an issue is referred as public if it results in allotment of securities to 50 investors or more. However, when the issuer makes an issue of securities to a select group of persons not exceeding 49 and which is a right do not issue nor a public issue it is called a private placement.16

Features of primary markets are

1. This is the market for new long term equity capital. The primary market is the market where the securities are sold for the first time. Therefore it is also called the new issue market (NIM).
2. In a primary issue, the securities are issued by the company directly to investors.
3. The company receives the money and issues new security certificates to the investors.
4. Primary issues are used by companies for the purpose of setting up new business or for expanding or modernizing the existing business.
5. The primary market performs the crucial function of facilitating capital formation in the economy.
6. The new issue market does not include certain other sources of new long term external finance, such as loans from financial institutions. Borrowers in the new issue market may be raising capital for converting private capital into public capital; this is known as "going public."
7. The financial assets sold can only be redeemed by the original holder.

The role of the ‘Primary Market’

The primary market provides the channel for sale of new securities. Primary market provides opportunity to issuers of securities; Government as well as corporate,
to raise resources to meet their requirements of investment and/or discharge some obligation. They may issue the securities at face value, or at a discount/premium and these securities may take a variety of forms such as equity, debt etc. They may issue the securities in domestic market and/or international market.\textsuperscript{17}

(ii) SECONDARY MARKET

Secondary market refers to a market where securities are traded after being offered to the public in the primary market or listed on the Stock Exchange. Secondary market comprises of equity, derivatives and the debt markets. The secondary market is operated through two mediums, namely, the Over-the-Counter (OTC) market and the Exchange-Traded market. OTC markets are informal markets where trades are negotiated.\textsuperscript{18}

The role of the Secondary Market

For the general investor, the secondary market provides an efficient platform for trading of his securities. For the management of the company, Secondary equity markets serve as a monitoring and control conduit—by facilitating value-enhancing control activities, enabling implementation of incentive-based management contracts, and aggregating information (via price discovery) that guides management decisions.\textsuperscript{19}

The products dealt in the Secondary Markets

Following are the main financial products/instruments dealt in the Secondary market which may be divided broadly into Shares and Bonds

SHARES

A share or stock is a document issued by a company, which entitles its holder to be one of the owners of the company. A share is issued by a company or can be purchased from the stock market.

Equity Shares

An equity share, commonly referred to as ordinary share, represents the form of fractional ownership in a business venture.
Rights Issue/ Rights Shares

The issue of new securities to existing shareholders at a ratio to those already held, at a price. For e.g. a 2:3 rights issue at Rs. 125, would entitle a shareholder to receive 2 shares for every 3 shares held at a price of Rs. 125 per share.

Bonus Shares

Shares issued by the companies to their shareholders free of cost based on the number of shares the shareholder owns.

Preference shares

Owners of these kinds of shares are entitled to a fixed dividend or dividend calculated at a fixed rate to be paid regularly before dividend can be paid in respect of equity share. They also enjoy priority over the equity shareholders in payment of surplus. But in the event of liquidation, their claims rank below the claims of the company’s creditors, bondholders/debenture holders.

Cumulative Preference Shares

A type of preference shares on which dividend accumulates if remained unpaid. All arrears of preference dividend have to be paid out before paying dividend on equity shares.

Cumulative Convertible Preference Shares

A type of preference shares where the dividend payable on the same accumulates, if not paid. After a specified date, these shares will be converted into equity capital of the company.

BOND

Bond is a negotiable certificate evidencing indebtedness. It is normally unsecured. A debt security is generally issued by a company, municipality or government agency. A bond investor lends money to the issuer and in exchange, the issuer promises to repay the loan amount on a specified maturity date. The issuer usually pays the bond holder periodic interest payments over the life of the loan. The various types of Bonds are as follows:
Zero Coupon Bond

Bond issued at a discount and repaid at a face value. No periodic interest is paid. The difference between the issue price and redemption price represents the return to the holder. The buyer of these bonds receives only one payment, at the maturity of the bond.

Convertible Bond

A bond giving the investor the option to convert the bond into equity at a fixed conversion price.

Treasury Bills

Short-term (up to one year) bearer discount security issued by government as a means of financing their cash requirements.20

THE DIFFERENCE BETWEEN THE PRIMARY MARKET AND THE SECONDARY MARKET

In the primary market, securities are offered to public for subscription for the purpose of raising capital or fund. Secondary market is an equity trading venue in which already existing/pre-issued securities are traded among investors. Secondary market could be either auction or dealer market. While stock exchange is the part of an auction market, Over-the-Counter (OTC) is a part of the dealer market.21

DEFINITION OF 'STOCK MARKET'

The market in which shares of publicly held companies are issued and traded either through exchanges or over-the-counter markets. Also known as the equity market, the stock market is one of the most vital components of a free-market economy, as it provides companies with access to capital in exchange for giving investors a slice of ownership in the company. The stock market makes it possible to grow small initial sums of money into large ones, and to become wealthy without taking the risk of starting a business or making the sacrifices that often accompany a high-paying career.22
STOCK MARKET – MEANING

Stock exchange is an organized market where Government securities, shares, bonds and debentures of the trading units are regularly transacted. Stock exchange provides a place to the buyers and sellers of the shares and securities. Stock exchange indicates about the good or bad health of economy. If the share prices are raising it means country is running on the path of development and prosperity.

IMPORTANCE OR FUNCTIONS OF STOCK EXCHANGE

The major functions of stock exchange under these headings:-

1. Providing a ready market

The organization of stock exchange provides a ready market to speculators and investors in industrial enterprises. It thus, enables the public to buy and sell securities already in issue.

2. Providing a quoting market prices

It makes possible the determination of supply and demand on price. The very sensitive pricing mechanism and the constant quoting of market price allow investors to always be aware of values. This enables the production of various indexes which indicate trends etc.

3. Providing facilities for working

It provides opportunities to Jobbers and other members to perform their activities with all their resources in the stock exchange.

4. Safeguarding activities for investors

The stock exchange renders safeguarding activities for investor which enables them to make a fair judgment of securities. Therefore directors have to disclose all material facts to their respective shareholders. Thus innocent investors may be safeguard from the clever brokers.

5. Operating a compensation fund

It also operates a compensation fund which is always available to investors suffering loss due the speculating dealings in the stock exchange.
6. **Creating the discipline**

   Its members controlled under rigid set of rules designed to protect the general public and its members. Thus this tendency creates the discipline among its members in social life also.

7. **Checking functions**

   New securities checked before being approved and admitted to listing. Thus stock exchange exercises rigid control over the activities of its members.

8. **Adjustment of equilibrium**

   The investors in the stock exchange promote the adjustment of equilibrium of demand and supply of a particular stock and thus prevent the tendency of fluctuation in the prices of shares.

9. **Maintenance of liquidity**

   The bank and insurance companies purchase large number of securities from the stock exchange. These securities are marketable and can be turned into cash at any time. Therefore banks prefer to keep securities instead of cash in their reserve. Thus, it facilitates the banking system to maintain liquidity by procuring the marketable securities.

10. **Promotion of the habit of saving**

    Stock exchange provides a place for saving to general public. Thus it creates the habit of thrift and investment among the public. This habit leads to investment of funds incorporate or government securities. The funds placed at the disposal of companies are used by them for productive purposes.

11. **Refining and advancing the industry**

    Stock exchange advances the trade, commerce and industry in the country. It provides opportunity to capital to flow into the most productive channels. Thus the flow of capital from unproductive field to productive field helps to refine the large scale enterprises.
12. Promotion of capital formation

It plays an important part in capital formation in the country. Its publicity regarding various industrial securities makes even disinterested people feel interested in investment.

13. Increasing Government Funds

The government can undertake projects of national importance and social value by raising funds through sale of its securities on stock exchange.²³

FEATURES OF STOCK EXCHANGE

The four main features of stock exchange are as follows:

(1) Organised Market

Stock exchange is an organised market. Every stock exchange has a management committee, which has all the rights related to management and control of exchange. All the transactions taking place in the stock exchange are done as per the prescribed procedure under the guidance of the management committee.

