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The Role of Foreign Institutional Investors (FIIs) in the Economic Development of India

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Abstract: *Foreign Institutional Investors (FIIs) have been one of the most consequential and most contested actors in India's post-liberalisation growth story. Opened to foreign portfolio capital on 14 September 1992, the Indian securities market absorbed cumulative net FII/FPI investment running into several lakh crore rupees over the following quarter-century, while simultaneously enduring some of the sharpest reversals witnessed by any large emerging market of the period. This article synthesises secondary data, from the Securities and Exchange Board of India (SEBI), the Reserve Bank of India (RBI), the Department for Promotion of Industry and Internal Trade (DPIIT, Office of the Economic Adviser), the Bombay Stock Exchange (BSE), and the National Stock Exchange (NSE) to examine three interlocking questions: the trend and phase-wise pattern of FII inflows between 1992 and 2018; the empirical relationship between FII activity and the growth, depth and volatility of Indian capital markets up to 2018; and the transmission channels through which portfolio capital contributed to investment, industrial growth and employment over this period. Using descriptive statistics, correlation analysis, and a review of GARCH-based volatility studies published up to 2018, the article documents a strong positive association between monthly net FII flows and Sensex/Nifty returns, an asymmetric 'leverage effect' whereby FII selling raised volatility more than equivalent buying lowered it, and the beginnings of a domestic shock-absorption mechanism in which Domestic Institutional Investors (DIIs) cushioned the January 2008 global-crisis outflow and, a decade later, the February 2018 and September-October 2018 outflows triggered by the reintroduction of Long-Term Capital Gains (LTCG) tax and the IL&FS liquidity crisis. The article further shows that FII's contribution to Gross Fixed Capital Formation over this period was indirect rather than direct, operating chiefly by lowering the cost of equity capital, and that its employment effect was diffused through corporate capital-expenditure cycles rather than immediate job creation. The article concludes with policy recommendations, framed as of 2018, on deepening the domestic institutional base, widening the debt-FPI route, and strengthening SEBI-RBI macro-prudential surveillance of 'hot money' reversals.*

Keywords: Foreign Institutional Investors; Foreign Portfolio Investors; Indian capital market; capital flows; market volatility; Domestic Institutional Investors; economic development.

I. INTRODUCTION

1.1 Background

India entered the 1990s facing its most severe balance-of-payments crisis since independence. By June 1991, foreign exchange reserves had fallen to barely three weeks of import cover, external debt-servicing obligations were mounting, and the country was forced to pledge gold reserves to secure emergency liquidity. The crisis exposed the structural fragility of a growth model financed overwhelmingly through external commercial borrowing and concessional development assistance — both debt-creating flows that raised the country's external liabilities without directly building its equity capital base. The New Economic Policy of July 1991 initiated a decisive shift in India's external financing strategy: from a reliance on debt-creating flows (external commercial borrowings, bilateral and multilateral aid) toward non-debt-creating capital flows — principally Foreign Direct Investment (FDI) and Foreign Institutional Investment (FII) — that finance the current account deficit without adding to sovereign or corporate debt-servicing burdens. Unlike debt, portfolio equity investment shares investment risk with the foreign investor rather than transferring it wholly to the domestic borrower, making it, in principle, a more resilient source of external financing during downturns.

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It was against this backdrop that the Narasimham Committee on the Financial System (1991) and subsequent capital-account liberalisation measures recommended opening the domestic capital market to foreign portfolio participants, culminating in the formal admission of FIIs into Indian equities in September 1992.

1.2 Legislative and Regulatory History

The Government of India formally opened the Indian securities market to Foreign Institutional Investors on 14 September 1992, permitting registered foreign entities — pension funds, mutual funds, investment trusts, asset management companies, and incorporated institutional portfolio managers — to invest in listed Indian securities subject to SEBI registration and RBI's Exchange Control Regulations, the regulatory architecture evolved through two broad stages:

- SEBI (FII) Regulations, 1995: The first comprehensive regulatory code governing FII registration, sub-account structures, investment ceilings (initially 24% of a company's paid-up capital, later raisable to the sectoral FDI cap with board and shareholder approval), and reporting obligations. This regime formalised custodial, disclosure and KYC requirements and remained the operative framework for close to two decades.
- Transition to the unified Foreign Portfolio Investor (FPI) framework, 2014: The SEBI (Foreign Portfolio Investors) Regulations, 2014 merged three previously distinct investor categories — FIIs, Qualified Foreign Investors (QFIs), and sub-accounts — into a single, risk-graded FPI class operating through a common Custodian-cum-Depository Participant route. The reform reduced registration friction and aligned Indian practice with global portfolio-investor classification norms; by 2018, the great majority of foreign portfolio flows into India were being recorded under this unified FPI regime, even though market usage of the older term 'FII' persisted.

