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Volatility Trends and Their Relationship with FIIs in Indian Stock Market

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Abstract

The study pertains to India, which is one of the fast growing markets in the world. India is an appropriate case for conducting such a study, as portfolio investment has become the dominant path of foreign investment in the Indian economy. India liberalized its financial market and allowed FIIs to participate in their domestic markets in 1992. The opening up of the market resulted in a number of positive effects. First, the stock exchanges had to improve the quality of their trading and settlement procedures in line with the best practices of the world. Second, the transparency and information flows improved on account of the entry of FIIs in India. However, people are also sensing negative effects in the form of potential destabilization because of the bulk buying and selling activity of FIIs. The Bombay Stock Exchange (BSE) and National Stock Exchange (NSE) are two leading stock exchanges of India. The foreign institutional investors are investing in these markets. So, both of these markets have been taken to study the determinants of the foreign institutional investment in India. The National Stock Exchange was launched in 1992 and FIIs were also permitted to invest in Indian market in September 1992. Because of this the reference period for the study to investigate the impact of FIIs on stock market in India has been taken from January 1986 to December 2014. However, due to its non-existence the data on NSE prior to 1994 was not available. Hence, it was not appropriate to take National Stock Exchange data to ensure the impact of foreign institutional investors on stock market return and volatility. Therefore, to determine the impact of FIIs on Indian stock market (i.e. on return and volatility) Bombay Stock Exchange has been considered.

Keywords: *Economy, Foreign Institutional Investments (FIIs), Indian Stock Market, and Volatility.*

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1. INTRODUCTION

The Economic Development of any country depends upon the existence of well-organized financial markets. It is the financial system, which supplies the necessary financial inputs for the production of goods and services, which in turn promote the well-being and standard of living of the people of a country. Capital Market are of crucial significance to capital formation as the main function of these markets is the mobilization of savings and their distribution for the industrial investment, thereby stimulating the capital formation and to that extent, accelerating the process of economic growth. There are two broad segments of the financial market viz. the money market and the capital market. The money market deals with short-term debt, whereas the capital market deals with long-term debt and stock (Equity and Preference). Each of these markets has a primary segment and a secondary segment. New financial assets are issued in the primary market; whereas outstanding financial assets are traded in the secondary segment. Figure 1 depicts the components of the Indian Corporate Security Market. When a company wishes to raise capital by issuing securities or other entity intends to raise funds through units, debt instruments or bonds etc. it goes to the primary market, which is the segment of the capital market where issuers exchange securities for long run funds. The primary market facilitates the formation of capital. There are three ways in which a company may raise capital in the primary market: Public Issue, Right Issue and Private Placement.

The secondary market in India, where outstanding securities are traded consist of the stock exchanges, which are self-regulatory bodies under the overall regulatory purview of the government and Security Exchange Board of India (SEBI). The government has accorded powers to the SEBI, as an autonomous body, to oversee the functioning of the security market and the operations of the intermediaries like mutual funds, merchant bankers, underwriters, portfolio managers, debentures trustees, bankers to an issue, registrars to an issue, share transfer agents, stock brokers and sub-brokers, Foreign Institutional Investors (FIIs), and rating agencies.

1.1 FIIs and Stock Market: Appraisal of Manuscript

In the absence of adequate empirical evidence, the emergence of FIIs in stock market has been a debatable issue over the posh lobby of the Parliament to common man. While it is generally held that FII flows benefit the economies of recipients countries, policy makers worldwide have been more than a little uneasy about such investment. FII flows often referred, as "hot money" is notoriously volatile compared to other forms of capital flows. Investors are known to pull back portfolio investments at the slightest hint of trouble in the host country often leading to disastrous consequences to its economy. They have been blamed to lead economic problems in a country by making large and concentrated withdrawals at the first sign of economic weakness. They have also been held responsible for spreading financial crises- causing 'contagion' in international financial market. However, some of the economists have some other view about the impact of FII flows in the economy. The theories relating to impact of FII investment on underlying stock market have been advanced explaining contradictory conclusion. Even about the impact of the FIIs flows on stock market return, there are two views:

1. A 'Positive Feed Back Trading' hypothesis that says FIIs enter the market when there are some positive signals of higher stock return and withdraws when they perceive some negative information.