(2) Dealings in Securities Issued by Various Concerns

Only those securities are traded in the stock exchange which is listed there. After fulfilling certain terms and conditions, security gets listed on the stock exchange.

(3) Dealing only through Authorised Members

Investors can sell and purchase securities in stock exchange only through the authorised members. Stock exchange is a specified market place where only the authorised members can go. Investor has to take their help to sell and purchase.

(4) Necessary to Obey the Rules and Bye-laws

While transacting in Stock Exchange, it is necessary to obey the rules and bye-laws determined by the Stock Exchange.²⁴
CHARACTERISTICS OF STOCK MARKETS

The following are the characteristics of stock markets are;

1. Growth Capital

Issuing of stock is the cornerstone of capital formation for enterprise in capitalist economic systems. The stock market provides a way for companies to issue stock to the investing public.

2. Liquidity

The free and transparent trading that takes place in the stock market prices all stocks according to demand and supply, bid and ask. In this way it provides liquidity for investors seeking to transact sales of their holdings through this active pricing mechanism.

3. Transparency

The public nature of trading maintains transparency in financial transactions. Efficiency, growth, freedom and variety are all possible because of transparency that allows all participants to access the bid and ask prices of all securities traded on the market and because all participants have access to the same information.

4. Organization

The stock market provides a degree of protection to investors through oversight by the SEC, FINRA and other legal regulatory and self-regulating bodies on state and professional levels that serve to create an organized and liquid group of stock exchanges and stock trading platforms.

5. Economic Indicator

One of the ten components of the Leading Economic Indicators is made up of the Standard & Poor's 500 Stock Index, one of the major stock market indexes. The direction of trading activity in the stock market provides an indication of the state of commerce and overall confidence in the economy.
6. Regulated Risk/Reward

An organized and regulated stock market serves as a way for investors who seek large returns on their investments to access organized, liquid, regulated and transparent risk investing.25

TYPES OF MARKETS

1. Physical Markets - Physical market is a set up where buyers can physically meet the sellers and purchase the desired merchandise from them in exchange of money. Shopping malls, department stores, retail stores are examples of physical markets.

2. Non Physical Markets/Virtual markets - In such markets, buyers purchase goods and services through internet. In such a market the buyers and sellers do not meet or interact physically, instead the transaction is done through internet. Examples - Rediff shopping, eBay etc.

3. Auction Market - In an auction market the seller sells his goods to one who is the highest bidder.


5. Black Market - A black market is a setup where illegal goods like drugs and weapons are sold.

6. Knowledge Market - Knowledge market is a set up which deals in the exchange of information and knowledge based products.

7. Financial Market - Market dealing with the exchange of liquid assets (money) is called a financial market.

Financial markets are of following types:

1. Stock Market - A form of market where sellers and buyers exchange shares is called a stock market.

2. Bond Market - A market place where buyers and sellers are engaged in the exchange of debt securities, usually in the form of bonds is called a bond market.
A bond is a contract signed by both the parties where one party promises to return money with interest at fixed intervals.

3. **Foreign Exchange Market** - In such type of market, parties are involved in trading of currency. In a foreign exchange market (also called currency market), one party exchanges one country’s currency with equivalent quantity of another currency.

4. **Predictive Markets** - Predictive market is a set up where exchange of good or service takes place for future. The buyer benefits when the market goes up and is at a loss when the market crashes.26

**ADVANTAGES OF INVESTING IN THE STOCK MARKET**

There are many benefits to investing in shares and we will explore how this common form of investment can be an effective way to make money. We will discuss some of the benefits of investing in shares such as diversification, tax benefits, capital growth as well as some of the disadvantages. There are two types of returns that an investor can expect to earn from an investment.

1. **Income return**

   The income return represents periodic cash flows generated by the investment. These include dividends paid for ordinary shares and periodic interest paid for bonds. Stocks that pay dividends typically distribute them quarterly. Government bonds pay interest on a semi-annual basis, and debentures pay interest monthly, quarterly, semi-annually or annually. Investors whose primary objective is to generate periodic income from their investments focus on the income return.

2. **Price change**

   Price change is the increase or decrease in price of the asset in relation to the purchase price or the market price in the previous time period. An appreciation in the price of the asset is called a capital gain while a price decline is called a capital loss. The prices of assets such as stocks, bonds, and real estate fluctuate over time in response to a variety of factors such as economic news, industry conditions, company’s performance, political conditions, as well as speculation. While the
investor expects a capital gain, there is no guarantee that the price will always increased in value. Those investors whose primary investment objective is capital appreciation focus on the price change component of return.

**Measuring returns**

The total rate of return of an investment can be measured in two ways. Rupee return and holding period return.

**a. Rupee return**

The rupee return is equal to the sum of the income and price change measured in the terms of the amount of rupees, during a specific period of time.

**b. Holding period return**

Holding period return is a very basic way to measure how much return you have obtained on a particular investment (HPR) i.e the sum of the income and capital gains generated during a specific period as a percentage of the initial purchase price or the beginning of the period price of the investment.

**3. Voting right**

Shareholders have a say in the affairs of the company. One of the ways they express themselves is by voting at the Annual and Extra-ordinary general meetings of the company. The board of directors needs the ratification of shareholders, before any major decision is taken. For instance, shareholders must give their consent before a company embarks on a public offer or a right issue. They also have the rights to sack erring directors. They do this by exercising their voting right.

Shareholders do not necessarily need to be physically present at the site of the company's annual meeting in order to exercise their right to vote. It is common for shareholders to voice their vote by proxy by mailing in their response.

**4. Right issues**

A rights issue is an invitation to existing shareholders to purchase additional new shares in the company. More specifically, this type of issue gives existing
shareholders securities called "rights", which, well, give the shareholders the right to purchase new shares at a discount to the market price on a stated future date. Each shareholder is given the option to purchase a number of shares in proportion to the number of shares already held by the shareholder. For example, a right ratio of one-for-two means a shareholder can subscribe to one new share for each two shares already held by the shareholder. An investor owing 100 shares prior to the right issue gets the right to subscribe to 50 new shares. This increases the firm’s number of shares outstanding.

5. Capitalization of reserves

When reserves are paid out to shareholders in the form of extra shares is called capitalization of reserves. In other way, Capitalization of Reserves is the issue of shares by the company to its existing shareholders by capitalizing its revenue reserves. Share holders receive free shares in proportion to their ownership. For example, a free share issue of one-for-five means that each shareholder receives one free share for each five shares held. An investor who owns 100 shares before the free share issue receives 20 additional shares without cost. When the company issues free shares by doing capitalization of reserves the company’s stated capital and the total number of shares will be increased.

6. Stock splits

Sometimes, companies split their shares into more shares. A stock split is where a company subdivides its outstanding shares so as to increase the number of shares.

7. Liquidity

Another benefit of investing in shares is that it is a liquid asset. The stocks traded in the market also have greater liquidity than other securities. This means that it can be easily converted into cash by selling the equities with other traders in the market because it is relatively easy to find buyers. Compare this to selling property, where you may have only 1 or 2 interested buyers.

8. Accessibility

Another advantage of investing in stocks is its accessibility. There are many stocks available in the market today. With proper research and analysis of the
stocks and the companies that issued them, anybody with sufficient capital can acquire ownership of stocks except some specific stocks.

9. Ease of diversification

Diversification is simply not putting all your eggs in one basket. If you make smaller investment in various different companies, the likelihood that one of your investments fails means that it won’t have a great effect on your total investment. If you have all your eggs spread between a numbers of baskets (investments), you are more insulated from any possible downturns. Because you can buy small parcels of shares ($500 is the minimum per parcel), you can get greater diversification though investing in shares. Compare this to say property where a large sum of money is placed in just one investment.

10. Tax benefits

Many of the costs associated with share trading are tax deductible, as you have to pay tax on your gains. Transaction fees, interest paid on margin loans and other costs associated with your investments can be deducted as an expense from your taxable income from the shares you’ve traded. Tax benefits can also come from franking credits (imputation credits) from shares. As companies have already pay tax on their profits investors receive franking credits on the dividends they receive.