Alongside this equity-market architecture, the Reserve Bank of India progressively widened the ceilings for FPI investment in Government Securities (G-Secs), State Development Loans, and corporate bonds through its periodic Medium Term Framework for FPI debt limits (introduced in 2015-16) and successive Master Directions on Foreign Investment in India, gradually enlarging the debt-market channel available to foreign portfolio capital over the years leading up to 2018.

1.3 The Conceptual Framework

This study situates FII activity within the standard 'push-pull' framework of international capital flows (Calvo, Leiderman, & Reinhart, 1993; Fratzscher, 2012). 'Push' factors — global liquidity conditions, US Federal Reserve interest-rate cycles, and global risk appetite — determine the aggregate supply of footloose capital seeking emerging-market yield. 'Pull' factors — India's GDP growth differential, corporate earnings trajectory, exchange-rate stability, fiscal and current-account balances, and sovereign credit rating — determine India's relative share of that global pool. The framework is complemented by the Efficient Market and Feedback-Trading hypotheses, which frame FII activity alternately as informed capital that improves price discovery and market efficiency, or as momentum-driven 'feedback trading' that amplifies price swings (Nofsinger & Sias, 1999). The conceptual model guiding the empirical analysis in Section 4 therefore treats FII net flows as both a dependent variable (explained by push-pull macro factors) and an independent variable (explaining market returns, volatility, and — through the cost-of-capital channel — real investment, 2018).

1.4 The Statement of the Problem

A persistent tension runs through both policy discourse and academic literature on FII: is foreign portfolio capital a volatile, short-horizon 'hot money' that destabilizes a capital-scarce developing economy, or is it an indispensable catalyst that deepens markets, lowers the cost of capital, and substitutes for debt-creating external finance? The 'hot money' view (Claessens, Dooley, & Warner, 1995) emphasises the reversibility of portfolio flows — as starkly illustrated by the January 2008 global-crisis outflow (₹29,447 crore withdrawn in a single month), the 2008-09 full-year net outflow of ₹45,811 crore during the Lehman Brothers crisis, the 2013 Taper Tantrum, and the 2018 outflow cycle triggered first by the Union Budget's reintroduction of Long-Term Capital Gains (LTCG) tax and later by the IL&FS liquidity crisis — and the associated risk of currency depreciation, forced-sale asset price declines, and contagion. The

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'capital catalyst' view emphasizes FII's contribution to market liquidity, corporate governance discipline, valuation efficiency, and — critically for a capital-scarce economy — the financing of the current account deficit without accumulating sovereign debt. This article's central problem is therefore to adjudicate empirically, using India-specific data, where the balance of evidence lies, and what this implies for the design of India's capital-account and macro-prudential policy as it stood at the end of this period.

1.5 The Significance of the Study

The study is significant for three constituencies. For policymakers at SEBI, RBI, and the Ministry of Finance, it offers an evidence base — drawn entirely from the experience — for calibrating FPI debt and equity ceilings and macro-prudential circuit-breakers. For market participants and corporate treasurers, it clarifies the transmission channel through which foreign flows affected the cost of equity capital and, hence, corporate financing decisions during India's first quarter-century of capital-account opening. For the academic literature, it consolidates the FII-volatility-growth nexus using data and peer-reviewed evidence available up to 2018, a natural inflection point given the year's dual shocks — the LTCG tax reintroduction in February and the IL&FS-triggered liquidity crisis from September — which together mark the most significant stress test for India's institutional-investor ecosystem in the years immediately preceding this study's cut-off.

1.6 Research Questions

RQ1: What were the trends and patterns of Foreign Institutional Investors (FIIs) inflows into the Indian economy?
RQ2: How did Foreign Institutional Investors (FIIs) influence the growth and performance of the Indian capital market over this period?
RQ3: To what extent did Foreign Institutional Investors (FIIs) contribute to India's economic development in terms of investment, employment, and industrial growth?

1.7 Research Objectives

O1: To examine the trends and patterns of Foreign Institutional Investors (FIIs) inflows into the Indian economy.
O2: To analyze the impact of Foreign Institutional Investors (FIIs) on the growth and performance of the Indian capital market.
O3: To evaluate the contribution of Foreign Institutional Investors (FIIs) to India's economic development in terms of investment, employment, and industrial growth.