2. A 'Base broadening' hypothesis suggests that the expansion of the investor base by including foreign investors leads to increased diversification followed by reduced risk and consequently lowering the required risk premium. Thus, there is a permanent increase in the equity share price through risk pooling which is the signal of higher returns.

1.2 Foreign Institutional Investors

In this globalised age significant amount of capital is invested into developing economies from developed world. Significant amount of these investment are bought to developing economies by the way of portfolio investments by foreign institutional investors (FII).

Foreign institutional investors have gained a significant role in Indian capital markets. Availability of foreign capital depends on many firm specific factors other than economic development of the country. In this context this paper examines the contribution of foreign institutional investment particularly among companies included in sensitivity index (Sensex) of Bombay Stock Exchange. We also examined the relationship between foreign institutional investment and firm specific characteristics in terms of ownership structure, financial performance and stock performance. It is observed that foreign investors invested more in companies with a higher volume of shares owned by the general public. The promoters' holdings and the foreign investments are inversely related. Foreign investors choose the companies where family shareholding of promoters is not substantial. Among the financial performance variables the share returns and earnings per share are significant factors influencing their investment decision.

Since 1990-91, the Government of India embarked on liberalization and economic reforms with a view of bringing about rapid and substantial economic growth and move towards globalization of the economy. As a part of the reforms process, the Government under its New Industrial Policy revamped its foreign investment policy recognizing the growing importance of foreign direct investment as an instrument of technology transfer, augmentation of foreign exchange reserves and globalization of the Indian economy. Simultaneously, the Government, for the first time, permitted portfolio investments from abroad by foreign institutional investors in the Indian capital market. The entry of FIIs seems to be a follow up of the recommendation of the Narsimhan Committee Report on Financial System. While recommending their entry, the Committee, however, did not elaborate on the objectives of the suggested policy. The committee only suggested that the capital market should be gradually opened up to foreign portfolio investments. Foreign Direct Investment (FDI) and Foreign Institutional Investment are the investment done in the foreign country. FDI is an investment made by a father country in a foreign country, whereas, FII is the investment done by any investor on the makers of foreign country.

In FII, only the company registration is needed in the stock exchange in order to make investments but FDI has very different criteria to be fulfilled to make an FDI investment. People also say the hot burning money to foreign Institutional Investment because the FII investor has liberty to withdraw to sell at any time, but same thing is not possible in Foreign Direct Investment (FDI). In a simpler word, we can say that, it is very easy to enter the stock market through Foreign Institutional Investment whereas, things are not easier in Foreign Direct Investment. FDI is highly preferred to the FII as they are considered to be the most beneficial kind of foreign investment for

the whole economy of the nation. This is the actual reason for which nations choose FDI's more than FIIs.

Foreign Direct Investment (FDI) flows into a company's assets, fuels production, employment, taxes and growth, etc. Whereas Foreign Institutional Investment (FII) flows into the secondary market, that is, stock exchanges. While both are important, FDI has a special importance for a developing country such as India. The FIIs, has added depth and substance stock market.

Table No. 1: FIIs INVESTMENT IN INDIA

Gross in Rupees Crore			Net		
Year	**Purchase**	**Sale**	**Rupees in Crore**	**Millions of US Dollars**	**Cumulative in millions of US Dollars**
1992-93	17	4	14	4	4
1993-94	5593	467	5126	1634	1638
1994-95	7631	2835	4796	1528	3167
1995-96	9694	2752	6942	2036	5202
1996-97	15554	6980	8575	2432	7635
1997-98	18695	12737	5958	1650	9285
1998-99	16116	17699	-1584	-386	8899
1999-00	56857	46735	10122	2474	11373
2000-01	74051	64118	9933	2160	13532
2001-02	50071	41308	8763	1839	15372
2002-03	47062	44372	2689	566	15937
2003-04	144855	99091	45764	10005	25943
2004-05	216951	171071	45880	10352	36294
2005-06	346976	305509	41467	9363	45657
2006-07	520506	489665	30841	6820	52477
2007-08	948018	881839	66179	16442	68919
2008-09	614576	660386	-45811	-9837	59081
2009-10	846468	703780	142658	30251	89333
2010-11	992599	846161	146438	32226	121559
2011-12	921285	837562	93725	18923	140482
2012-13	904845	736481	168367	31047	171529
2013-14	1021010	969361	51649	8876	180405