11. Availability of information

Information about a particular companies shares, especially Milanka Companies shares, are just about everywhere, news on TV, newspaper and most financial websites. Some of the other advantages of investing in the stock market include:

a) Superior long term performance - over the long term, stocks have consistently provided better returns than any other type of investment.

b) Stocks have consistently stayed ahead of the inflation rate, something that is not always true of bonds and other fixed income investments. For instance, if your money market is yielding 2% a year, but inflation is 3%, you are actually losing money. The returns of the stock market provide investors with a better chance of staying ahead of inflation.
c) Owning stocks allows the investor to participate in the growth of the economy. When you buy shares of stock, you actually become part owner of the company, and you therefore are entitled to share in the good fortunes of that company.

d) Stocks can be an excellent choice for retirement vehicles, especially for those with a long time to retirement. The longer your time horizon, the more valuable stocks can be. A long time horizon will help to even out the inevitable ups and downs of the market.

DISADVANTAGES OF INVESTING IN THE STOCK MARKET

Disadvantages of investing in the stock market include:

1. Stocks are volatile investments. The price of a single stock can vary quite widely from day to day, and the factors that cause these price fluctuations are beyond the control of the investor.

2. Buying a widely diversified basket of stocks can be difficult for all but the wealthiest investor. Small investors are better off buying a quality stock mutual fund. Mutual funds pool the investments of many different people in order to buy a diversified set of stocks. This diversified approach helps to reduce the risk inherent in the stock market.

3. As investors near retirement, the amount of stocks in the portfolio should be reduced. Investors who are close to retirement age can no longer afford to take chances with their money, and that mean moving a significant portion of their retirement funds to safer and more stable investments.

4. Buying and selling stocks costs money in the form of brokerage commissions, and many brokerage firm’s charge account maintenance fees as well. It is important to look for low cost alternatives when buying and selling stocks.

BENEFITS OF INVESTING IN STOCK MARKET

1. Easy Liquidity

It is the very first benefits of investing, In stock market shares and securities are traded in very high volume which make it a volatile market so there is very
easy liquidity in stock market, like if you want to turn your investment in stock market into cash then you can do that very easily.

2. Flexibility

Investing in stock market is very flexible like the market have ups and downs in prices at every trade session, price of stock market moves with the rapidity and flexibility of this market.

3. Regulatory Framework

Stock Market works under some regulatory framework to protect and safeguard all its investors. For example: In India the Securities and Exchange Board of Indie (SEBI) works as a Regulatory Framework Body to safeguard all investors.

4. Maximum Returns

According to the long term perspective it is found that Investing in Stock Market gives maximum returns. For example: 1 Lakh INR (Indian Rupees) invested in stock market in the year 1992 (when SENSEX was 2020 INR) is now near about 9 Lakh 50 Thousand INR (Indian Rupees) (today SENSEX is 18,900 INR).

5. Business Taste

Well, According to me it is the best benefits of investing in stock market can ever have, here from Business Taste I mean that when a person trades or invest in stock market everything is here works like a business a modern style business.

6. Sole Proprietorship

If you invest in stock market then you are starting your own business where your investment is your capital, like the more your trade is in profit the more your business grows and you are the only person to run this business that is why investing in stock market is your sole proprietorship business.
MAJOR CHARACTERISTICS OF INVESTMENTS

Certain features characterize all investments. The following are the main characteristic features of investments:

1. Return

All investments are characterized by the expectation of a return. In fact, investments are made with the primary objective of deriving a return. The return may be received in the form of yield plus capital appreciation. The difference between the sale price & the purchase price is capital appreciation. The dividend or interest received from the investment is the yield. Different types of investments promise different rates of return. The return from an investment depends upon the nature of investment, the maturity period & a host of other factors.

2. Risk

Risk is inherent in any investment. The risk may relate to loss of capital, delay in repayment of capital, non-payment of interest, or variability of returns. While some investments like government securities & bank deposits are almost risk less, others are more risky. The risk of an investment depends on the following factors.

a) The longer the maturity period, the longer is the risk.

b) The lower the credit worthiness of the borrower, the higher is the risk.

The risk varies with the nature of investment. Investments in ownership securities like equity share carry higher risk compared to investments in debt instrument like debentures & bonds.

3. Safety

The safety of an investment implies the certainty of return of capital without loss of money or time. Safety is another features which an investors desire for his investments. Every investor expects to get back his capital on maturity without loss & without delay.

4. Liquidity

An investment, which is easily saleable, or marketable without loss of money & without loss of time is said to possess liquidity. Some investments like company
deposits, bank deposits, P.O. deposits, NSC, NSS etc. are not marketable. Some investment instrument like preference shares & debentures are marketable, but there are no buyers in many cases & hence their liquidity is negligible. Equity shares of companies listed on stock exchanges are easily marketable through the stock exchanges.

An investor generally prefers liquidity for his investment, safety of his funds, a good return with minimum risk or minimization of risk & maximization of return.29

RISK-RETURN RELATIONSHIP IN INVESTMENTS

The entire scenario of security analysis is built on two concepts of security: Return and risk. The risk and return constitute the framework for taking investment decision. Return from equity comprises dividend and capital appreciation. To earn return on investment, that is, to earn dividend and to get capital appreciation, investment has to be made for some period which in turn implies passage of time. Dealing with the return to be achieved requires estimated of the return on investment over the time period. Risk denotes deviation of actual return from the estimated return. This deviation of actual return from expected return may be on either side – both above and below the expected return. However, investors are more concerned with the downside risk.

The risk in holding security deviation of return deviation of dividend and capital appreciation from the expected return may arise due to internal and external forces. That part of the risk which is internal that in unique and related to the firm and industry is called ‘unsystematic risk’. That part of the risk which is external and which affects all securities and is broad in its effect is called ‘systematic risk’.

The fact that investors do not hold a single security which they consider most profitable is enough to say that they are not only interested in the maximization of return, but also minimization of risks. The unsystematic risk is eliminated through holding more diversified securities. Systematic risk is also known as non-diversifiable risk as this cannot be eliminated through more securities and is also called ‘market
risk’. Therefore, diversification leads to risk reduction but only to the minimum level of market risk.

The investors increase their required return as perceived uncertainty increases. The rate of return differs substantially among alternative investments, and because the required return on specific investments change over time, the factors that influence the required rate of return must be considered.

**Figure – 02**

**Chart-A: RELATIONSHIP BETWEEN RISK AND RETURN**

- **Rate of Return**
  - Low Risk
  - Average Risk
  - High Risk
  - Market Line
- **Risk**
  - Risk free return
  - Slope indicates required return per unit of risk

**Chart-B: RISK RETURN RELATIONSHIP: DIFFERENT STOCKS**

- **Rate of Return**
  - Risk Premium
    - Ordinary shares
    - Preference shares
    - Subordinate loan stock
    - Unsecured loan
    - Debenture with floating charge
    - Mortgage loan
    - Government (i.e. risk free) stock
  - Market Line
Above chart-A represent the relationship between risk and return. The slop of the market line indicates the return per unit of risk required by all investors highly risk-averse investors would have a steeper line, and Yields on apparently similar may differ. Difference in price, and therefore yield, reflect the market’s assessment of the issuing company’s standing and of the risk elements in the particular stocks. A high yield in relation to the market in general shows an above average risk element. This is shown in the Char-B.  

**RISK AND RETURN IN INVESTMENTS**

There are different motives for investment. The most prominent among all is to earn a return on investment. However, selecting investments on the basis of return in not enough. The fact is that most investors invest their funds in more than one security suggest that there are other factors, besides return, and they must be considered. The investors not only like return but also dislike risk. So, what is required is:

1. Clear understanding of what risk and return are,
2. What creates them, and
3. How can they be measured?

**Return**

The return is the basic motivating force and the principal reward in the investment process. The return may be defined in terms of (i) realized return, i.e., the return which has been earned, and (ii) expected return, i.e., the return which the investor anticipates to earn over some future investment period. The expected return is a predicted or estimated return and may or may not occur. The realized returns in the past allow an investor to estimate cash inflows in terms of dividends, interest, bonus, capital gains, etc, available to the holder of the investment. The return can be measured as the total gain or loss to the holder over a given period of time and may be defined as a percentage return on the initial amount invested. With reference to investment in equity shares, return is consisting of the dividends and the capital gain or loss at the time of sale of these shares.
Risk

Risk in investment analysis means that future returns from an investment are unpredictable. The concept of risk may be defined as the possibility that the actual return may not be same as expected. In other words, risk refers to the chance that the actual outcome (return) from an investment will differ from an expected outcome. With reference to a firm, risk may be defined as the possibility that the actual outcome of a financial decision may not be same as estimated. The risk may be considered as a chance of variation in return. Investments having greater chances of variations are considered more risky than those with lesser chances of variations. Between equity shares and corporate bonds, the former is riskier than latter. If the corporate bonds are held till maturity, then the annual interest inflows and maturity repayment are fixed. However, in case of equity investment, neither the dividend inflow nor the terminal price is fixed.