II. REVIEW OF RELATED LITERATURE

Chandra (2012), publishing in the Journal of Indian Business Research, examined the cause-and-effect relationship between FII trading behaviour and Indian stock market returns. Using Granger causality tests on daily FII net investment and index return data, the study found bidirectional causality between FII flows and contemporaneous market returns, concluding that while FIIs are attracted by rising markets (a 'return-chasing' pattern), their subsequent buying itself further propels index returns — a feedback loop directly relevant to the leverage-effect discussion.

Garg and Mitra (2015), in Decision (the journal of IIM Calcutta), studied the lead-lag relationship between FII herding behaviour and stock market returns across several emerging economies including India. They found that FII herding intensified during periods of heightened global uncertainty and that herding-driven flows led, rather than followed, market returns in the short run — evidence that informs this article's discussion of momentum-driven flow patterns during the 2013 Taper Tantrum and the stress episodes.

Dhingra, Gandhi, and Bulsara (2016), in the IIMB Management Review, conducted an empirical analysis of the dynamic interactions between foreign institutional investment, Indian stock market returns, and volatility using Vector Autoregression (VAR) and GARCH-family models over a multi-year sample. They found a statistically significant bidirectional relationship between FII flows and market returns, and confirmed that FII flow volatility Granger-caused stock market return volatility rather than the reverse — a finding this article draws upon directly in structuring the volatility-transmission discussion.

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Poshakwale and Mandal (2016), writing internationally in the Review of Quantitative Finance and Accounting, examined the sources of time-varying return co-movements in the emerging Indian equity market across different economic regimes (pre-crisis, crisis, and recovery). They found that the intensity and direction of foreign-flow-driven return co-movement varied substantially by regime, with the Global Financial Crisis regime showing markedly higher sensitivity of Indian returns to foreign flow shocks than the subsequent recovery regime — a result corroborating this article's phase-wise treatment of FII impact.

Singhania and Saini (2016), in the international Journal of Wealth Management, examined FII flows, Indian stock exchange returns, and the leverage effect using asymmetric GARCH specifications. They confirmed a significant leverage effect in Indian equity returns associated with FII activity, whereby negative FII-flow shocks (net selling) generated larger increases in conditional volatility than positive shocks (net buying) of equivalent magnitude — the single most important econometric regularity synthesised of this article.

Bansal and Agrawal (2018), in FOCUS: Journal of International Business, used fifteen years of daily Sensex, Nifty, and FII flow data (April 2001-March 2017) to test the relationship between FII capital flows and Indian stock market volatility. After confirming data stationarity through the Augmented Dickey-Fuller test, they applied GARCH(1,1) modelling alongside descriptive and correlation statistics and concluded that a strong, positive relationship exists between FII flows and stock market returns, with volatility transmission running from FII activity to both the Sensex and the Nifty. As the most recent India-specific study published within this article's 2018 cut-off, it anchors the empirical synthesis presented.

2.1 The Research Gap

Three gaps emerge from this review. First, while the reviewed studies (Chandra, 2012; Garg & Mitra, 2015; Dhingra et al., 2016; Bansal & Agrawal, 2018) robustly establish the volatility-transmission and leverage-effect regularities within Indian equity markets, none extend their sample beyond early-to-mid 2018 and hence do not incorporate the dual stress episodes of that 2018 LTCG-tax-driven outflow and the September-October 2018 IL&FS-crisis-driven outflow — within a single, integrated empirical account. Second, while the international studies (Poshakwale & Mandal, 2016; Singhania & Saini, 2016) robustly identify regime-dependent sensitivity and asymmetric leverage effects, they do not connect these findings explicitly to the real-economy transmission channel — i.e., how portfolio flows affected Gross Fixed Capital Formation and employment in India specifically over the same window. Third, no reviewed study jointly integrates trend analysis (1992-2018), econometric volatility evidence, and macroeconomic contribution analysis within a single, updated framework culminating precisely at the 2018 inflection point — the gap this article addresses.

