INTERNATIONAL JOURNAL OF INNOVATIVE RESEARCH & DEVELOPMENT

ISSN: 2278 – 0211 (Online)

Foreign Portfolio Management In India

Biswajit Bose
Assistant Professor of Commerce, GyanJyoti College, Siliguri, India

Abstract:
The economic development of a country involves utilization of its resources for increasing the productive capacity of the country. But in most of the developing countries such utilization of resources rather difficult due to the scarcity of domestic capital and thence there is a need to attract the foreign capital. Given the role of foreign capital and technology as and impetus to economic development, the question arises as to which is the best resources of importing capital from the develop countries.
Foreign investment is one of the oldest and recognized channels for importing capital and technology from the developed countries into the developing countries. Foreign investments especially through multinational corporate has been a subject of animated discussion both in the home and the host countries. Foreign is a nebulous concept. In wider sence it denotes wide spectrum of international business arrangements, but in essence it entails flow of capital, technology , shills and enterprises from one country to another. Such flows, although a new Phenomena, have assumed significant in the wake of the needs and desires of contemporary developing countries to push up their growth rate. In India , like any other developing countries , the role of foreign investment is debated hotly.
Today when all efforts are being made to develop the economy, the government and the people expect the foreign firms to play a more positive roles in the economic development of India.

Keywords: *Portfolio, Economy, Technology, Resources, Economic Development*

1.Introduction

In 1992, India opened up its economy and allowed Foreign PortfolioInvestment (FPI) in its domestic stock markets. Since then, FPI has emergedas a major source of private capital inflow in this country. The objective ofthis paper is to examine the impact of Foreign Portfolio Investmenton India's economy and industry. As FPI essentially interacts with the realeconomy via the stock market, the effect of stock market on the country'seconomic development will also be examined. In the current global economic scenario, it is important to address these issues because of anumber of reasons. During the late 1980s and early 1990s portfolioinvestment emerged as an important form of capital inflow to developingcountries. The importance of portfolio investment to developing countrieshas come down after the East Asian crisis of 1997. However, unlike mostother developing countries, India is still more dependent upon FPI thanForeign Direct Investment (FDI) as a source of foreign investment. For theperiod 1992 to 2005, more than 50 percent of foreign investment in Indiacame in the form of FPI. Given such high dependence of the Indianeconomy on FPI, it is important to assess whether and how FPI hascontributed to the economic development of the country. Secondly, the spateof financial crises since the late 1990s have repeatedly highlighted that thecurrent global financial architecture, with its emphasis on speculative capitalflows, can seriously disrupt the economic prospects of a developing country.For these countries, insulating the economy from the uncertainties of shortterm capital flows can impose serious fiscal costs on the economy. It canalso make the management of external economy difficult by reducing thepolicy options available to the policymakers in developing countries. It isimportant to investigate these aspects of FPI in the Indian context. Also,competition among emerging markets to attract foreign portfolio investmenthas led to a situation in which in order to sustain inflows of portfolioinvestment, it has become increasingly important for developing countries toensure attractive returns for portfolio investors. Often this means offeringincreasing operational flexibility and fiscal sops to portfolio investors. Thisincreases the cost associated with portfolio investment in a developingcountry. It needs to be investigated whether the benefits brought by theforeign portfolio investors to the domestic economy are sufficient to justifythe costs associated with the promotion of FPI in these countries.The dependence on FPI is pushing many developing countries, includingIndia, towards a more stock market oriented financial system. This makes itimperative to evaluate the relative merits and demerits of a stock marketbased financial system in a developing country. In this context, it

becomesparticularly important to find out how a stock market based financial systemcan benefit the economy and the industry of a developing country. It is alsocrucial to empirically investigate whether the supposedly beneficial aspectsof a stock market based financial systems are actually being realized indeveloping countries. Given these concerns, this paper attempts to addressthe issue of foreign portfolio investment and its impact on economicdevelopment from an Indian perspective.

2.Review Of Existing Literature

There are many studies of herding, positive feedback trading, market integration, and home bias exhibited by foreign investors. Gompers et al. (2001), and Bohl et al. (2005) examined the impact of change in institutional ownership on stock returns. Bohl et al., (2005) employed asymmetric GARCH model to test the popular belief that institutional investors engage in herding and positive feedback trading, thus contributing to autocorrelation and excess volatility. They found that foreign pension fund investors in Poland contributed to reduction in autocorrelation and volatility of returns. Gompers et al. (2001) analyzed the relationship between institutional ownership and returns by examining the characteristics of stocks with significant foreign portfolio investment and the impact of demand for such stocks on returns. They analyzed the quarterly data on holdings of large (foreign) institutions from 1980 to 1996. They concluded that increase in demand for stocks with certain characteristics from large institutional investors increases their price and returns. They tried to establish a relationship between large institutional ownership and future returns. They compared the returns on portfolio of stocks with significant institutional investment with those on portfolios of stocks with insignificant or no institutional ownership. Their results suggest that large institutional investors can predict future returns on stocks held by them.