Risk should be differentiated with uncertainty: Risk is defined as a situation where the possibility of happening or non happening of an event can be quantified and measured: while uncertainty is defined as a situation where this possibility cannot be measured. Thus, risk is a situation when probabilities can be assigned to an event on the basis of facts and figures available regarding the decision. Uncertainty, on the other hand, is a situation where either the facts and figures are not available, or the probabilities cannot be assigned.

TYPES OF RISK

The types of risks can be classified into two types. They are

1. Systematic Risk

Systemic risk refers to that portion of variability in return which is caused by the factors affecting all the firms. It refers to fluctuation in return due to general factors in the market such as money supply, inflation, economic recessions, interest rate policy of the government, political factors, credit policy, tax reforms, etc. these are the factors which affect almost all firms. The effect of these factors is to cause the prices of all securities to move together. This part of risk arises because every security has a built in tendency to move in line with fluctuations in the market. No
investor can avoid or eliminate this risk, whatever precautions or diversification may be resorted to. The systematic risk is also called the non-diversifiable risk or general risk.

a. Market Risk

Market prices of investments, particularly equity shares may fluctuate widely within a short span of time even though the earnings of the company are not changing. The reasons for this change in prices may be varied. Due to one factor or the other, investors’ attitude may change towards equities resulting in the change in market price. Change in market price causes the return from investment to very. This is known as market risk. The market risk refers to variability in return due to change in market price of investment. Market risk appears because of reaction of investors to different events. There are different social, economic, political and firm specific events which affect the market price of equity shares. Market psychology is another factor affecting market prices. In bull phases, market prices of all shares tend to increase while in bear phases, the prices tend to decline. In such situations, the market prices are pushed beyond far out of line with the fundamental value.

b. Interest-rate Risk

Interest rates on risk free securities and general interest rate level are related to each other. If the risk free rate of interest rises or falls, the rate of interest on the other bond securities also rises or falls. The interest rate risk refers to the variability in return caused by the change in level of interest rates. Such interest rate risk usually appears through the change in market price of fixed income securities, i.e., bonds and debentures. Security (bond and debentures) prices have an inverse relationship with the level of interest rates. When the interest rate rises, the prices of existing securities fall and vice-versa.

c. Purchasing power or Inflation Risk

The inflation risk refers to the uncertainty of purchasing power of cash flows to be received out of investment. It shows the impact of inflation or deflation on
the investment. The inflation risk is related to interest rate risk because as inflation increases, the interest rates also tend to increase. The reason being that the investor wants an additional premium for inflation risk (resulting from decrease in purchasing power). Thus, there is an increase in interest rate. Investment involves a postponement in present consumption. If an investor makes an investment, he forgoes the opportunity to buy some goods or services during the investment period. If, during this period, the prices of goods and services go up, the investor losses in terms of purchasing power. The inflation risk arises because of uncertainty of purchasing power of the amount to be received from investment in future.

2. Unsystematic Risk

Unsystematic risk represents the fluctuation in return from an investment due to factors which are specific to the particular firm and not the market as a whole. These factors are largely independent of the factors affecting market in general. Since these factors are unique to a particular firm, these must be examined separately for each firm and for each industry. These factors may also be called firm-specific as these affect one firm without affecting the other firms. For example, a fluctuation in price of crude oil will affect the fortune of petroleum companies but not the textile manufacturing companies. As the unsystematic risk results from random events that tend to be unique to an industry or a firm, this risk is random in nature. Unsystematic risk is also called specific risk or diversifiable risk.

a. Business Risk

Business risk refers to the variability in incomes of the firms and expected dividend there from, resulting from the operating condition in which the firms have to operate. For example, if the earning or dividends from a company are expected to increase say, by 6%, however, the actual increase is 10% or 12%. The variation in actual earnings than the expected earnings refers to business risk. Some industries have higher business risk than others. So, the securities of higher
business risk firms are more risky than the securities of other firms which have lesser business risk.

b. Financial Risk

It refers to the degree of leverage or degree of debt financing used by a firm in the capital structure. Higher the degree of debt financing, the greater is the degree of financial risk. The presence of interest payment brings more variability in the earning available for equity shares. This is also known as financial leverage. A firm having lesser or no risk financing has lesser or no financial risk.31

TYPES OF RETURN

There are three basic asset classes, or investment types. They are

a) Investment Return

When you invest, you're interested in whether you're making progress toward your financial goals. Return on investment can help you gauge how much progress you're making.

b) Historical Returns

Although past performance is no guarantee of future results, historical returns illustrate how often and how much an investment's value typically fluctuates over time.

c) Benchmarks

An investment benchmark is a standard against which you can measure the performance of an individual security or group of securities.32

CO INTEGRATION

Co integration is an econometric/statistical property of time series variables. If two or more series are themselves non-stationary, but a linear combination of them is stationary, then the series are said to be co integrated. A common example is where the individual series are first-order integrated (I (1)) but some (co integrating) vector of coefficients exists to form a stationary linear combination of them. For instance, a stock market index and the price of its associated futures contract move through time,
each roughly following a random walk. Testing the hypothesis that there is a statistically significant connection between the futures price and the spot price could now be done by testing for a co-integrating vector. (If such a vector has a low order of integration it can signify an equilibrium relationship between the original series, which are said to be co-integrated of an order below one.)

Before the 1980s many economists used linear regressions on (de-trended) non-stationary time series data, which Clive Granger and others showed to be a dangerous approach, that could produce spurious correlation. His 1987 paper with Robert Engle, formalized the co-integrating vector approach, and coined the term. For his contribution to the technique's development Clive Granger shared the 2003 Nobel Memorial Prize.

It is often said that co-integration is a means for correctly testing hypotheses concerning the relationship between two variables having unit roots (i.e. integrated of at least order one).

What does this mean? A series is said to be "integrated of order d" if one can obtain a stationary series by "differencing" the series d times. For example, suppose a stock price is 5 on Monday, 6 on Tuesday, 7 on Wednesday, and 8 again on Thursday. One differences that series by turning it into a series of daily price increments. In this case, if we difference just once we get 1 ... 1 ...1. (This series is actually trend stationary, so should be de-trended rather than differenced).

The usual procedure for testing hypotheses concerning the relationship between non-stationary variables was to run Ordinary Least Squares (OLS) regressions on data which had initially been differenced. Although this method is correct in large samples, co-integration provides more powerful tools when the data sets are of limited length, as most economic time-series are.

**Co-integration vs. spurious regression vs. spurious correlation**

Co-integration means there is a correlation among variables, while spurious regression means there is no actual correlation. It is easy to confuse spurious regression with co-integration. For example, If there are two variables, a relation between them could be found, and with this specific relation, there will be a series of
residuals. If the residual has a pattern, then the specific relation is misspecified. If residual are stationary (normally distributed is a special case), the two variables are co-integrated and there is a long run relationship between the two variables (when residuals are normal, the long run & short run relationships are the same); and if residuals are random walk, the two variables are not co-integrated.

Usually, people go another way around with cycle reasoning. They assume the process is with a specific order of integration, then try to find the co integration vector, and then do test.

Test

The three main methods for testing for co integration are:

1. The Engle-Granger two-step method (null: no co integration, so residual is a random walk).
2. The Johansen procedure.
3. Phillips-Ouliaris Co integration Test available with R (null: no co integration)

In practice, co integration is used for such series in typical econometric tests, but it is more generally applicable and can be used for variables integrated of higher order (to detect correlated accelerations or other second-difference effects). Multi co integration extends the co integration technique beyond two variables, and occasionally to variables integrated at different orders.

