FIIs Portfolio Investment Trends in Indian Companies

K Lakshmi*

The strong trends towards globalization in many countries during 1990s have brought about significant developments in the world economy. One of them is the tremendous increase in the mobility of capital across national borders.

Globalization had led to widespread liberalization and implementation of financial market reforms in many countries, mainly focusing on integrating the financial markets of these countries with the global markets. These reforms included deregulation of markets like eliminating foreign exchange controls, reducing taxes imposed on foreign investors, relaxing the restrictions on the purchase of domestic securities by foreign investors, the issuance of bonds by foreign borrowers in the domestic markets and so on. These measures have allowed the free flow of capital from developed markets to emerging markets, from capital surplus countries to capital scarce countries, seeking the highest rate of return and thereby, enhancing the productivity and efficiency of capital at the global level.

Trends in global capital flows

Between 1942 and 1970, the capital flows were only among industrialized countries and the flows towards the developing countries were only marginal. But after the first oil price shock in 1973, capital started flowing to developing countries. These flows were generally in the form of syndicated bank loans. This trend continued unabated resulting in increased interest burden on the developing countries till the Latin American debt crisis in 1982. The size of the capital flows to developing countries was averaging around US $ 163 billion per annum between 1973 and 1982. There was a considerable slow down in the international capital flows to developing countries after 1982. It was around US $ 103 billion per annum in the period 1983 to 1989. After 1982 the debt flows started registering a decline and the Foreign Direct Investment (FDI) flows started picking up slowly. However, the FDI flows remained lower than the debt flows in quantum till 1987. With worldwide trends towards globalization and improved economic performance by developing countries, there was a surge in capital flows during 1990 to 1997. The net capital flows to developing countries were at the peak at US $ 325 billion representing 5.5 percent of GDP of developing countries in 1997. There has been a steady slide in capital flows from 1997 due to various reasons like Asian crisis in 1997-98, turmoil in the global fixed income markets, collapse of the Argentine currency board peg in 2001 and the spate of corporate failures and accounting irregularities in US in 2002. However, the global capital flows to developing countries have bounced back and have registered a sharp increase in 2003 reaching US $ 228 billion representing about 3.6% of the gross domestic product of developing countries.

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* Assistant Professor, Institute of Business Administration and Training, Bhuwaneshwar. The views expressed and the approach suggested in this paper is of the author and not necessarily of NSE.

Table 1

Net capital flows to developing countries

Year	Net capital flows to developing countries US $ billion
1970	11.3
1980	82.8
1990	100.8
1995	237.2
1996	281.6
1997	324.3
1998	266.5
1999	236.7
2000	193.7
2001	206.1
2002	190.6
2003	228.2

Source : Global development finance various issues

The composition of capital flows to emerging market economies have gone through significant changes over time. As mentioned earlier, bank loans were the major component of capital flows in 1970s. The FDI flows which started picking up in early 1980s gained real momentum between 1987 and 1997. In 1994, these flows were in excess of net debt flows for the first time. The portfolio flows, which were non-existent till 1980s, have become a major component of international capital flows from the early 1990s.

Table 2: Composition of capital flows to developing countries (US $ billion)

Year	FDI flows	Portfolio flows	Debt flows
1970	2.2	0.0	6.9
1980	4.4	0.0	65.2
1990	24.5	3.7	43.4
1995	95.5	32.1	77.0
1996	119.0	45.88	87.6
1997	171.1	22.6	105.3
1998	175.6	6.6	57.6
1999	181.7	12.6	13.8
2000	162.2	12.6	-9.8
2001	175.1	4.4	-1.2
2002	147.1	4.9	7.3
2003	135.2	14.3	44.3