Source: Annual Reports of SEBI

The gross purchases of equity by FIIs increased by 12.8 percent to Rs. 10,21,010 crore in 2013-14 from Rs. 9,04,845 crore in 2012-13. The combined gross sales by FIIs also increased by 31.6 percent to Rs. 9,69,361 crore from Rs. 7,36,481 crore during the same period in previous year. The total net investment of FII was Rs. 51,649 crore as compared to of Rs. 1,68,367 crore in 2012-13. This was the lowest net FII investments into Indian securities market in the last five financial year so far. Cumulative investment by FIIs at acquisition cost, which was US$ 1,71,529 million at the end of March, 2013, increased to US$ 1,80,405 million at the end of March, 2014. During 2013-14, FIIs invested Rs. 79,709 crore in equity and Rs. (-) 28,060 crore in debt as compared to an investment of

Rs. 1,40,033 crore in equity and Rs. 28,334 crore in debt during 2012-13 respectively. Month-wise, the net FII investment was the highest in equity segment in May, 2013 (Rs. 22,169 crore) followed by March, 2014 (Rs. 20,077 crore) and December, 2013 (Rs. 16,086 crore). In debt segment, FII investment was the highest in January, 2014 (Rs. 12,609 crore) followed by March, 2014 (Rs. 11,586 crore) and February, 2014 (Rs. 11,337 crore).

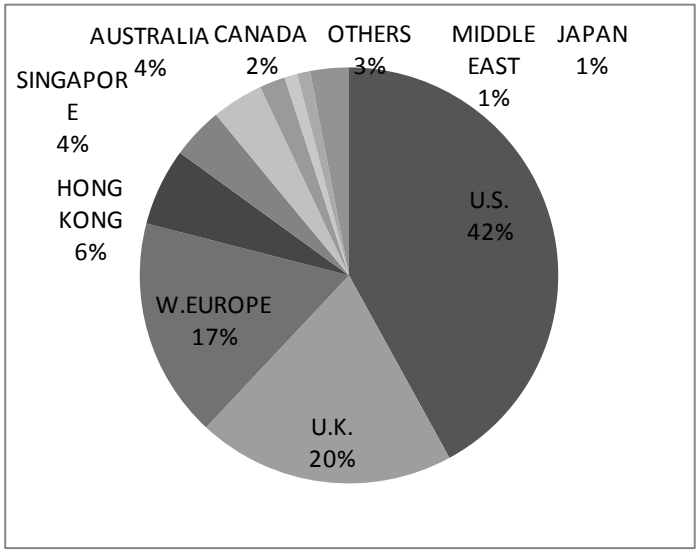
Table No. 2: FIIs REGISTERED IN INDIA

Financial Year	During the Year	Total Registered at the End of the Year
1992-93	0	0
1993-94	3	3
1994-95	153	156
1995-96	197	353
1996-97	99	439
1997-98	59	496
1998-99	59	450
1999-00	56	506
2000-01	84	528
2001-02	48	490
2002-03	51	502
2003-04	86	540
2004-05	145	685
2005-06	131	803
2006-07	190	993
2007-08	326	1319
2008-09	316	1635
2009-10	78	1713
2010-11	9	1722
2011-12	43	1765
2012-13	23	1874
2013-14	12	1923

Source: Annual Reports of SEBI

The diversity of FIIs has been increasing with the number of the registered FIIs in India steadily rising over the years as shown in the table 2. In 2004-05, 145 new FIIs were registered with the Securities and Exchange Board of India and as on March 31, 2005, there were 685 FIIs registered in India. The names of some prominent FIIs registered during 2011-12 are: California Public Employees Retirement System (CalPERS), United Nations for and on behalf of the United Nation Joint Staff Pension Fund, Public School Retirement System of Missouri, Commonwealth of Massachusetts Pension Reserve Investment Trust, Treasure of the State North Carolina Equity Investment Fund Pooled Trust, the Growth Fund of America and AIM Funds Management Inc. At the end of the financial year 2013-2014 the Total No of FIIs registered with SEBI was 1923.