III. THE METHODOLOGY OF THE STUDY

This article adopts a descriptive-analytical research design based entirely on secondary data drawn exclusively up to and including financial year 2018-19, ending March 2019). Data on FII net investment (annual and monthly frequency, disaggregated into equity, debt, and hybrid instruments) were compiled from the Government of India's Key Economic Indicators — External Sector Statistics compendium, published by the Office of the Economic Adviser, Department for Promotion of Industry and Internal Trade (DPIIT), which itself sources FPI/FII figures from SEBI. Market performance data (Sensex, Nifty-50 movements) and contemporaneous FII/DII trading-activity figures around the January 2008 and February/September/October 2018 stress episodes were drawn from financial-press reporting of exchange-level data. Macroeconomic series — annual FDI equity inflows, the rupee-dollar exchange rate, and merchandise trade statistics — were likewise drawn from the DPIIT/RBI/FEDAI compilation. The analytical toolkit combines: (a) descriptive and phase-wise trend analysis of FII flows; (b) a synthesis of correlation coefficients and GARCH-family results reported in the peer-reviewed literature reviewed in Section 2, restricted to studies published up to 2018, supplemented by the study's own comparative reading of FII-flow and index-movement co-movement across the major shock episodes of the period (Objective 2); and (c) a comparative and transmission-channel analysis of FII vis-à-vis FDI in financing Gross Fixed Capital Formation, industrial output, and employment through 2018. Because the study relies on secondary aggregated data rather than primary firm-level panels, its econometric claims in Section 4.2 are reported as a structured review and cross-validation of published pre-2019 GARCH/VAR results rather than as new primary estimation — a deliberate scope limitation appropriate to a review-and-synthesis research design of this kind.

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IV. THE ANALYSIS AND INTERPRETATION

4.1 Trends and Patterns of FII Inflows into India, 1992-2018 (Objective O1)

Phase-wise historical analysis, summarised in Table 1, divides the 1992-2018 period into three episodes distinguished by regulatory regime, global liquidity conditions, and the direction and magnitude of net flows.

Table 1. Phase-wise Net FII Investment in Indian Equity and Debt Markets

Phase	Period	Regulatory / Global Context	Net Flow Pattern
Phase I: Inception & Consolidation	1992-2002	SEBI (FII) Regulations, 1995; gradual liberalisation of sectoral caps	Low, steady net inflows building a cumulative base of foreign portfolio participation from a zero starting point in September 1992
Phase II: The Great Bull Run & GFC Reversal	2003-2008	Rapid capital-account liberalisation; global liquidity boom; 2008 Lehman Brothers crisis	Record annual inflows through FY2007-08 (equity ₹53,404 crore, debt ₹12,775 crore, total ₹66,179 crore), followed by a sharp reversal to a net outflow of ₹45,811 crore in FY2008-09 (equity outflow ₹47,706 crore), including a single-month outflow of ₹29,447 crore in January 2008
Phase III: Post-GFC Recovery, Global Shocks & 2018 Domestic Stress	2009-2018	Post-crisis recovery; 2013 Taper Tantrum; Demonetisation (2016); GST rollout (2017); Feb 2018 LTCG tax; Sept 2018 IL&FS crisis; US Fed rate hikes; US-China trade tensions	Strong recovery inflows in FY2009-10 (₹1,42,658 crore) and FY2010-11 (₹1,46,438 crore); moderated in FY2011-12 (₹93,726 crore) amid Eurozone stress; renewed peak in FY2012-13 (₹1,68,367 crore); Taper-Tantrum-affected FY2013-14 (₹51,649 crore net, with a debt outflow of ₹28,060 crore partly offsetting a ₹79,709 crore equity inflow); record FY2014-15 inflow of ₹2,77,461 crore; a rare full-year net outflow of ₹18,176 crore in FY2015-16 amid a global commodity and China-growth scare; a modest FY2016-17 inflow of ₹48,411 crore in the year of Demonetisation; a strong FY2017-18 inflow of ₹1,44,682 crore; and a full-year net outflow of ₹38,930 crore in FY2018-19, driven by the February 2018 Budget's reintroduction of LTCG tax and the September-October 2018 IL&FS liquidity crisis, including a then-record single-month outflow of ₹38,906 crore in October 2018

Source: Compiled by the author from Department for Promotion of Industry and Internal Trade, Office of the Economic Adviser, Key Economic Indicators – External Sector Statistics (Table-1, FPI/FII Net Investment, source: SEBI); BusinessToday (2018, Feb 15; 2018, Nov 16).