Source : Global development finance various issues

Capital flows to India

Till the beginning of 1991, India had a highly regulated financial system with a restrictive foreign exchange regime. It had a closed capital account and capital mobility was restricted through administrative controls. According to Y.V.Reddy (2002), the environment in financial sector was characterized by segmented and under developed financial markets, coupled with paucity of instruments before 1991. The trade and investment policies did not encourage foreign capital. FDI was tightly regulated and small compared to other Asian economies and foreign portfolio flows was totally prohibited. Initially till early 1980s India was totally dependent on multilateral and bilateral concessional forms of finance for external flows. Since the current account deficit widened subsequently the country started supplementing the traditional forms of borrowing with commercial borrowing including short-term borrowings and deposits from non-resident Indians (NRIs). As a consequence, in 1991, India was faced with a balance of payments crisis and had to devalue money. Since official assistance was not available because of its global decline, India had to embark on economic reforms programme to transform the controlled economy into a market oriented one. The financial liberalization strategy, which was a part of the general economic reforms, included dismantling of capital controls, reforms in trade and investment policies and so on. India's foreign investment regime was liberalized. FDI was confined to a narrow group of industries with majority control and to a large number with a 40% equity control with foreign investors till 1991. In 1991, Industrial policy statement permitted majority control in a large number of industries and 100% control in several industries. These lists have been subsequently puffed up and from 1995 most of the industries are open to FDI. In 1992, the foreign portfolio investments by Foreign Institutional Investors (FIIs) are allowed. Indian companies with high credit rating were allowed to float Global Depository Receipts (GDRs) and the American Depository Receipts (ADRs). These measures, which were conscious efforts to integrate the Indian financial markets with the global markets, brought about a radical transformation in the quantum and nature of capital flows to India.

Table 3

Composition of capital inflows to India

Year	Total net capital inflows (US $ billion)	Non-debt creating inflows as a percent of total flows	FDI flows as a percent of total flows	Portfolio flows as a percent of total flows	Debt-creating flows as a percent of total
1990-91	7.1	1.5	1.4	0.1	83.3
1995-96	4.1	117.5	52.4	65.1	57.7
1996-97	12.0	51.3	23.7	27.6	61.7
1997-98	9.8	54.8	36.2	18.6	52.4
1998-99	8.4	28.6	29.4	-0.8	54.4
1999-00	10.4	49.7	20.7	29.0	23.1
2000-01	10.0	67.8	40.2	27.6	59.4

2001-02	10.6	77.1	58.0	19.1	9.2
2002-03	12.1	46.6	38.5	8.1	-10.6

Source : Reserve Bank of India., Report on currency and finance, 2002-03

Ever since the introduction of economic reforms, India has become one of the chosen destinations of the international capital flows. The net capital flows were averaging around US $ 4 billion during the 1980s. After the reforms they shot up to an average around US $ 9 billion during 1993-2000, registering an increase of more than double. During the ten years between 1990-91 and 1999-00, India has mobilized around US $ 40 billion in foreign investment. The cross border capital flows have recorded a tremendous increase from 1999-2000 crossing US $ 10 billion mark every year. As it can be noticed from Table 3, the composition of capital flows has also gone through a transformation over time in line with the global trends. The non-debt capital flows have slowly become a major component of total net capital flows replacing debt-creating capital flows. The ratio of non-debt creating capital flows to debt creating capital flows has changed from 1.5 to 83.3 in 1990-91 to 44.6 to –6.6 in 2002-03, thereby reducing the incidental interest burden on the economy. The portfolio flows that were negligible in 1990-91 have gained momentum over time and have come to play a significant role on the economy.

Foreign Portfolio Investment Flows to India

As mentioned above, a major force that has changed the quantum and nature of international capital flows to India is the portfolio investment flows. India has witnessed a decade of portfolio flows and they are gaining more significance with every passing year. It has come to play a dominant role in the Indian economy.

Portfolio investments include investments in American Depository Receipts (ADRs)/Global Depository Receipts (GDRs) and offshore funds in addition to investments by FIIs. Foreign portfolio investments in India have received importance and are allowed in the Indian stock markets as a follow up of the recommendation of the Narasimham committee report on financial system. The committee recommended their entry and stated:

'The committee would also suggest that the capital market should be gradually opened up to foreign portfolio investments and simultaneously efforts should be initiated to improve the depth of the market by facilitating the issue of new types of equities and innovative debt instruments.' (Narasimham committee report, p.121)

