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Factors Influencing International Institutional Investments: A Case Study of the 21st Century India

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ABSTRACT

At the turn of the 21st century, globalization of developed and developing countries in the world witnessed institutional inflows from international investors which became the main characteristic of global capital markets. The current research has assessed time-series data from 2000 to 2017 to understand how the different elements that have influenced the foreign institutional investments and helped India become a global market for such investors. The results revealed that political risk, financial market development, trade openness of the country, size of the economy, and rate of return on investment are the important determinants in attracting foreign institutional investments in India. The chapter also found economic risk and financial market risk played an insignificant role in determining foreign institutional investment in India. The findings of the research help the present government and market regulators to introduce policies aimed at increasing the flow of funds from international institutional investors.

INTRODUCTION

International trade had created pathways among countries but in the beginning of the twenty-first century, true globalization took birth as the world witnessed institutional capital flows from investors irrespective of geography, which became the main characteristic of global capital markets. Earlier the international capital markets were narrow in scope due to geographical limitations but with the technological and institutional developments, the capital markets matured both locally and globally. The wave of globalization was experienced by India in the 1990s when the financial crisis in Indian economy forced the country to open its gates to foreign portfolio investors in September 1992. Since the globalization of Indian economy, international institutional investors have been playing a major role in the Indian economy and are the prime source to foreign portfolio investments. These international institutional investors are often referred as foreign institutional investors and are defined as those entities which are based outside Indian Territory and invest in securities and other financial assets of the country. These entities can be pension funds, university funds, endowments and charitable trusts etc. and are regulated by the Securities and exchange board of India (SEBI) and the Reserve bank of India (RBI). Foreign institutional investors have been able to give an upward thrust to the prices of the domestic stock market and boost the quantitative as well as qualitative developments. Foreign investors help to reduce the cost of capital for firms in host country as they increase the demand for domestic stocks. This increase in demand for domestic stocks causes an upsurge in equity prices thereby lowering the cost of capital for firms (Fischer, 1995). Literature substantiates the positive influence of FIIs trading behaviour on stock markets of different countries (Dornbusch and Park, 1995; Banaji, 2000; Richards, 2002; Mohan, 2006; Upadhyay, 2006).

The international finance theory states that inflows from foreign institutional investors are an outcome of the risk diversification by portfolio managers holding investments in different countries. The foreign investors while investing in a country take into consideration multiple factors before making an investment. Factors, such as country risk and currency risk in the host country other than the risk related to the company have to be taken into consideration by foreign investors before channeling their investments. Country risk is the risk related to investing in a particular country and the country's ability or inability to repay its financial obligations. (Taffler and Abassi, 1984) have defined country risk as the inability of a country to repay its' external debt. External debt is the debt in the form of sovereign debt or loans given to public sector or private sector by non-residents which have to be repaid by the borrower country's government in foreign currency, goods and services. International Country Risk Guide (2012), has encapsulated country risk into three types - economic, political and financial risk. If a country is rated with a high risk it implies a risk in its political, economic and social environment. The risks in home and host country can lead to new problems on the macroeconomic front and cause sudden exit of foreign flows from a country, thereby altering its balance of payment position and destabilizing its exchange rate. The Asian crisis is an example of the adverse impact of volatile foreign investments on the balance of payment position of major Asian countries.

Some governments have blamed FIIs for the increase in market volatility and disruption in their capital markets. Previous studies have demonstrated that the influx of FIIs have led to higher volatility in the markets (Rai and Bhanumurthy, 2004; Porwal et al., 2005; Chittedi, 2008). The entry of FIIs resulted in the increased uncertainty in the markets of host country as FIIs are more speculative and may have huge unfavorable impact on the markets of developing countries (Pal, 1998). Thus, FIIs have been criticized for their short-term nature and are notoriously called "Hot Money".

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