Instruments of inflow show a discernible structural evolution across this period. Equity remained the dominant channel through most years, but the debt segment grew markedly in relative importance from FY2013-14 onward, briefly overtaking equity as the larger component in FY2017-18 (debt ₹1,19,036 crore against equity ₹25,635 crore, out of a total net inflow of ₹1,44,682 crore) as the RBI's widening Medium Term Framework ceilings for FPI investment in Government Securities and corporate bonds took fuller effect. The FY2018-19 reversal was likewise concentrated more heavily in the debt segment (net debt outflow of ₹42,357 crore against a broadly flat equity position of -₹88 crore), reflecting the disproportionate sensitivity of debt-FPI holdings to the sharp rise in US Treasury yields and India's own widening current account deficit during 2018.

Key drivers of these inflow patterns, consistent with the push-pull framework of Section 1.3, include: (i) global liquidity conditions, chiefly the US Federal Reserve's policy-rate cycle — the 2013 Taper Tantrum and the four Fed rate increases through 2018 both coincide with the sharpest recorded outflow episodes in the sample, while the post-

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2008 quantitative easing era coincides with the FY2009-10 and FY2014-15 surges; (ii) domestic macroeconomic indicators — GDP growth differential, fiscal deficit, and CPI inflation, with the FY2014-15 record inflow widely associated with post-election reform optimism; (iii) exchange-rate dynamics — the rupee depreciated from an annual average of ₹64.45 per US dollar in FY2017-18 to ₹70.04 in FY2018-19 (reaching a monthly average of ₹73.63 in October 2018 alone), a depreciation that both reflected and reinforced the FII exit of that year; and (iv) firm-specific and systemic shocks, most visibly the September 2018 default by Infrastructure Leasing & Financial Services (IL&FS), which triggered a broader liquidity crisis across India's non-banking financial company (NBFC) sector and materially dented foreign-investor confidence in domestic credit markets in the final months of the period under study.

4.2 FII Impact on the Growth, Performance, and Volatility of the Indian Capital Market

FII turnover constituted a substantial share of total trading activity on the NSE and BSE throughout this period, and shifts in that turnover were widely used by market participants as a real-time barometer of institutional sentiment. Table 2 synthesises the correlation, regression, and volatility-modelling evidence reported in the pre-2018 literature reviewed in Section 2.

Table 2. Summary of Empirical Findings on FII-Market Relationships in Indian Studies

Study	Data Period / Method	Key Empirical Finding
Chandra (2012)	Daily FII and index-return data; Granger causality	Bidirectional causality between FII net flows and index returns; FII buying both follows and further propels rising markets
Garg & Mitra (2015)	Cross-country emerging-market panel including India; herding and lead-lag tests	FII herding intensifies with global uncertainty; herding-driven flows lead short-run market returns
Dhingra, Gandhi & Bulsara (2016)	Multi-year Sensex/Nifty and FII-flow data; VAR & GARCH	Bidirectional FII flow-return relationship; FII flow volatility Granger-causes market return volatility
Singhania & Saini (2016) [international]	Asymmetric GARCH on Indian index and FII-flow data	Confirmed leverage effect: FII net selling raises conditional volatility more than equivalent net buying
Bansal & Agrawal (2018)	Daily Sensex/Nifty/FII data, April 2001-March 2017; ADF unit-root test, correlation, GARCH(1,1)	Strong positive correlation between FII flows and index returns; volatility transmission from FII activity to both Sensex and Nifty

Source: Author's synthesis of the literature reviewed in Section 2: Chandra (2012); Garg and Mitra (2015); Dhingra, Gandhi, and Bulsara (2016); Singhania and Saini (2016); Bansal and Agrawal (2018).

Two econometric regularities recur across this literature. First, the linear relationship: monthly and daily net FII flows and movements in the BSE Sensex and NSE Nifty-50 exhibit a strong positive correlation, and regression models confirm that net flows are statistically significant predictors of index returns over the sample windows studied; Bansal and Agrawal (2018), using the longest available pre-2018 daily series (April 2001-March 2017), confirm this relationship holds robustly across both major indices. Second, the non-linear or asymmetric relationship: Generalised Autoregressive Conditional Heteroskedasticity (GARCH(1,1)) modelling, and its asymmetric extensions used by Singhania and Saini (2016), consistently detect volatility clustering in Sensex and Nifty return series and confirm a leverage effect specific to institutional selling — episodes of FII net selling generate significantly larger conditional-variance shocks than equivalent episodes of FII net buying. This asymmetry is consistent with the observed market behaviour during the two principal stress episodes captured within this study's 2018 cut-off: the January 2008 single-month outflow of ₹29,447 crore, which coincided with the Sensex's then-largest single-day point loss of 1,408 points on

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21 January 2008 and a further intraday low of 15,332 (down 2,273 points) the following day; and the September-October 2018 IL&FS-driven outflow, during which the Nifty registered roughly a 10 percent correction while small- and mid-cap stocks fell by a considerably sharper 25-40 percent, illustrating that FII-linked volatility shocks transmit unevenly across market segments, with less liquid mid- and small-cap counters absorbing disproportionately larger price shocks than the benchmark large-cap indices.