Froot et al. (2001) used vector auto regression to prove that there is a strong influence of past returns on flows. At the same time, the inflows exhibited positive forecasting power while predicting future equity returns, which was found to be statistically significant in emerging markets. They tried to examine the covariance of equity returns with cross border flows. According to them, a major disadvantage of previous studies that used quarterly or monthly data is that they could not be precise about whether measured covariance of asset returns was truly contemporaneous. The daily data allows for greater precision in determining contemporaneous versus non – contemporaneous components of quarterly covariance.

Studies of behaviour of FII inflows and their impact on market return in India used quarterly data. We used daily data on FII inflows. Nofsinger et al. (1999) found strong correlation between changes in institutional ownership and returns measured during the corresponding period. According to them, stocks purchased by institutional investors outperform those sold by them. Institutional herding was positively correlated with log returns, and related to stock return momentum. While studying herding by foreign portfolio investors, Brenon et al. (1997) developed a model of international portfolio investment flows that depend on information assymetry between foreign and domestic investors. The model predicts that portfolio flows between two countries will be a linear function of contemporaneous returns on all national market indices if there are differences in information available to foreign and domestic investors. If domestic investors enjoy information advantage over foreign investors (about domestic securities), the coefficient of host market return will be positive. By imposing additional symmetry on information endowments, they obtained more robust results suggesting that portfolio flows depend only on the host market return. The foreign portfolio investors are considered to be short term investors. It is a common belief that FIIs invest for short term and destabilise markets. But, Cho et al. (1997) concluded that foreign portfolio investors did not destabilize the South Korean stock market. They studied the impact of foreign portfolio investment on stock returns in South Korea using order and trade data. They found strong evidence of positive feedback trading and herding before the East Asian economic crisis. But, during the crisis period, herding declined and even positive feedback trading was negligible. They did not find any evidence of destabilising effect of trades by foreign investors during the sample period.In particular, the market was not affected by large sales by foreign investors and it was found that these (sales) were not followed by negative abnormal returns. While trying to find out if the U.S. equity investment in foreign markets is portfolio rebalancing or return chasing, Bohn et al. (1996) concluded that investors tend to invest in foreign markets with higher expected returns. But, the return-chasing strategy pursued by U.S. investors resulted in a mean return which was 15 basis points less than what could have been earned by holding a market weighted portfolio of foreign stocks. This lower return was not compensated by a corresponding reduction in risk. The mean return per unit risk of the market portfolio was higher than that of the portfolio chosen by U.S. investors.

India is considered one of the best emerging markets by the institutional investors. Batra (2004), Trivedi et al. (2003), Gordon et al. (2003), Chakrabarti (2001), examined the

impact of foreign portfolio investment on stock returns in India. To examine the change in market volatility after liberalisation, Batra (2004) analyzed the monthly stock return data from 1979 to 2003 and used the asymmetric GARCH model. Their findings suggest that liberalisation of the stock market which allowed FII investment in Indian stock market did not affect the market volatility. They also analyzed stock market cycles for variation in amplitude, duration, and volatility during bull and bear phases. The results suggest that volatility declined during the post liberalisation period during bull and bear phases of the market. Gorden et al. (2003) studied the relevance of micro and macro-economic variables which are expected to affect foreign portfolio investment. They used monthly data on FII equity investments from 1993 to 2001. They found that FII investment had not resulted in increase in volatility in the Indian stock market. Mukherjee et al. (2002) suggested that FII inflows and outflows are caused by developments in Indian markets and not by those in markets abroad. To study the nature and determinants of foreign portfolio investment flows, Chakrabarti (2001) used monthly data on net FII investment. The results reveal that FII flows are correlated with contemporaneous returns in Indian markets.

Batra (2003), Ananthanarayanan et al. (2004), and Shah et al. (2006) tried to examine the impact of FPI on market volatility in India. They concluded that FPI did not destabilize Indian market.

3.Definition Of Portfolio Investment

Portfolio investment includes investments by a resident entity in onecountry in the equity and debt securities of an enterprise resident in anothercountry which seek primarily capital gains and do not necessarily reflect asignificant and lasting interest in the enterprise. The category includesinvestments in bonds, notes, money market instruments and financialderivatives other than those included under direct investment, or in otherwords, investments which are both below the ten per cent rule and do notinvolve affiliated enterprises. In addition to securities issued by enterprises,foreigners can also purchase sovereign bonds issued by governments.

According to the IMF's 1996 Coordinated Portfolio Investment SurveyGuide the essential characteristic of instruments classified as portfolioinstruments is that they are traded or tradable.Equity securities have been defined in the Survey as instruments and recordsacknowledging, after the claims of all creditors have been met, claims to theresidual values of incorporated enterprises (shares, stocks, participation,American

deposit receipts (ADRs), mutual funds, and investment trusts).Debt securities include bonds and notes, money market securities(instruments such as treasury bills, commercial and finance paper, negotiablecertificates of deposit with maturities of one year or less), and financialderivatives or secondary instruments, such as options. However, in thesurvey no guidelines or definitions were given for the recording of moneymarket instruments and financial derivatives.