The Government of India issued the guidelines for FII investments on September 14, 1992. Prior to 1992, only Non-resident Indians (NRIs) and Overseas Corporate Bodies (OCBs) were allowed to undertake portfolio investment in India. Three years later in November 1995, Securities and Exchange Board of India (SEBI) notified the Foreign Institutional Investors Regulations, which are largely, based on the earlier guidelines issued in 1992. The country's stock market are opened up for direct participation by FIIs such as pension funds, mutual funds, investment trusts, asset management companies, nominee companies and incorporated institutional portfolio managers or their power of attorney holders (providing discretionary and non-discretionary

portfolio management services). These investors are welcome to invest in all the securities traded on the primary and secondary markets including the equity and other securities/instruments of companies listed/to be listed on the stock exchanges in India including the OTC exchanges in India. These would include shares, debentures, warrants and schemes offered by domestic mutual funds. SEBI requires the FIIs to register with them and to obtain approval from RBI under the Foreign Exchange Regulation Act, 1973 to enable them to buy and sell securities, open foreign currency accounts and permits and repatriates funds. For all practical purposes, full convertibility of rupee is available to FII investments. Gradually the scope of FII operations in India has been expanded and presently the ceiling for overall investment for FIIs is 24% of the paid up capital of the Indian company which can be raised up to the sectoral cap/statutory ceiling subject to the approval of the board and the general body of the company passing a special resolution to that effect.

Trends in portfolio flows to India

The table below gives the source specific foreign portfolio investment in India during the period 1992-93 to 2002-03.

Table 4 : Composition of Foreign Portfolio Investment in India

(US $ million)

Year	GDRs/ADRs*	FII investment@	Offshore funds	Total
1992-93	240	1	3	244
1993-94	1520	1665	382	3567
1994-95	2082	1503	239	3824
1995-96	683	2009	56	2748
1996-97	1366	1926	20	3312
1997-98	645	979	204	1828
1998-99	270	-390	59	-61
1999-00	768	2135	123	3026
2000-01	831	1847	82	2760
2001-02	477	1505	39	2021
2002-03#	600	377	2	979

provisional

* represents the amount raised by Indian corporates through Global Depository Receipts (GDRs) and American Depository Receipts (ADRs)

@ represents fresh inflows of funds by FIIs Source: Reserve Bank of India

Portfolio flows in India have become synonymous with FIIs investment. The FII flows, which were only US $ 1 million in 1992-93, have risen over time and are at US $ 1505 million in 2001-02 and at US $ 377 million in 2002-03. The net investment flows by FIIs have always been positive every year from the year of their entry except in the year 1998-99. The net investment flows by FIIs were negative during 1998-99 primarily because of the uncertainty that prevailed after India tested a series of nuclear bombs in May 1998 and the imposition of economic sanctions by the US, Japan and other industrialized countries. The FIIs portfolio flows

quickly recovered and have become a positive net investment from the subsequent years onwards. Foreign portfolio inflows into equity and debt markets amount to Rs.130 billion in the first quarter of calendar 2004, nearly 447% higher than Rs.24 billion in the corresponding period of calendar 2003. Equity investments by FIIs amounted to Rs.112 billion between January to March 2004 as compared with Rs.17 billion in the corresponding period last year. Equity investments made by FIIs in the first quarter of calendar 2004 are close to 50% of the total equity investments of Rs.244 billion made in the year 2003.

Table 5 : Trends in FII investment

Year	Gross purchases Rs. million	Gross sales Rs. million	Net investment Rs. million	Net investment US $ million*	Cumulative net investment US $ million
1993-94	55925	4663	51262	1634	1638
1994-95	76310	28348	47963	1528	3167
1995-96	96935	27517	69420	2036	5202
1996-97	155539	69794	85745	2432	7634
1997-98	186947	127372	59575	1649	9284
1998-99	161150	176994	-15844	-386	8898
1999-00	568555	467335	101219	2339	11237
2000-01	740506	641164	99340	2160	13396
2001-02	499200	411650	87552	1846	15242
2002-03	470601	443710	26889	562	15804
2003-04	1448575	990940	457645	9949	25754

* Net investment in US $ million at monthly exchange rate.