Even within this pre-2019 window, Domestic Institutional Investors (DIIs) had already begun to play a measurable cushioning role during FII-selling episodes, foreshadowing the more pronounced shock-absorption role DIIs would come to play in later years. Table 3 documents this offset across three dated episodes within the study period.

Table 3. FII Outflows Partly Offset by DII Inflows: Selected Episodes

Episode	Net FII Flow	DII / Offsetting Response	Market Outcome
21 January 2008 (global crisis sell-off)	–₹4,265 crore (single day)	+₹2,778 crore DII purchases on the same day	Sensex nonetheless recorded its then-largest single-day loss of 1,408 points
January 2008 (full month, GFC)	–₹29,447 crore	+₹16,414 crore DII inflows over the month	Sharp correction, though DII buying moderated the single-day extremes
6-8 February 2018 (LTCG Budget announcement)	–₹7,754 crore (up to 14 Feb)	+₹6,609 crore DII purchases over the same window	Sensex and Nifty fell for a seven-day losing streak before stabilising; the outflow was nearly matched rupee-for-rupee by DII buying
September-October 2018 (IL&FS liquidity crisis)	–₹21,035 crore (Sept) and –₹38,906 crore (Oct, then a record single-month outflow)	Sustained mutual-fund buying cushioned the benchmark indices even as it could not prevent a broader sell-off	Nifty corrected by roughly 10%, while small- and mid-cap stocks fell 25-40%, indicating the limits of DII cushioning outside the largest, most liquid counters

Source: Author's compilation from BusinessToday (2018, Feb 15; 2018, Nov 16), reporting NSE/BSE FII-DII trading-activity data.

This evidence indicates that, well before the more fully developed domestic-institutional ecosystem of later years, the seeds of a genuine shock-absorption mechanism were already visible in the Indian market by 2018: DII buying nearly matched the February 2018 LTCG-related FII outflow rupee-for-rupee over the relevant window, even though the same mechanism proved insufficient to fully protect small- and mid-cap valuations during the more severe IL&FS-driven sell-off later that year. The 2018 experience as a whole therefore illustrates both the growing maturity of India's domestic institutional base and the continuing limits of that maturity when a foreign-capital shock coincides with a genuine domestic credit-market stress event such as the IL&FS default.

4.3 FII Contribution to Macroeconomic Development)

A useful starting point is the comparative annual scale of FDI and net FII flows summarised in Table 4, drawn from official Government of India data.

Table 4. Annual FDI Equity Inflows and Net FII Investment, India, FY2006-07 to FY2018-19 (US$ million)

Financial Year	FDI Equity Inflow (US$ mn)	Net FII Investment (US$ mn)
2006-07	22,826	3,225
2007-08	34,843	20,328

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Financial Year	FDI Equity Inflow (US$ mn)	Net FII Investment (US$ mn)
2008-09	41,873	-15,017
2009-10	37,745	29,048
2010-11	34,847	29,422
2011-12	46,556	16,812
2012-13	34,298	27,582
2013-14	36,046	5,009
2014-15	45,148	40,923
2015-16	55,559	-4,016
2016-17	60,221	7,735
2017-18	60,974	22,165
2018-19	64,374	-2,225

Source: Department for Promotion of Industry and Internal Trade, Office of the Economic Adviser, Key Economic Indicators – External Sector Statistics (Table-2, FDI/FII Inflows; source: DIPP & RBI).

Table 4 makes visible the central comparative feature of FDI and FII as sources of external finance for India across this period: FDI equity inflows rose in almost every year of the sample, from US$22.8 billion in FY2006-07 to US$64.4 billion in FY2018-19, without ever turning negative, whereas net FII investment swung from a positive US$40.9 billion (FY2014-15) to negative territory in three separate years (FY2008-09, FY2015-16, and FY2018-19) within the same thirteen-year window. This contrast is precisely the empirical signature of the 'debt-versus-hot-money' distinction discussed in Section 1.4: FDI's direct, management-linked, illiquid character makes it resistant to short-term reversal, while FII's liquid, passive character makes it structurally more volatile, even though, over the full period, cumulative net FII investment still added substantially to India's non-debt-creating external financing base.

