

Foreign Institutional Investment and Stock Market Returns in India: Evidence from ARDL Bounds Testing Approach

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The paper uses Autoregressive Distributed Lag (ARDL) bounds testing approach to examine the dynamic behaviour of net foreign institutional investment flows on stock market returns in India for the daily data series from 1st July, 1999 to 28th February, 2009. By and large, the analysis reveals that there is an evidence of positive and negative feedback trading hypothesis in the short-run and long-run respectively. This implies that foreign institutional investment acts as destabilising forces in the short-run and has a smoothening effect in the long-run.

I Introduction

With the advent of globalisation, there have been massive Foreign Institutional Investment (FII) flows into emerging equity markets like India during the past two decades. Foreign equity investment is widely viewed as one of the principal vehicles for obtaining the capital easier by the start-up companies as well as existing companies. The foreign investors' participation also increases the liquidity of local markets, makes the base of investor broader, increases risk sharing, and thus lowers the cost of capital for investment. Further, the foreign investors' demand for higher investment leads to better rules and regulations in local markets. These rules primarily relate to information quality and higher accounting standards (Evans 2002). Hence, financial markets become more transparent by the participation of foreigners, leading to better allocation of resources and healthier financial markets.

The other side of the argument is that foreign portfolio flows may exert a destabilising influence on emerging market economies. Foreign investors were often blamed for the dramatic difficulties of the East Asian countries and for the collapse of their currencies and stock markets. For instance, Stiglitz (1998) has called for greater regulation of capital flows as the developing countries are now more vulnerable to vacillations in international flows than ever before. Dornbusch and Park (1995) have argue that foreign investors pursue positive feedback trading strategies that make stock price overreact to changes in fundamentals and such trading strategies may cause bubbles and crashes in local

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The authors are thankful to the anonymous referees, who gave valuable comments and suggestions on the earlier draft of the paper.