Figure No. 1: SOURCE OF FIIs IN INDIA



It is obvious from above figure that, in term of the country of origin, the USA topped the list with a share of 42 percent of the number of FIIs registered in India, followed by UK's 20 percent. Beside UK, and US other investing countries include Luxemburg, Hong Kong, Australia and Singapore. European and Japanese FIIs have also started taking an increasing interest in India and of the FIIs that registered with SEBI in October 2014, a significant number belonged to them. These developments have helped to improve the diversity of the set of FIIs operating in India.

Foreign institutional investors have always remained the hot issue of the debate and discussion world over. India is not exception to this controversy and the issue has become more important among the economist, regulators, researchers and academicians due to the beginning of sub-prime crisis in US.

The questions which are generally raised about the FIIs investments include:

1. How do the foreign portfolio investments affect the stock market and economy of the host country (India)?
2. What determines the quantum of capital flows from FIIs?

Someone has rightly said "Don't use the theory unless you understand the principles. Use whatever you learn." As the FIIs are the current issue so it is the right time to revisit the status and issues regarding the foreign institutional investment in Indian Stock Market.

2. OBJECTIVES OF THE STUDY

The broad objective of the study is to analyze the impact of foreign institutional investors investment on Indian stock market. The specific objectives of the study are as follows:

- To study the role of FIIs in Indian stock markets.
- To ascertain the volatility in the share prices with the construction mode of various stock market indices.
- to suggest ways and means for proper operations of FIIs in India.

3. HYPOTHESIS

Keeping in view the above-mentioned objectives of the study, it was intended to test the following hypotheses:

a) h_0 = There is no change in market volatility after the introduction of FIIs investment;

b) h_1 = There is no relation between the trade volume in Indian stock market and FIIs investment; and

There is no impact of arrival of foreign institutional investors on the Indian stock market capitalization.

4. DATABASE

To achieve the various objectives of the study, we utilized the secondary data on various parameters pertaining to stock markets and economy of both India and US. These parameters include daily as well as monthly opening and closing index value, trading volume and market capitalization. The reference period for the study ranges from January 1986 to December 2014. In order to determine the impact of foreign institutional investments on return and volatility of Indian stock market return the study period is sub-divided into pre and post FIIs period. The period from January 1986 to August 1992 denotes the pre FIIs arrival period and the period from September 1992 to March 2014 denotes the Post FIIs arrival period. The requisite data was collected from the various websites such as http://finance.yahoo.com, http://scholar.google.com, www.allstocks.com, www.bseindia. com, www.cmie.com, www.icraratings.com, www.masci.com, www.moneybhai.com, www.nseindia.com, www.rbi.org,in etc. Further publications of Security and Exchange Board of India (SEBI), National Stock Exchange (NSE) and Bombay Stock Exchange (BSE) etc. were used to collect other related and useful information. PROWESS database maintained by the CMIE (Center for Monitoring Indian Economy) remained an important source of data relating to study.

4.1 Statistical and Econometric Tools

The statistical tools applied to analyze the data include percentage, ratios, arithmetic mean, standard deviation, maximum, minimum, kurtosis, skewness, simple and multiple regression, compound annual growth rate, two-tailed T-test and F-test. The structure regression techniques namely: GARCH model is the econometric tools applied for the analysis.

5. REVIEW OF LITERATURE

Investment of FIIs are motivated not only by the domestic and external economic conditions but also by short run expectations shaped primarily by what is known as market sentiment. The element of speculation and high mobility in FII investment can increase the volatility of stock return in emerging markets. In fact, a widely held perception among academicians and practitioners about the emerging equity markets is that price or return indices in these markets are frequently subject to extended deviations from fundamental values with subsequent reversals and that these swings are in large part due to the influence of highly mobile foreign capital. Volatility is an unattractive feature that has adverse implications for decisions pertaining to the effective allocation of resources and, therefore, investment. Volatility makes investors averse to holding stock due to increased uncertainty. Investors in turn demand higher risk premium so as to ensure against increased uncertainty. A greater risk premium implies higher cost of capital and