The empirical literature on FII and Gross Fixed Capital Formation (GFCF) reveals what might be termed an empirical puzzle: direct statistical tests typically find only a weak contemporaneous relationship between aggregate net FII flows and aggregate GFCF, in sharp contrast to the far more direct FDI-GFCF relationship implied by Table 4. This is not, however, evidence that FII was economically inert over 1992-2018. Rather, the transmission operated through an indirect channel: sustained FII buying — particularly during the FY2009-10, FY2012-13, and FY2014-15 surge years — raised equity valuations and market liquidity, which lowered the cost of equity capital for domestic listed firms. A lower cost of equity capital allowed Indian firms to raise fresh equity more cheaply — through Qualified Institutional Placements, Follow-on Public Offers, and Initial Public Offerings — and to use that capital to finance capacity expansion, which registers in GFCF with a lag rather than contemporaneously. Dhingra, Gandhi, and Bulsara (2016) provide direct support for this transmission mechanism, showing that FII flow shocks Granger-caused stock-market volatility and return shocks that, in turn, are the proximate determinants of the cost of equity capital in standard asset-pricing frameworks.

On industrial and manufacturing growth, the broader pattern across 1992-2018 is that periods of sustained FII inflow (2003-2008, 2009-2010, 2012-2015, 2017-18) generally coincided with periods of above-trend real GDP growth and industrial output expansion, though the direction of causality remains contested in the reviewed literature: buoyant domestic growth is itself a pull factor attracting FII, making simple correlation an unreliable guide to causal direction without more granular firm-level or instrumental-variable analysis than is available in the secondary aggregate data used in this study. The FY2018-19 reversal, by contrast, coincided with slowing industrial momentum in the following year, consistent with — though not conclusive proof of — a lagged transmission from the capital-market stress of late 2018 into the real economy.

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Volume 8, Issue 1, August 2019

4.4 Impact on Employment

Because FII investment is, by regulatory design, a passive portfolio holding rather than a controlling or managerial stake, its direct effect on employment over 1992-2018 was negligible: a foreign institutional investor purchasing listed shares on the secondary market did not, in itself, create a single job. The employment contribution of FII is therefore best understood as long-term and indirect, operating through at least three channels over this period: (i) the cost-of-capital channel described in Section 4.3, whereby cheaper equity capital enabled corporate capital-expenditure (capex) expansion and, over the medium term, hiring, particularly visible during the FY2009-10 to FY2014-15 sustained-inflow years; (ii) the market-confidence and valuation-signal channel, whereby buoyant FII sentiment supported corporate balance-sheet strength and access to further financing for expansion, including in the comparatively labour-intensive infrastructure and manufacturing sectors; and (iii) the broader economic-multiplier effect, whereby the liquidity and capital-formation effects documented above supported aggregate demand and investment cycles that generated employment well beyond the directly financed firms. This diffuse, indirect employment channel contrasts sharply with FDI's typically more direct and traceable employment effect at the enterprise or project level — a contrast reinforced, over the period studied, by FDI's steadily rising and never-negative annual inflow shown in Table 4, against FII's considerably more volatile year-to-year pattern.

4.5 Discussion: Reconciling the 'Hot Money' and 'Capital Catalyst' Views

The evidence assembled in Sections 4.1-4.4 suggests that the long-standing dichotomy between FII as destabilising 'hot money' and FII as an essential capital catalyst is best resolved not by choosing one label over the other, but by recognising that both descriptions are simultaneously accurate at different time horizons and through different channels, even within the comparatively shorter 1992-2018 window examined here. At high frequency — daily to monthly — FII flows behaved much as the 'hot money' literature (Claessens et al., 1995) predicts: they proved reversible within days, they responded sharply to global push factors such as US bond yields, and their outflows generated materially larger volatility shocks than their inflows, exactly the asymmetric leverage-effect pattern documented by Singhania and Saini (2016) and corroborated by Bansal and Agrawal (2018). Viewed only through this high-frequency lens, the January 2008 crisis outflow, the 2013 Taper Tantrum, and the 2018 LTCG-tax and IL&FS episodes would appear to vindicate the cautionary view of foreign portfolio capital as an unreliable and even dangerous source of finance for a capital-scarce economy.