However, these tests for co integration assume that the co integrating vector is constant during the period of study. In reality, it is possible that the long-run relationship between the underlying variables change (shifts in the co integrating vector can occur). The reason for this might be technological progress, economic crises, changes in the people’s preferences and behaviour accordingly, policy or regime alteration, and organizational or institutional developments. This is especially likely to be the case if the sample period is long. To take this issue into account Gregory and Hansen (1996) have introduced tests for co integration with one unknown structural break and Hatemi-J (2008) has introduced tests for co integration with two unknown breaks.
Other procedures are: The variable addition approach of Park (1990); similar to Engle-Granger's residual based test, Shin (1994) gave a test with the null to be there is co integration; Stock & Watson (1988) gave the stochastic common trends approach. 

**JOHANSEN TEST**

In statistics, the **Johansen test**, named after Søren Johansen, is a procedure for testing co integration of several I(1) time series. This test permits more than one co integrating relationship so is more generally applicable than the Engle–Granger test which is based on the Dickey–Fuller (or the augmented) test for unit roots in the residuals from a single (estimated) co integrating relationship. 

There are two types of Johansen test, either with trace or with eigen value, and the inferences might be a little bit different. The null hypothesis for the trace test is the number of co integration vectors $r \leq ?$, the null hypothesis for the eigen value test is $r = ?$.

Just like a unit root test, there can be a constant term, a trend term, both, or neither in the model. For a general VAR ($p$) model:

\[
X_t = \mu + \Phi D_t + \Pi_p X_{t-p} + \ldots + \Pi_1 X_{t-1} + \epsilon_t, \quad t = 1, \ldots, T
\]

There are two possible specifications for error correction: that is, two VECM (vector error correction models):

1. The longrun VECM:

\[
\Delta X_t = \mu + \Phi D_t + \Pi_p X_{t-p} + \Gamma_{p-1}\Delta X_{t-p+1} + \Gamma_1\Delta X_{t-1} + \ldots + \epsilon_t, \quad t = 1, \ldots, T
\]

where

\[
\Gamma_i = \Pi_1 + \ldots + \Pi_i - I, \quad i = 1, \ldots, p-1.
\]

2. The transitory VECM:

\[
\Delta X_t = \mu + \Phi D_t - \Gamma_{p-1}\Delta X_{t-p+1} - \ldots - \Gamma_1\Delta X_{t-1} + \Pi X_{t-1} + \epsilon_t, \quad t = 1, \ldots, T
\]

where

\[
\Gamma_i = (\Pi_{i+1} + \ldots + \Pi_p), \quad i = 1, \ldots, p - 1
\]
Be aware that the two are the same. In both VECM,

$$\Pi = \Pi_1 + \ldots + \Pi_p - I.$$

**PREVIOUS STUDIES**

A brief review of select studies has been presented in the following pages.

*Shrikanth M. and Kishore B.* (2012), in their paper, “Net FII Flows into India: A Cause and Effect Study”, investigated a cause and effect relationship between FII and Indian capital market. They observed that FIIs carried the institutional flavour in terms of market expertise and fund management by way of pooling small savings from retail investors. The main objective of FIIs is maximizing returns and minimizing risk while keeping liquidity of the investments intact. They concluded that net FII inflows had a positive impact on the Indian stock market and foreign exchange reserves.\(^{35}\)

The article entitled (2012), “Do FIIs Impact Volatility of Indian Stock Market?” by *Loomba, J.*, attempted to testify the behaviour of FII trading and its effect on Indian stock market. The course of capital market liberalization, foreign capital has become increasingly significant source of finance and institutional investors are growing their influence in developing markets. The study concluded that the Indian stock markets have come in age where there were significant developments in the last 15 years make the markets at par with the developed markets.\(^{36}\)

*Bohra, N. Singh and Dutt, Akash.* (2011), in their article, “Foreign Institutional Investment in Indian Capital Market: A Study of Last One Decade”, studied the behavioural pattern of FII in India and figure out the reasons for indifferent responses of BSE Sensex due to FII inflows. They found the correlation between FII investment and turnover of different individual groups at BSE sensex. They concluded that there is a positive correlation between FII investment and stock market but in year 2005 and 2008, it was also observed that positive or negative movement of FII’s investment leads to a major shift in the sentiments of domestic or related investors in market.\(^{37}\)
A study on “FII Equity Investment and Indian Capital Market: - An Empirical Investigation” by Shukla, K. Rajeev et al (2011), investigated the impact of foreign institutional investors on Indian stock indices. India, after United States hosts the largest number of listed companies and Global investors now enthusiastically seek India as their preferred destination for investment. Many Indians working in foreign countries now divert their savings to stocks. They concluded that FIIs have significant impact on the share prices of the Midcap & Small-cap companies but small and a periodic shift in their behaviour leads to market volatility.38

Kaur, Manjinder and Dhillon, S. Sharanjit (2010), in their paper, “Determinants of Foreign Institutional Investor’s Investment in India”, focused on the determinants of Foreign Institutional investment in India. Market capitalization and stock market turnover of India have significant positive influence only in short-run but Stock market risk has negative influence on FIIs inflows to India. Among macroeconomic determinants, economic growth of India has positive impact on FIIs investment in both long run and short run but all other macroeconomic factors have significant influence only in long run like inflation.39

The article entitled (1987), “The Behaviour of a Stock Market in a Developing Economy” by Darat and Mukherjee, applied a Vector Auto Regression (VAR) model and found that a significant causal relationship exists between stock returns and selected macroeconomic variables of China, India, Brazil and Russia which are emerging economies of the world using oil price, exchange rate, and moving average lags values as explanatory variables employed MA (Moving Average) method with OLS (Ordinary Least Square) and found insignificant results which postulate inefficiency in market. Finally they concluded that in emerging economies the domestic factors influence more than external factors, i.e., exchange rate and oil prices.40

“Stock prices and the effective exchange rate of the dollar” by Bahmani and Sohrabian (1992), studied the causal relationship between U.S. stock market (S&P 500 index) and effective exchange rate of dollar in the short period of time. Their theory established bidirectional causality between the two for the time period
taken. However, co-integration analysis failed to identify any long run relationship between the two variables.  

A study on “Cointegration and Causality between Macroeconomic Variables and Stock Market Returns” by Kwon and Shin (1999) applied Engle-Granger cointegration and the Granger causality tests from the VECM and found that the Korean stock market was cointegrated with a set of macroeconomic variables. However, using the Granger-causality test on macroeconomic variables and the Korean stock index, the authors found that the Korean stock index was not a leading indicator for economic variables.


“The Nature of The Casual Relationship between Stock Market and Macroeconomic Aggregates in India: An Empirical Analysis” by Bhattacharya and Mukherjee (2002), investigated the nature of the causal relationship between BSE Sensitive Index and the five macroeconomic aggregates in India (i.e., IIP, money supply, national income, interest rate and inflation rate) using monthly data for the period 1992-93 to 2000.