consequently lowers physical investment. In addition, great volatility may increase the "option to wait" thereby delaying investment. Also weak regulatory system in emerging market economies (EMEs) reduce the efficiency of market signals and the processing of information, which further magnifies the problem of volatility. But some researchers have the opposite assumption of non-disestablishing hypothesis that says FIIs have no adverse impact on the market volatility. The conclusion about the impact of FIIs activities on the volatility of India's stock market are rather divided: some studies like Karmakar, Madhusudan (2006); Porwal and Gupta (2006); Upadhyay, Saroj(2006); Bhattacharya and Jaydeep (2005); Biswas, Joydeep (2005); Pal, Parthapratim (2005); Rai and Bhunumurthy (2004); Singh, Sharwan Kumar (2004) and Batra (2003) find evidences of higher volatility in the market due to the arrivals of FIIs. On the other hand, Banerjee and Sarkar(2006), Biswas, Jaydeep(2006), Mohan, T.T.Ram (2006), and Kim and Singal (1993) do not find any destabilizing impact on stock prices. Even some researchers such as S.S.S. Kumar (2000) have the view that the FIIs reduce stock market volatility. Trading by FIIs happens on a continuous basis and, therefore, has a lasting impact on the local stock market. There is, however, surprisingly little empirical evidence on the impact of FIIs trading on the host country's stock return volatility, thereby making it imperative that this aspect of local equity markets, which is important for both risk analysis and portfolio construction, be examined. This paper attempts to fill the gap. Beside the introduction, this paper is classified into two parts. Part I presents the impact of foreign institutional investors on the Indian stock market volatility (refer point 6). Part II shows the structure of the volatility before and after introduction of the foreign institutional investors in Indian stock market (refer point 7).

6. FINDINGS CONCERNING IMPACT OF FIIS ON VOLATILITY

Regarding the impact of FIIs on volatility of Indian stock market, the study revealed a signification decrease in the volatility after introduction of the foreign institutional investment in India. But this can't be attributed exclusively to FIIs arrival since after their entry the Government of India and SEBI have initiated a number of reforms to ensure operational as well as informational efficiency. Thus, decrease in volatility may be caused by these reforms also. To make an in-depth investigation, we also used GARCH, an econometric technique.

The use of GARCH technique to find out the impact of FIIs on stock market volatility brought out that the past volatility as indicated by the GARCH (1) and recent news indicated by the ARCH (1) coefficient have had a significant bearing on the volatility. However, the effect of the recent news is found higher than the historical volatility. It refers that shocks to conditional variance take a long time to die out in Indian market. The foreign institutional investments have significant negative impact on the stock market volatility which implies that after introduction of foreign institutional investment in India, our stock market has been strengthened and has become more disciplined as the fluctuations have decreased adequately. The impact of the recent news as measured by the ARCH (1) has increased after the arrival of the foreign institutional investors in Indian market. It means information is quickly disseminated and quality of information has improved after arrival of the foreign institutional investors.

The analysis carried on the monthly basis data offered that The GARCH term is significantly associated with the stock market volatility. It implies that historical volatility leads future volatility. ARCH term is found insignificant. FII investment also turned insignificant this time. So

we can conclude that regulations by the SEBI on stock market during the liberalization period have led to the reduction in the volatility in post FIIs arrival period. However, as the specific impact of the FII investments have turned insignificant, hence, it can be concluded that foreign institutional investments have no impact on Indian stock market volatility.

Table No. 3: RESULT OF FISHER F- TEST

Series	Mean	S.D.	Variance(S^2)	No.of Obs.
Pre – liberalization 01 : 1986 – 08 : 1992	.1539	2.1598	4.6647	1395
Post – liberalization 09 : 1992 – 12 : 2014	.0634	1.6013	2.5642	3661
	F-Value (1394, 3660)		1.8192	
	Table Value (1394, 3660)		1	