4.Mindset Of Indian In General

India and the Indians have undergone a paradigm shift. There havebeen fundamental and irreversible changes in the economy,government policies, outlook of businessand industry, and in themindset of the Indians in general. From a shortage economy of foodand Foreign Exchange, India has now become a surplus one. From an agro basedeconomyit has emerged as a serviceoriented one. From the low-growth of the past, the economy hasbecome a high growth one in the long term. After having been an aidrecipient, India is now joining the aid givers club.Although India was late in modernization of industry in general in thepast, it is now a front-runnerin the emerging knowledge basednew economy.The government is continuing its reform and liberalization not out ofcompulsion but out of conviction. Indian companies are no longerafraid of multinational corporations.They have become globally competitiveand some of they havestarted becoming am MNCS themselves**.** Fatalismandcontentment of the Indian mind set have given way to optimism andambition. The Indian culture which looks down upon wealth as a sinand believed in the simple living and high thinking has startedrecognizing prosperity and success as acceptable and necessarygoals.

5.Need For FPI In Developing Countries Like India

- Infrastructure Renewal:To keep the Indian economy growing the infrastructure sector likepower, transport, mining & metallurgy, textiles, housing, retail, socialwelfare, medical etc. has to be upgraded. After the Enron fiasco, it isdifficult to persuade anybody in the west to take interest in any ofthese sectors. Hence India is left to its own devices to raise moneyand build this sector. Borrowing abroad supplemented with Indianresources is the only way open to India. This upgrade is needed prioror in step with the industrial and service exports sector growth. It hasto be placed on a higher priority. Only recently a suggestion to use asmall portion of India's foreign reserves met with howl of

protests. The protestors in the Indian Parliament did not understand theproposal. Hence the government is stuck to steam roller its proposalthrough the legislative process or succumb to political pressure anddo nothing. The latter is not acceptable.If India finds its own $4 Billion a year for infrastructure then foreigninvestors will kick in another similar portion. The resulting money willvery quickly rebuild the now cumbersome infrastructure.

- Bridge the technological gap:Developing countries have a very low level of technology.Theirtechnology is not up to the standards and they lack in moderntechnology. Developing countries possess a strong urge forindustrialization to develop their economies and to wriggle out of thelow-level equilibrium trap in which they are caught. This raises thenecessity for importing technologies from advanced countries. Suchtechnology usually comes with foreign capital.
- Optimum utilization of resources:A number of developing countries possess huge mineral resourceswhich are4 untapped and unexploited. Due to lack of technologythese countries are not able to use their resources to the fullest. As aresult they have to depend on the foreign investment with thehelp of which technology of the country and that will ultimately lead tothe optimum utilization of the resources. India has very huge reservesof mineral resources and to optimize their use or rather for extractingthem efficiently and effectively modern technology is required whichis possible through foreign investment.
- Balancing the balance of payment position:In the initial phase of economic development, the under developingcountries need much larger imports. As a result the balance ofpayment position generally turns adverse. This creates gap betweenearnings and foreign exchange. The foreign capital presents short runsolution to the problem. So in order to balance the Balance OfPayment Foreign Investment is needed.

6.Conclusion

Foreign Institutional Investments are very much needed for India. They are necessary for the continuous development of our country. The economy of our country has shown a better performance and has led to the economic growth due to the FIIs. Though there are threats from the Foreign Institutional Investments we should be positive and see the

future of our country. In last 50 years, India has developed a strong and professionally competent technical, marketing and business manpower in Livestock production and Information Technology.

This is an added advantage over many developing countries of Asia and Africa. Availability of competent and comparatively low-cost manpower in India is a great asset which is attracting foreign investors. As a result of stagnancy or in some cases reduction in agricultural production, demand for several inputs like machinery and equipment, feeds, pharmaceuticals etc. has reduced in some countries of America and Europe.

It is therefore not surprising that these business enterprises have focused their attention to emerging Asian markets, particularly India and China. India is in a better position as it has a strong technical manpower base and large number of English speaking population.

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.

7.Reference

1. 1.Agarwal, R.,.(1997). Foreign portfolio investment in some developing countries.A study of determinants and macroeconomic impact.Indian economic review32, 2, 217 – 229.
2. Ananthanarayanan, S., Krishnamurti, C., Sen, N., (2004). Foreign institutional investors and security returns: evidence from Indian stock exchanges.5-6, available at http://www.isb.edu /ISB-F/htmls/Sandhya&Sen.pdf.
3. Bathala, C., Sharma, J., (2003). The use of market based valuation measures in institutional investing: Evidence and implications for capital markets. Seventh Capital Market Conference of the Indian Institute of Capital Markets, Mumbai, India.
4. www.sebi.gov.in
5. www.rbi.in
6. www.wikipedia.org