The paper entitled (2006), “Macroeconomic Variables And Stock Market Interactions: New Zealand Evidence” by Gan, Lee, Yong and Zhang, examined the macroeconomics variables and stock market interaction: New Zealand Evidence. Their studied had a set of seven macroeconomic variables and used co-integration tests, johansen maximum likelihood and granger-causality tests. In addition, their paper also investigated the short run dynamic linkages between NZSE40 and macroeconomic variables using innovation accounting analyses. In general analysis it was found that the NZSE40 is consistently determined by the interest rate, money

74
supply and real GDP but there is no evidence that the New Zealand Stock Index is a leading indicator for changes in macroeconomic variables.45

“A Study of the Effect of Macroeconomic Variables on Stock Market: Indian Perspective” by Kumar (2008), established and validate the long-term relationship of stock prices with exchange rate and inflation in Indian context. There were numerous studies on the relationship of stock indices with macroeconomic variables. This gave a strong subjective background to test the existence of any such relationship in India. The research primarily dealt with an empirical method by combining different statistical techniques to check the presence of co-integration between the stock index (Sensex) and other variables. Co-integration is a well accepted indicator of a long term relationship between more than one time series variables. The study took into consideration past ten years experience of Indian economy reflected into the stock index, wholesale price index and exchange rates. A causal relationship could not be established without the existence of co-integration between the selected macroeconomic variable.46

The paper entitled (2010), “Causal Relationship between Macro-Economic Variables and Stock Market: A Case Study for India” by Dharmendra Singh, explored the relation especially the causal relation between stock market index i.e. BSE Sensex and three key macro economic variables by using correlation, unit root stationarity tests and Granger causality test. Monthly data has been used for all the variables and results showed that the stock market index, IIP, WPI, and exchange rate contained a unit root and were integrated of order one. They found that results show bilateral granger causality between IIP and Sensex while WPI is having strong correlation and unilateral causality with Sensex which means Indian stock market is approaching towards informational efficiency at least with respect to two macroeconomic variables, viz. exchange rate and inflation.47

“Causal Relationship between Macro-Economic Indicators and Stock Market in India” by Tripathy (2011), investigated the market efficiency and causal relationship between selected Macroeconomic variables and the Indian stock market by using Ljung-Box Q test, Breusch-Godfrey LM test, Unit Root test, Granger Causality test. The study confirms the presence of autocorrelation in the Indian stock
market and macro economic variables which implies that the market fell into form of Efficient Market Hypothesis. Then the Granger-causality test shows the bidirectional relationship between stock market and interest rate and exchange rate, international stock market and BSE volume, exchange rate and BSE volume. The study also reported unidirectional causality running from international stock market to domestic stock market, interest rate, exchange rate and inflation rate indicating sizeable influence in the stock market movement.48

Dasgupta (2012), in their paper, “Long-Run and Short-Run Relationships between BSE Sensex and Macroeconomic Variables” attempted to explore the long-run and short-run relationships between BSE Sensex and four key macroeconomic variables of Indian economy by using descriptive statistics, ADF tests, Johansen and Juselius’s cointegration test and Granger causality test. Monthly data has been used for all the variables, i.e., BSE Sensex, WPI, IIP, EX and call money rate. Results showed that all the variables has contained a unit root and are integrated of order one. Johansen and Juselius’s cointegration test pointed out at least one cointegration vector and long-run relationships between BSE Sensex with index of industrial production and call money rate. Granger causality test was then employed. The Granger causality test has found no short-run unilateral or bilateral causal relationships between BSE Sensex with the macroeconomic variables. Therefore, it is concluded that, Indian stock markets had no informational efficiency.49

The article entitled (2011), “The Relationships between Inflation and Stock Market: Evidence from Malaysia, United States and China” by Geetha et.al., studied the relationships between inflation and stock returns. Researchers revealed that there were no long-run relationships between expected and unexpected inflation with stock returns and there was also no short-run relationships between the variables for Malaysia and US but it existed for China.50

“Do Indian Stock Markets Matter? - Stock Market Indices and Macroeconomic Variables” by Pethe and Karnik (2000), attempted to find the impact of macroeconomic variables on Indian stock price indices. But, this study had run causality tests in an error correction framework on non-co integrated variables, which
is inappropriate and not econometrically sound and correct. The study reported weak causality running from IIP to share price indices (i.e., SENSEX and S&P CNX NIFTY) In other words, it holds the view that the state of economy had affected stock prices.\textsuperscript{51}

The paper entitled (2008), \textit{“Effect of Macroeconomic Variables on Stock Market Returns for Four Emerging Economies: Brazil, Russia, India, And China”} by Gay, analyzed the association between stock prices and macroeconomic variables among China, India, Brazil and Russia which are emerging economies of the world by using oil price, exchange rate, and moving average lags values as explanatory variables with OLS (Ordinary Least Square) and found insignificant results. And finally concluded that in emerging economies the domestic factors influence more than external factors namely exchange rate and oil prices.\textsuperscript{52}

\textit{“Dynamic Relationship between Stock Prices and Exchange Rates: Evidence from Three South – Asian Countries”} by Rahman and Uddin (2009), examined the relationship between exchange rates and stock prices of three emerging countries of South Asia named as Bangladesh, India and Pakistan. They took average monthly nominal exchange rates of US Dollar in terms of Bangladeshi Taka, Indian Rupee and Pakistani Rupee and monthly values of Dhaka Stock Exchange General Index, Bombay Stock Exchange Index and Karachi Stock Exchange and all Share Price Index for period of January 2003 to June 2008 for the purpose of the study and found there was no co-integrating relationship between stock prices and exchange rates. They also applied Granger causality test which showed there is no casual relationship between stock prices and exchange rates in chosen countries for the study period.\textsuperscript{53}

Yadav and Lagesh (2011), in their paper, \textit{“Macroeconomic Relationship in India: ARDL Evidence on Cointegration and Causality”}, studied the dynamic interrelations among the macroeconomic variables of real output, money, price, interest rate and exchange rate using monthly data for India covering the period from 1991:1 to 2007:12 .The bounds test revealed that there existed a long-run relation between real output, money supply, interest rate and exchange rate when the price variable was the dependent variable. Also, a long-run relationship between real
output, money supply, price and interest rate was found when exchange rate was the dependent variable. The short-run causality found no evidence between real output and money and a unidirectional causality running from price and interest rate to real output was found. Finally, it was found that output, money, price and interest rate had no effect on exchange rate in the short-run.⁵⁴

“Stock Prices and Exchange Rates: Are They Related? Evidence from South Asian Countries” by Muhammad and Rasheed (2002), examined the exchange rates and stock price relationships for Pakistan, India, Bangladesh and Sri Lanka using monthly data from 1994 to 2000. The results show that there is a bi-directional long-run causality between these variables for only Bangladesh and Sri Lanka. No associations between exchange rates and stock prices are found for Pakistan and India.⁵⁵

A study on “Stock Market and Macroeconomic Fundamental Dynamic Interactions: ASEAN-5 Countries” by Wongbampo and Sharma (2002), explored the relationship between stock returns and five macroeconomic variables such as GNP, inflation, money supply, interest rate, and exchange rate in five Asian countries viz. Malaysia, Indonesia, Philippines, Singapore and Thailand. Their study used monthly data for the period of 1985 to 1996, and it was found that, in the long run stock price indices of all the five countries were positively related to growth in output and negatively related to the aggregate price level. However, they found a negative relationship between stock prices and interest rate for Philippines, Singapore and Thailand, but positive relationship for Indonesia and Malaysia.⁵⁶

The article entitled (2004), “Relationship between Macroeconomic Variables and Stock Market Indices: Cointegration Evidence from Stock Exchange of Singapore’s All-S Sector Indices” by Maysami et al., examined the relationship among the macroeconomic variables and sector wise stock indices in Singapore using monthly data from January 1989 to December 2001. They employed the Johansen co-integration and VECM approaches and found a significant long-run equilibrium relationship between the Singapore stock market and the macroeconomic variable tested.⁵⁷
Ahmed and Osman (2007), in their paper, “Macroeconomic Factors and Bangladesh Stock Market”, investigated the long run equilibrium and short term dynamics between DSE stock index and a set of macroeconomic variables like money supply, 91 day T-bill rate, interest rate GDP and industrial production index. The cointegration test suggests that there exist two co integrating vectors one is statistically significant. In the VECM test, they found that the lagged stock index was adjusted to long run equilibrium by 43.82 percent by the combined lagged influence of all the selected macroeconomic variables. Granger causality test provides only one unidirectional causality from interest rate change to stock market return.\(^{58}\)

“Effect of Macroeconomic Variables on Stock Market Returns for four Emerging Economies: Brazil, Russia, India and China” by Robert (2008), investigated the effect of two macroeconomic variables (exchange rate and oil price) on stock market returns for four emerging BRIC economies, namely, Brazil, Russia, India and China using monthly data from March 1999 to June 2006. Results affirmed that there was no significant relationship between present and past market returns with macroeconomic variables. Furthermore, no significant relationship was found between respective exchange rate and oil price on the stock market index of the four countries studied.\(^{59}\)