After examining the volatility of stock market with the use of traditional measures, we applied econometric model named as GARCH. More, specifically we used the GARCH (1) model. The dummy variable was introduced in the GARCH equation in order to measure the impact of FIIs. To specify the GARCH model two equations have to be specified. One is the mean equation and the second is the variance equation. The mean equation is as follows:

$$BSE_t = a + b_1\ R\_BSE + b_2\ S\&P + b_3\ R\_S\&P + b_4\ EXCHAGE\ RATE + b_5\ FBIR + b_6\ IIP + B_7\ TBR\_IND + e_t \text{------(1)}$$

Where BSE_t = Return at Bombay Stock Exchange
a = Intercept
$b_1, b_2, b_3 \ldots\ldots b_7$ = Coefficients
R_BSE = Risk at Bombay Stock Exchange
S&P = Return of Standard and Poor 500
R_S&P = Risk at Standard and Poor 500
EXCHAGE RATE = Exchange Rate US $ v/s Indian Rupee
FBIR = Federal Bank Three Months Treasury Bills Rate
IIP = Index of Industrial Production
TBR_IND = Interest Rate of Indian 3 Months Treasury Bills in India
e_t = Error Term

Second equation used is the variance equation of the following form:

$$h_t = w + a_i e^2_{t-1} + b_i\ h_{t-j} + \Psi FII \quad \text{----(2)}$$

Where **h_t** is the conditional variance at period **t**. In equation (2) first term after the intercept w is the ARCH term, which shows the effect of recent news on the volatility of the underlying stock market by putting the square of previous error term. And second term is the GARCH term, which shows the effect of previous volatility on the current volatility. And DFII is showing the impact of the dummy variable on the volatility in the return of underlying stock market, which is BSE in case of the present study. The empirical results in this regard are reported in next table.

Table No. 4: Impact of Introduction of Foreign Institutional Investors on Volatility of BSE (Analysis of Daily Data)

Variable	Coefficient	Standard Error	Prob.
Constant	0.0000166	0.00000163	0.0000
ARCH (1)	0.121213	0.007309	0.0000
GARCH (1)	0.845663	.008074	0.0000
FIIs Dummy	-.00000752	.00000118	0.0000

7. STRUCTURE OF VOLATILITY BEFORE AND AFTER ARRIVAL OF FIIS

After an investigation into the impact of FII flows on stock market return instability an attempt is made to analyze changes in the structure of the instability. To determine the structure of the volatility into Indian stock market we classified the data into four parts (i) before the announcement of permission granted to the foreign institutional investors [from January 1986 to August 1992] (ii) after announcement of permission granted to the foreign institutional investors [i.e. September 1992 to December 2007] (iii) before the arrival of the foreign institutional investors [from January 1986 to September 1992] and (iv) after the arrival of the foreign institutional investors[i.e. October 1992 to December 2014]. The structure of the Volatility is searched by using the GARCH (1) model, the equation for the same is as follows:

$$h_t = w + a_i e^2_{t-1} + b_i h_{t-j}\text{----l} \qquad \text{----(3)}$$

where the first term after intercept is the ARCH term and second term is the GARCH term and the results of the same are given in Table 5. The table reveals that the coefficients of ARCH and GARCH for the entire period of the study are 0.1655 and 0.7794 respectively. Note worthy is that both of these coefficients are significant at 1 percent level. It means recent past news about the volatility have a significant bearing on the stock market volatility. The magnitude of the GARCH (1) is comparatively higher and statistically significant which indicates the tendency of volatility clustering. It means past volatility affects current volatility in a significant manner. By this we can conclude that the historical information affect the stock market in a significant way and shock to conditional variance take a long time to die out in Indian market.

Table No. 5: Pattern of Stock Market Volatility in India

Variable	Statistics	Constant	ARCH (1)	GARCH (1)
Pre – liberalization 01 : 1986 – 08 : 1992	Coefficient	.0000169	.116949	.846768
	Probability	.0000000	.000000	.000000
Post – liberalization 09 : 1992 – 12 : 2007	Coefficient	.0000485	.167302	.612751
	Probability	.0000000	.000000	.000000
Pre – liberalization 01 : 1986 – 10 : 1992	Coefficient	.0000138	.098115	.870536
	Probability	.0000000	.000000	.000000
Post – liberalization 11 : 1992 – 12 : 2014	Coefficient	.0000129	.155620	.800390
	Probability	.0000000	.000000	.000000
Whole Period 01 : 1986 – 12:2014	Coefficient	.0000178	.165501	.779462
	Probability	.0000000	.000000	.000000