Source : SEBI Bulletin, April 2004

Trends in the FIIs registration

The rise in FIIs inflows into the country coincides with the rise in the number of FIIs registered with SEBI. The FIIs registered with SEBI come from as many as 28 countries including money management companies operating in India on behalf of foreign investors. US based institutions account for slightly over 41%, those from UK constitute about 20% and the institutions from the western European countries account for another 17%. These national affiliations may not essentially mean that the funds are from these particular countries. They may be on behalf of the residents in other countries. Nevertheless, the regional break down of the FII affiliations does give an indication of the relative importance of these regions of the world to FII inflows to India.

Table 5 :FIIs Registered with SEBI

As on	No. of FIIs
5 February 2004	531
31 December 2003	517
31 December 2002	489

31 December 2001	482
31 December 2000	556

Source:SEBI

These developments have given rise to a keen interest in understanding the impact and the implications of the FII investment on Indian companies. Since these portfolio investments are made in the securities offered by the Indian companies and since the magnitude of these flows have recorded a sharp increase over the last decade it would certainly have implications for the Indian companies. This study evaluates the impact of FII investment on the Indian companies by analyzing the change in the shareholding pattern of the companies in the year 2003. The year 2003 is chosen for the evaluation of the impact of FII investment on the shareholding pattern of the companies because this year has witnessed the biggest FII inflows in a single year. FIIs have injected a total of US $ 7.74 billion by means of net investment in secondary markets in 2003. This includes their investment in both equity and debt. FIIs equity purchases in the secondary market is US $ 20.71 billion and their equity sales is US $ 14.03 billion in 2003. It leaves a net investment of US $ 6.68 billion. The purchases and sales figures in the debt market for the same year are US $ 2.34 billion and US $ 1.28 billion respectively. The net investment in the debt market stands at US $ 1.06 billion. The net FII investment in equity is US $ 5.62 billion in excess of the net investment in debt market.

The study

Since the portfolio flows of the FIIs is on the increase over time and as the major chunck of this investment goes into equity markets it certainly would have an impact on the shareholding pattern of Indian companies listed on the stock exchanges. According to BSE capital market review 2003, the FIIs account for over 10 per cent of the turnover on the Indian bourses and 50-60 per cent of the deliveries. About 95 per cent of FII funds are invested in stocks that comprise the key indices and half of it in the top five stocks that comprise the key indices. So to analyze the impact of FIIs investment on Indian companies, this study has taken up the 50 companies included in the S & P CNX NIFTY index which has a market capitalization of Rs.978.20 million as at the end of the financial year 2002-03. The study has looked at the share holding pattern of these companies as filed with the National Stock Exchange and Bombay Stock Exchange for the quarter December 2003 and December 2002. As the information for one of the quarters are not available for Maruti Udyog it was excluded from the sample. Hence the study relates to the rest of 49 companies.

A study on the shareholding pattern brings out the following observations. The FIIs hold an investment in each of the companies included in the index at both the points in time. In 45 of the 49 companies studied FIIs have increased their stake in the calendar year 2003. In as many as 30 companies the shares held by the FIIs are more than 10% of the total shares outstanding of these companies. Of these 30 companies, the shares held by the FIIs are more than 20% in the case of 14 companies.

Table 6 : Shareholding pattern

Category	Total shares outstanding in thousands as of December 2003 I	Shares held as a percentage of I	Total shares outstanding in thousands as of December 2002 II	Shares held as a percentage of II
Promoters	10709524	51.55	10671715	52.19
Mutual funds	778606	3.75	1102672	5.39
Banks/Financial institutions/Central govt./State govt./non-govt. institutions	1930191	9.29	1849902	9.05
FIIs	2677724	12.89	1877925	9.18
Private corporate bodies	517273	2.49	559789	2.74
Indian public	1903821	9.16	2145555	10.49
NRIs/OCBs	902385	4.34	941740	4.61
Others	1355181	6.52	1298110	6.35
Total	20774705	100	20447408	100