A study on “The Relationship of Stock Prices and Macroeconomic Variables revisited: Evidence from Karachi Stock Exchange” by Akbar et al. (2012), studied the relationship between the Karachi stock exchange index and macroeconomic variables for the period of January 1999 to June 2008. Employing a co-integration and VECM, they found that there was a long-run equilibrium relationship exists between the stock market index and the set of macroeconomic variables. Their results indicated that stock prices were positively related with money supply and short-term interest rates and negatively related with inflation and foreign exchange reserve.\(^{60}\)

Sarkar (2005), in their paper, “Stock Market, Capital Accumulation and Growth in India since 1950”, examined the relation between growth and capital accumulation exists in case of India. They have used annual data on various variables like nominal and real share price, share market turnover ratio, number of listed firms
in the stock market, fixed capital formation and growth of real GDP and industrial output. But results show no positive relationship exists between real and stock market variables either in short run or long run during 1950-51 to 2005.\textsuperscript{61}

The paper entitled (2008), “Aggregate Economic Variables and Stock Market in India” by Ahmed, employed the Johansen’s approach of co-integration and Toda – Yamamoto Granger causality test to investigate the relationship between stock prices and the macroeconomic variables using quarterly data for the period of March, 1995 to March 2007. The results indicated that there was an existence of a long-run relationship between stock price and FDI, money supply, & index of industrial production. Causality was found running from stock price movement to movement in industrial production.\textsuperscript{62}

“Impact of Macroeconomic Indicators on Indian Capital Markets” by Pal and Mittal (2011), investigated the relationship between the Indian stock market and macroeconomic variables using quarterly data for the period January 1995 to December 2008 with the Johansen’s co-integration framework. Their analysis revealed that there was a long-run relationship exists between the stock market index and set of macroeconomic variables. The results also showed that inflation and exchange rate have a significant impact on BSE Sensex but interest rate and gross domestic saving (GDS) were insignificant.\textsuperscript{63}

Sharma and Mahendru (2010), in their article, “Impact of Macroeconomic Variables on Stock Prices in India”, analysed long term relationship between BSE and macroeconomic variables, vis-à-vis, change in exchange rate, foreign exchange reserve, inflation rate and gold price. The study period ranges between January 2008 and January 2009. The multiple regression models was applied and the results reveal that exchange rate and gold prices highly effect the stock prices, while FOREX and inflation have limited influence on stock prices.\textsuperscript{64}

Sabunwala (2012), in their paper, “A Study of the Impact of macroeconomic Variables on Stock Price Movements”, attempts to unravel the relationship between the real economic variables and the capital market in Indian context. The study considers the monthly data of several economic variables like the
national output, fiscal deficit, interest rate, inflation, exchange rate, foreign institutional investment in Indian markets between 1994 and 2010, and tries to reveal the relative influence of these variables on the sensitive index of the Bombay stock exchange (BSE). Linear regression model was applied to identify the relationship between BSE stock price movement and macro-economic variables. The finding shows that interest rate, output, money supply, inflation rate and the exchange rate have considerable influence in the stock market movement in the considered period, while fiscal deficit and foreign institutional investment have very negligible impact on the stock market.65

A study on “Testing Granger Causal Relationship between Macroeconomic Variables and Stock Price Behaviour: Evidence from India” by Ray (2012) explored the impact of different macroeconomic variables on the stock prices in India using annual data from 1990-91 to 2010-11. A multiple regression model was used to test the effects of macroeconomic variables on the stock prices and granger causality test is conducted to examine whether there exist any causal linkage between stock prices and macroeconomic variables. Results indicate that there is no causal association between stock price and interest rate, stock price and index of industrial production, but unidirectional causality exist between stock price and inflation, stock price and foreign direct investment, stock price and gross domestic product, stock price and exchange rate, stock price and gross fixed capital formation. However, bi-directional causality exist between stock price and foreign exchange reserve, stock price and money supply, stock price and crude oil price and stock price and whole price index. The multiple regression results of the study indicate that oil price and gold price have a significant negative effect on stock price, while balance of trade, interest rate, foreign exchange reserve, gross domestic product, industrial production index and money supply positively influence Indian stock price. On the other hand, inflation rate, foreign direct investment, exchange rate and wholesale price index do not appear to have any significant effect on stock price.66

The paper entitled (2012), “The Impact of Macroeconomic Fundamentals on Stock Prices Revisited: Evidence from Indian Data” by Naik and Padhi, investigated the relationship between the Indian stock market index (BSE Sensex) and
five macroeconomic variables, namely, industrial production index, wholesale price index, money supply, treasury bills rates and exchange rates over the period April, 1994–June, 2011. Johansen’s co-integration and vector error correction model were applied. The analysis reveals that macroeconomic variables and the stock market index are co-integrated. It was observed that the stock prices positively relate to the money supply and industrial production but negatively relate to inflation. The exchange rate and the short-term interest rate were found to be insignificant in determining stock prices. In the Granger causality test, a bidirectional causality between industrial production and stock prices and unidirectional causality from money supply to stock price, stock price to inflation and interest rates to stock prices were found.67

Makan et al (2012), in their article, “A Study of the Effect of Macroeconomic Variables on Stock Market: Indian Perspective”, tried to test the influence of macroeconomic variables on BSE stock prices. The macroeconomic variables are represented by the IIP, CPI, call rate, exchange rate, gold price, oil price and FII. Monthly data for the duration of April 2005 – March 2012 was considered. The paper employed Granger causality test, regression analysis and correlation analysis to examine such relationships. Based on the results it was concluded that three out of seven variables were relatively more significant and likely to influence Indian stock market. These factors were exchange rate, FII and call rate. There is a positive relation between FII and Sensex, call rate and Sensex whereas exchange rate and Sensex shows a negative relation. In granger causality test call rate was seen affecting BSE.68

The paper entitled (1993), “Equity Portfolio Investment in Developing Countries: A Literature Survey” by Classens, analysed the return and diversification benefits for an investor in an industrial country of investing in emerging markets and barriers which prevent a free flow of funds. Study found that equity portfolio flows can be affected by efficiency of domestic stock market as well as market segmentation created by barriers. Investors’ perception and attitudes may thus matter as much as formal barriers.69
Batra (2003), in their paper, “The Dynamics of Foreign Portfolio Inflows and Equity Returns in India”, made an attempt to build up an understanding of investment decisions, trading strategies and behaviour of the FIIs in Indian equity market. The author scrutinized the daily & monthly data to investigate the trading behaviour of FIIs & their impact on the stability of stock market. It is found that the positive feedback investors and trend chasers of FIIs on the basis of daily data analysis but no evidence of positive feedback trading while analysed data on monthly basis.70

Pal (2006), in their article, “Foreign Portfolio Investment in Indian Equity Markets: Has the Economy Benefited?” examined the impact of foreign portfolio investment on India’s economy and industry. As FPI essentially interacts with the real economy via the stock market, the effect of foreign portfolio on the country’s economic development examined. The result of this study suggests that the entry of foreign portfolio investors will boost a country’s stock market and consequently the economy, does not seem to be working in India.71

A study on “Determinants of Foreign Institutional Investment in India: The Role of Risk Return and Inflation” by Rai and Bhanumurthy (2006), analyzed the determinants of foreign institutional investment in India using monthly data. The study revealed the positive association of FIIs investment with return on BSE-SENSEX, inflation in US (home country) and negative association with inflation in India (host country), return on S&P 500 index, ex-ante risk on BSE and ex-ante risk on S&P 500 index. However, the ex-post risk neither in US nor in India affected FII inflow to India.72

Arya & Purohit (2012), in their paper, “An Analytical Research on FIIs in India”, found that FII has gained a significant role in Indian stock markets. The beginning of 21st century has revealed the real dynamics of Indian stock market and its various benchmarking indices. The study was mainly focused to check the volatility of stock market & returns due to the existence of FIIs in India.73

“A Study of Influence of FII Flows on Indian Stock Market” by Shrivastav (2013), examined whether market movement in terms of stock prices
could be explained by foreign investors, and also examined the relationship between FII and Indian stock market. The study found that FII is thus an important macroeconomic indicator which can help us analyze a particular stock and the whole stock market in a better manner.\textsuperscript{74}