Table also shows the ARCH (1) and GARCH (1) estimates before and after the announcement and entry of the foreign institutional investors in Indian stock market. In case of pre-announcement

ARCH (1) and GARCH (1) values are 0.1169 and 0.8467 respectively while in post announcement period the former coefficient has increased to 0.1673 and later component has declined to 0.6128. It indicates that impact of recent news about the volatility has increased after the introduction of foreign institutional investors in Indian stock market. The phenomenon is the same in case of the real entry of the foreign institutional investors in the Indian stock market. ARCH (1) value has increased from 0.0981 to 0.1556 and GARCH (1) value decreased from 0.8705 to 0.8004. Simply speaking, the information is quickly disseminated and quality of information has improved in the market in the post liberalization period.

8. CONCLUSION

The study has offered numerous useful points based on which policy makers may find a path to strengthen the Indian capital market in general and stock market in particular. Here we have made some suggestion based on the findings on this study in this regard.

First, Indian equity market return is found as the prime mover of the FII net flows into India. Hence, the rate of FII flows into the country would be governed by the performance of the domestic equity market and/ or foreign investors expectations about this performance. Given the fact that a drop of return in the Indian equity market may result in sudden massive withdrawals of FII, which may result in quite disturbing consequence on the country's economy. Similarly, the rise in return would attract a lot of foreign capital to India. The above behavior of FIIs would cause variation in the country's foreign exchange reserve and to some extent, and then they may be outside the monetary authority's control as is being observed in the last quarter of the previous year. Policy implications of the findings just mentioned above are that a move towards a more liberalized regime in the emerging market economies like India should be accompanied by the further improvements in the regulatory system of the financial sector. For instance, the policy makers in India should stop justifying the need of capital account convertibility without considering its side effects. India could survive in the midst of Asian crisis 1997 simply because of its proper foreign exchange regulations. The same need to be stressed in future too. While liberalizing capital account, they (policy makers) must come up with genuine grounds.

Second, concerning the impact of FIIs on volatility of stock market return, there prevails an opinion that they destabilize the market. But, this study provides vice-versa findings. It puts forward that FIIs are not 'villains' as our study suggested no impact of foreign institutional investors arrival on Indian stock market. In most of the market crashes which took place after arrival of FIIs, they were net buyers. For instance, in case of 17 May 2004 Black Monday episode, FIIs were not the culprits. Though there was a net outgo; there was also a comeback in the next month June as a net inflow. Thus, we argued that FIIs tend to support stock market purely to ensure stability and safety of their own investments and supports the broad base hypotheses. FIIs add liquidity to the local market and reduce volatility. So it would be beneficial for the India to promote FIIs.

Next, in order to stimulate FII flows, the government must set up FII investments caps over and above the FDI sectoral limits. In cases, where the limits have to be combined, they should be sufficiently at high levels. FII flows may be encouraged by greater volume of issuance of, good quality equities in the Indian market. This would be assisted by public sector units disinvestments. As it has been seen in the case of the initial public offering (IPOs) of Gas

Authority of India Limited (GAIL), Oil and Natural Gas Corporation (ONGC) and National Thermal Power Corporation (NTPC), the response of institutional investors including FIIs registered with SEBI was extremely positive.

We further suggest that in order to attract the portfolio investment and retain the confidence of them, the Indian government must follow stable macro-economic policies. The fact is that developing countries such as India have their own compulsions arising out of the very state of their social, political and economic development. FIIs view the domestic situations from their own point of view. So both ruling and opposite parties, legislatures and other responsible leaders must refrain on their speech while talking about the issues of national importance like foreign capital, 123 nuclear treaty with US, inflationary scenario etc.

It is also suggested that The SEBI must follow the "Know your Client" principle and have information about the end-investors. So that proper implementation of policies can be ensured. Last suggestion is that the regulatory authority must look into alleged restrictive practices by FIIs like price rigging. Once this is achieved, a built-in –cushion against possible destabilizing effects of sudden reversal of foreign inflows might drop. Only then it would be possible to reap fully the benefits of capital market integration.

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