At lower frequency — the multi-year horizon relevant to Gross Fixed Capital Formation and industrial capacity building — a different picture emerges from the same 1992-2018 data. The cumulative effect of FII participation since 1992 was to deepen market liquidity, tighten bid-ask spreads, improve price discovery, and, critically, lower the average cost of equity capital available to Indian listed firms relative to a counterfactual in which the market had remained closed to foreign portfolio participation. This lower cost of capital financed IPO and follow-on equity issuance across the multiple economic cycles captured in Table 1, including the FY2009-10 post-crisis recovery and the FY2014-15 record-inflow year. The 'catalyst' view is therefore best understood as a claim about the cumulative, structural effects of having FII participation available at all over a twenty-six-year window, rather than a claim that any given year's net flow figure was by itself developmental.

A further reconciling observation concerns the gradually changing identity of the marginal investor in Indian equities over this period. In the earlier phases of this study's periodisation (Phase I and much of Phase II), FIIs were plausibly the marginal price-setting investor in large segments of the market, meaning that FII sentiment swings translated with limited domestic cushioning into index-level volatility, as the January 2008 episode illustrates. By 2018, the evidence in Table 3 shows that domestic mutual-fund buying had grown sufficiently to nearly offset the February 2018 LTCG-related outflow in rupee terms, even though it remained insufficient, later in the same year, to prevent a much sharper correction in less liquid mid- and small-cap segments during the IL&FS crisis. This suggests that, as of 2018, India's domestic shock-absorption capacity was real but still partial and segment-dependent — a transitional state between the FII-dominated market structure of the 1990s and 2000s and whatever more developed domestic-institutional structure might emerge in subsequent years, a question this article's scope does not extend to address.

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V. CONCLUSIONS AND POLICY IMPLICATIONS

5.1 Summary of Findings

This article's synthesis of secondary data and the reviewed empirical literature, all restricted to the period 1992-2018, supports three principal conclusions, corresponding to the three research objectives. First, FII inflows into India grew substantially in scale over this quarter-century, from a near-zero base in 1992 to peak annual net inflows exceeding ₹2.7 lakh crore in FY2014-15, but remained markedly volatile throughout, with three separate years of full-year net outflow (FY2008-09, FY2015-16, FY2018-19) punctuating an otherwise generally positive trend. Second (O2), FII activity was strongly and asymmetrically linked to Indian equity market performance and volatility across the period: net flows correlated positively with index returns in every reviewed study, while GARCH-family evidence confirmed that outflows generated materially larger volatility shocks than equivalent inflows — a vulnerability that domestic institutional buying had, by 2018, begun to cushion in the large-cap segment (as in February 2018) without yet being able to fully protect the broader market (as the IL&FS-driven mid- and small-cap correction later that year showed). Third, FII's contribution to real economic development — investment, industrial growth, and employment — over 1992-2018 was real but indirect, transmitted chiefly through lower costs of equity capital and sustained primary-market financing rather than through any direct, contemporaneous link to Gross Fixed Capital Formation or hiring. In short, as of 2018, FII had demonstrably increased market depth and lowered capital costs for Indian firms, but its inherent liquidity continued to leave India's capital market exposed to external and domestic shocks alike, as the events of that very year illustrated.

5.2 Policy Recommendations

- Strengthening the domestic institutional base: Regulators and asset managers should continue to promote retail financialisation through mutual funds, building on the demonstrated — if still partial — role DII buying played in cushioning the February 2018 FII outflow, with a view to extending similar cushioning capacity to the mid- and small-cap segments that proved more exposed during the September-October 2018 IL&FS crisis.
- Deepening the debt market: The RBI and SEBI should continue to widen FPI debt participation ceilings under the Medium Term Framework, building on the growing share of debt within total net FII investment observed by FY2017-18, while monitoring the debt channel's demonstrated sensitivity to US yield movements, as the FY2018-19 debt outflow illustrates.
- Macro-prudential monitoring: SEBI and the RBI should maintain and refine robust risk-monitoring frameworks — including sector-wise FPI ownership caps, circuit-breaker mechanisms, and real-time FII/DII flow surveillance — to manage sudden 'hot money' reversals of the kind witnessed during the January 2008 global crisis, the 2013 Taper Tantrum, and the dual February and September-October 2018 episodes, particularly given the demonstrated risk of a foreign-capital shock coinciding with a domestic credit-market event such as the IL&FS default.

Future research would benefit from firm-level panel data linking FII ownership changes directly to capital-expenditure and hiring decisions, which the aggregate secondary data used in this study cannot fully resolve, as well as from extending the GARCH/EGARCH estimation and phase-wise trend analysis presented here beyond 2018 once further years of data and peer-reviewed literature become available.

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