It can be seen that the shareholding pattern of the companies has gone through a change over the year 2003. The percentage of shares held by each of the categories of shareholders has registered a change. The FIIs have become the second largest shareholder in these companies after the promoters as of December 2003. The domestic financial institutions (DFIs) are the second largest shareholder among the non-promoter shareholders group. The Indian public who were the second largest shareholders as of December 2002 have let the FIIs and the DFIs overtake them and have settled for the fourth position. Their shareholding has come down from 10.49% to 9.16% over the period of study. In fact there has been a decline in the shareholding of all categories of shareholders other than FIIs and DFIs. While the shares held by FIIs have increased from 9.18% to 12.89% during 2003, the increase in case of DFIs is only marginal by 0.24%. The decline in the shareholding of NRIs/OCBs and Private corporate bodies has also been marginal at less than a percent each in both the cases. The decline in the shareholding of the mutual funds has been more than marginal. It has dropped from 5.39% in December 2002 to 3.75% in December 2003. In addition to FIIs, NRIs/OCBs have also invested in the shares of Indian companies. Even though their investment has recorded a marginal decline over the year, they are also ahead of the mutual funds as of December 2003.

Table 7 : Shares held by the various categories of shareholders as a percentage of total outstanding shares

Category	December 2003	September 2003	June 2003	March 2003	December 2002
Promoters	51.55	52.17	52.17	52.10	52.19
Mutual funds	3.75	4.25	5.75	5.06	5.39
Banks/Financial institutions/Central govt./State govt./non-govt. institutions	9.29	9.48	9.06	9.30	9.05
FIIs	12.89	10.49	11.47	9.08	9.18
Private corporate	2.49	2.58	2.89	3.97	2.74

bodies					
Indian public	9.16	9.80	11.92	10.08	10.49
NRIs/OCBs	4.34	4.57	4.59	4.88	4.61
Others	6.52	6.66	2.15	5.53	6.35
Total	100	100	100	100	100

An analysis of all the five quarters shows that the Indian public was the second largest shareholders till June 30, 2003. In the last two quarters that position was occupied by the FIIs. The two categories of shareholders whose holding of shares has declined by more than one percent between December 2002 and December 2003 are the mutual funds and the Indian public. A major increase in shareholding of FIIs has come about between September 2003 and December 2003. The trends that came out in the analysis of data for the whole year is more or less valid even if carried out for each of the quarter.

When the shares held by both the mutual funds and the Indian public are added, as the funds of individual investors only get invested through mutual funds, their total holding of shares has always been more than the shareholding of FIIs. However, they have been registering different trends over time, the FIIs have found to be improving on their investment level while the investment by mutual funds and the Indian public have been continuously bearing a declining trend, thereby narrowing the gap between them. The total number of shares held by both mutual funds and Indian public as a percentage of the total outstanding shares as of December 2002 was 15.88% and that of FIIs 9.18%. Because of the opposite trends that prevailed in their investment pattern the comparable figures for December 2003 have become 12.91% and 12.89% respectively.

Table 8 : Comparison of shares held by FIIs and the Indian investors

Category	December 2003	September 2003	June 2003	March 2003	December 2003
Mutual funds and the Indian public#	12.91	14.05	17.67	15.14	15.88
FIIs#	12.89	10.49	11.47	9.08	9.18

#shares shown as a percentage of the total outstanding shares

An attempt is made to compare the total investment by all foreign investors in the non-promoters category, which includes the investments by the FIIs and the NRIs/OCBs. Other than in June 2003, the total foreign investment has exceeded the investment by the mutual funds and the Indian public.

Table 9

Shares held by foreign investors

As of	Shares held by FIIs and NRIs/OCBs as a percentage of total outstanding shares
December 2003	18.23
September 2003	15.06
June 2003	16.06
March 2003	13.96
December 2002	13.79

All these analyses show that the FIIs have come to play a dominant role in the India's stock market like never before. The pace of their inflows into equities is picking up momentum over the years. What would it mean for the Indian stock markets? Dornbusch and Park (1995) suggest that foreign investors pursue positive feedback trading strategies that make stocks over react to changes in fundamentals. Bonser, Neal et. al.(2002) analyze the foreign trading behavior on the Jakarta stock exchange (Indonesia) between 1995 and 2002. They detect herding and positive feedback trading by foreign investors but find no evidence to indicate that such trading behaviour by foreign investors destabilized the market prices during the Asian crisis. Griffin et al. (2002) use a theoretical model and empirical analysis to show that global stock return performance is an important factor in understanding equity flows. Amita Batra (2003) indicates that foreign investors have a tendency to herd on the Indian equity market even though they all may not do it on the same day. In times of pressure in the stock market on account of a financial crisis in the region there is excessive sell side herding even though the extent of herding on the average and on either side of the market during the crisis may be lower than in the immediately preceding period. On investigating the impact of trading imbalance across days they do not find any significant evidence that would make it possible to attribute equity market instability to FIIs. A question that needs to be asked is whether the Indian market is more vulnerable to volatile trading conditions as the overseas investors are generally perceived as being fickle.

