

Does Foreign Institutional Investment in India Increase Financial Vulnerability?

An Empirical Investigation Using an Event Study Approach

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POLICY MOTIVATION FOR RESEARCH

Emerging market policy makers have been concerned about the financial stability implications of financial globalization. These concerns are typically focused on behavior under stressed conditions. For example, it would be helpful to understand if tail events in the home country trigger off extreme responses by foreign investors – are foreign investors ‘fair weather friends’? Policymakers can find it useful to know if foreign investors have a major impact on domestic markets through large inflows or outflows – are they ‘big fish in a small pond’? Another possibility worth exploring is whether extreme events in world markets induce extreme behavior by foreign investors, thus making them vectors of crisis transmission.

POLICY IMPACT

To take India as an example, both the Finance Minister and the Governor of the Reserve Bank of India have made statements over the last three years concerning possible policy adjustments toward foreign portfolio flows into India. Both have also stated that capital inflows are a valuable input for India’s future growth for example in areas such as infrastructure. This research provides empirical analysis on possible risks of inflows and outflows, and can be a concrete input into policy decisions.

AUDIENCE

The policy audience for this research consists of senior macroeconomic policymakers in emerging markets, for example, in India, the Finance Ministry and the Reserve Bank of India.

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POLICY IMPLICATIONS:

- **Conceptual tools for assessing financial stability**

Policy makers in emerging markets are less concerned with academic questions of market efficiency than with they are with market behavior under stressed conditions, whether 'efficient' or not. As an example, it is possible that a large exit by foreign investors in the aftermath of a domestic crisis brings prices closer to fundamental value. In the eyes of the existing finance literature on foreign investors, this would be viewed as a case where foreign investors are 'stabilizing' since they restore market efficiency. However, policy makers in emerging markets would, nonetheless, be concerned about the financial stability implications of such behavior.

- **Empirical tools for measuring domestic impacts of foreign investor behavior**

The empirical methodology of our paper provides a flexible tool for evaluating the impacts of equity investment by foreign investors on domestic markets. The methodology imposes few structural constraints, allowing the data to speak for itself. In the example of India, no serious evidence of negative effects of 'hot money' on the stock market is found, but this does not preclude different results for other economies or other time periods.

- **Specific implications for India**

The empirical results for India suggest that policymakers may need to worry relatively less about the destabilizing effects of foreign portfolio flows on Indian financial markets, or on the exchange rate, when they are conceptualizing policy and framing responses toward various forms of foreign capital.

IMPLEMENTATION:

The main message of our analysis is not to suggest the wisdom of a particular policy or set of policies, so implementation of specific policies is not an implication of this work. Instead, the research is meant to illustrate the value of detailed empirical analysis as a precursor to any policymaking.

DISSEMINATION:

Finance ministers, finance ministry officials, central bankers and central bank officials in emerging markets

FURTHER READINGS:

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