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Title: Impact of Foreign Institutional Investment on the Volatility7 and Return of Indian Stock Marke

Abstract

It is generally believed that FII's are the major reason for the volatility of the Indian stock market, but the present study found that FII flow has led to decline in the market volatility. It means FII can be used for the benefit of the market and investors. The impact of FII flow on market return and volatility is a controversial issue among policy formulator's researchers and investors. The present study is an attempt to identify the real impact of FII flow on market return and volatility. The present study was based on the daily data for a period of 12 years from April 2003 to March 2015. The study has used modern econometric models such as VAR model, Granger causality Test and further explained by Impulse Response Function and Variance Decomposition Analysis.

The study found that FII has significant positive impact on FII flow and the study has also examined the dynamic relationship between institutional investment and stock returns in Indian securities market using VAR approach and Granger causality test. The impulse response function shows that the response of FII flows due to shock in stock return are more lasting and significant when compared to the response on stock return due to a shock in FII flows. The study supports the existence of momentum or feedback trading hypothesis. The empirical result also shows the evidence for bidirectional *causality* between market return and FII flows. To conclude the study accepts the hypothesis that the investment activities of FIIs have significant impact on stock market movements. Both FII flows and market movements are mutually reinforce each other but the impact of market return on FII flows is more lasting and significant compared to the influence of FII flows on market movements.

The second part of the study is an attempt to model the volatility of the Indian stock market and to examine the impact of foreign portfolio investor's investment activities on the market volatility. Based on the residual distribution and arch test, the present study found the existence of volatility clustering in the Indian stock market. The study found leverage effect of volatility based on E-GARCH and TARCH models. The investment activities of FII's have significant impact on market volatility. FIIs gross sales have greater impact on the volatility of stock return than that of FIIs gross purchase. FIIs gross purchase (FIIP) and net flow (FIIN) have negative impact on Indian stock market volatility. The model adequacy tests confirm that the selected model is acceptable. The study concluded that FII has led to decline in the Indian stock market volatility.