Islam (2003), in their article, “The Kuala Lumpur stock market and economic factors: a general-to-specific error correction modeling test”, replicated the short-run dynamic adjustment and the long-run equilibrium relationships between four macroeconomic variables (interest rate, inflation rate, exchange rate, and the industrial productivity) and the Kuala Lumpur Stock Exchange (KLSE) Composite Index. His conclusions were similar: there existed statistically significant short-run (dynamic) and long-run (equilibrium) relationships among the macroeconomic variables and the KLSE stock returns.\textsuperscript{75}

Islam and Watanapalachaikul (2003), in their paper, “Time series financial econometrics of the Thai stock market: a multivariate error correction and valuation model”, showed a strong, significant long-run relationship between stock prices and macroeconomic factors (interest rate, bonds price, foreign exchange rate, price-earning ratio, market capitalization, and consumer price index) during 1992-2001 in Thailand.\textsuperscript{76}


The paper entitled (2003), “Time series analysis of the impact of real interest rates on stock market activity and liquidity in Egypt: Co-integration and error correction model approach” by Omran, focused on examining the impact of real interest rates as a key factor in the performance of the Egyptian stock market, both in terms of market activity and liquidity. The cointegration analysis through error correction mechanisms (ECM) indicated significant long-run and short-run
relationships between the variables, implying that real interest rates had an impact upon stock market performance.78

Vuyyuri (2005), in their paper, “Relationship between real and financial variables in India: A cointegration analysis”, investigated the cointegrating relationship and the causality between the financial and the real sectors of the Indian economy using monthly observations from 1992 through December 2002. The financial variables used were interest rates, inflation rate, exchange rate, stock return, and real sector was proxied by industrial productivity. Johansen (1988) multivariate cointegration test supported the long-run equilibrium relationship between the financial sector and the real sector, and the Granger test showed unidirectional Granger causality between the financial sector and real sector of the economy.79

A study on “Causal relations among stock prices and macroeconomic variables in the small, open economy of Jordan” by Maghyereh (2002), investigated the long-run relationship between the Jordanian stock prices and selected macroeconomic variables, again by using Johansen’s (1988) cointegration analysis and monthly time series data for the period from January 1987 to December 2000. The study showed that macroeconomic variables were reflected in stock prices in the Jordanian capital market.80

Gunasekarage, Pisedtasalasai and Power (2004), in their paper, “Macroeconomic influence on the stock market: evidence from an emerging market in South Asia”, examined the influence of macroeconomic variables on stock market equity values in Sri Lanka, using the Colombo All Share price index to represent the stock market and (1) the money supply, (2) the treasury bill rate (as a measure of interest rates), (3) the consumer price index (as a measure of inflation), and (4) the exchange rate as macroeconomic variables.81

The paper entitled (2002), “FII’s influence on Stock Market” by Stanley Morgan, examined that FIIs have played a very important role in building up India’s forex reserves, which have enabled a host of economic reforms. Secondly, FIIs are now important investors in the country’s economic growth despite sluggish domestic sentiment. The Morgan Stanley report notes that FII 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.\textsuperscript{82}

A study on “Stock Market in India and Foreign Institutional Investments: An Appraisal” by Saha, Malayendu (2009), investigated the participation of foreign institutional investors and the other financial institutions in India and the performance of the Indian stock markets and she concluded that Indian stock market is regarded at par with the developed markets Moreover, it had a very unique economic model and is based on strong economic growth with huge liquidity and it is not depended on the US economy for its GDP growth.\textsuperscript{83}

Singh, Sumanjeet (2009), in their article, “Foreign capital flows into India: Compositions, regulations, issues and policy options”, revealed that the size of net capital inflows to India increased from US $ 7.1 billion in 1990-91 to US $ 108.0 billion in 2007-08. India has one of the highest net capital inflows among the EMEs of Asia. Capital inflows, however, not an unmitigated blessing, the main danger posed by large and volatile capital inflows is that they may destabilize macroeconomic management. The study concluded that the intensified pressures due to large and volatile capital flows in India in the recent period in an atmosphere of global uncertainties.\textsuperscript{84}

A study on “Impact of Private Foreign Capital Inflows On Economic Growth In India: An Empirical Analysis” by Sethi, Narayan and Sucharita, Sanhita (2009), attempted to explain the effects of private foreign capital inflows (FINV) on some macroeconomic variables in India using the time series data between April 1995 to Dec 2007. They found that Foreign Direct Investment (FDI) is positively affecting the economic growth, while Foreign Institutional Investment (FII) is negatively affecting the economic growth.\textsuperscript{85}

Prasanna, P.K. (2008), in their paper, “Foreign Institutional Investor: Investment preference in India”, discussed role of FII in Indian Capital market and
examined the contribution of foreign institutional investment particularly among companies included in sensitivity index (Sensex) of Bombay Stock Exchange. She found that Higher Sensex indices and high price earnings ratio are the country level factors attracting more foreign investment in India and the foreign investment is more in the companies with higher volume of publically held shares. The promoter’s holdings and the foreign investments are inversely related.86

Chittedi, Krishna Reddy (2008), in their article, “Volatility of Indian Stock Market and FIIs”, analyzed a performance of the sensex Vs FIIs in the Indian stock market. The study revealed that the liquidity as well as the volatility was highly influenced by FII inflows in BSE sensex so the foreign institutional investment is the significant factor for determining the liquidity and volatility in the stock market prices. The study concluded that the FIIs who have been so bullish in India for the last so many years might start looking at other cheaper emerging markets for better returns. So, it is very tough to predict that whether the sensex will sustain the momentum in future or not.87

Sethi, Narayan (2008), evaluated the impact of international capital flow on economic growth, trends and composition and suggested the policy implication thereof. He observed that the foreign institutional investors (FIIs) have negative impact on growth, but it is very negligible. He concluded that India should move to influence both the size and composition of capital flows, strengthened their banking system rather than promoting financial market, banks can provide the surest vehicle for promoting long term growth and industrialization.88

Poshakwale, Sunil and Thapa, Chandra (2007), in their paper, “Impact of foreign Portfolio investments on market investment market co movements: Evidence from the Emerging Indian stock market”, compared the influence of foreign institutional investments in the long and short run on Indian equity market with the main developed equity markets of the US and the UK by using daily return series and portfolio investments made by foreign institutional investors. They found that Indian stock returns are significantly influenced by the short and long term innovations in the US and UK stock market.89
A study on “Foreign Institutional Investment in India” by Dhamija, Nidhi (2007), described that the increase in the volume of foreign institutional investment (FII) inflows in recent years has led to concerns regarding the volatility of these flows, threat of capital flight, its impact on the stock markets and influence of changes in regulatory regimes. She suggested that as the pace of foreign investment began to accelerate, regulatory policies have changed to keep up with changed domestic scenarios.90

Singh, Manmohan (2007), in their working paper, “Use of Participatory Notes in Indian Equity Markets and Recent Regulatory Changes”, attempted to explain the use of participatory notes (PNs) by foreign investors, as a conduit of portfolio flows into Indian capital markets for more than a decade. The broadening of India's foreign investor base, in recent years, has a bias towards hedge funds/unregistered foreign investors who invest primarily via participatory notes (PNs).91

A study on “FII Flows to India: Nature and Causes” by Chakrabarti (2001), conducted the pair-wise Granger Causality tests between FII inflows and returns on the BSE National Index. He found that portfolio investment from FIIs was more an effect than a cause of market returns in India.92

Mukherjee, Bose and Coondoo (2002), in their paper, “Foreign Institutional Investment in the Indian Equity Market: An Analysis of Daily Flows during January 1999–May 2002”, studied the cause-and-effect relationship between FII flows and returns on the Indian equity market. They found that FII flows to and from the Indian market tend to be caused by returns in the domestic equity market and not the other way round.93

A study on “Sensitivity of Capital Flows to Interest Rate Differentials: An Empirical Assessment for India” by Verma and Prakash (2011), found that the interest rate sensitivity of FII flows is not statistically significant and concluded that the BSE Sensex is a major pull factor for these flows into the domestic financial markets.94
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CONCLUSION

In Chapter – III, the Review of Literature and other concepts related to study
area has been presented. The Analysis of macroeconomic variables, foreign
institutional investments and the Indian stock market have been dealt with in Chapter - IV.