Volatility of portfolio flows

Unlike many emerging markets the portfolio flows into India are not vulnerable to external shocks. An analysis of the quarterly data for about 17 emerging markets for which comparable data are available from IFS suggests that the volatility of portfolio flows into India is small in comparison to other emerging markets (Gordon and Gupta 2003). Given the reporting and registration requirements, the volatility of the portfolio flows are very much under check and control. The fact that the country has not suffered any major capital flight problem bears evidence to this argument. India has not witnessed net portfolio outflows other than in 1998, which bounced back in the subsequent years and has always been positive till date. Monthly FII flows to India have always been mostly positive, except for a few months due to 9/11 terrorist attacks in 2001, border tensions, Iraq war, etc. In all these instances, the impact was short lived. Data available on emerging markets also brings out the fact that the volatility of portfolio flows into India is small when compared to other emerging markets.

Table 10 : Average portfolio flows and their volatility during 1995 to 2002

Country	Mean US $ million	Coefficient of variation (percent)
India	1950.3	69.4
Malaysia	-651.0	109.4
Philippines	2556.3	103.2
Korea	10998.6	57.9

Mexico	1705.6	371.3
Indonesia	234.1	1253.5

Source: International Financial Statistics, IMF

The low volatility of portfolio flows to India is attributed to the strong economic performance of the country since the last decade and the low integration of the Indian economy and the global economy. (Gordon and Gupta 2003)

Though the general tendency of the researchers is to denigrate the portfolio investment as temporary and volatile in the light of various capital flight crises that have happened elsewhere in the world, the room for such an argument is limited in case of India. Given the important contributions that portfolio flows can make to increase the liquidity and efficiency of the domestic capital markets, their role cannot be underplayed.

Conclusions and implications for the policy makers

The foreign portfolio flows have come to be acknowledged as one of the important source for strengthening and improving the functioning of the domestic capital markets. This study has found that the FIIs investment in the 49 companies that comprise the S&P CNX NIFTY is only about 12 per cent of the total outstanding shares. National stock exchange reports that FIIs hold only a meager 4.26 per cent of the total outstanding shares of the companies listed on NSE as at the end of March 2003. An sectoral study of the data reveals that FIIs hold less than 10 per cent all the sectors barring just two namely FMCG and Media and Entertainment..

These figures are very low given the size of our capital market. According to the Global stock markets fact book 2003, India ranks 19th in terms of market capitalization, 17th in terms of total value traded in the stock exchanges and 2nd in terms of number of listed companies at the end of 2002. As a whole, India's large stock exchanges are considered highly liquid, with only six countries having a higher annual turnover ratio than India at the end of 2002, which was 165 per cent. According to Stulz (1999) the foreign ownership for Argentia was 38 per cent, Chile 17 per cent, Mexico 25 per cent, Peru 38 per cent and Venezuela was 36 per cent of the market capitalization. All these figures are well above our figures. The figures at the macro level also suggest that the relative share of the foreign portfolio flows towards our remains marginal.

Table 11 : Inward portfolio equity flows to India

Year	All developing countries	India
1990	4.5	0.1
1995	20.2	1.6
1996	33.6	4.0
1997	26.7	2.6
1998	7.4	-0.6
1999	15.0	2.3
2000	26.0	1.6
2001	6.0	1.7

2002	9.4	0.9

Source: Global development finance 2003

FII inflows are even smaller when compared to the size of our economy. Over the last decade, the FII equity flows into our country have averaged around a meager ½ per cent of GDP per annum. This figure is the lowest among the emerging markets. China, where most of the stock markets were closed to foreign investors till December 2002, accounted for more than 40 per cent of all developing-country portfolio equity in 2002 and almost 75 per cent of the East Asia's region. Hence, the policy makers of our country have to craft appropriate strategies to attract more foreign portfolio flows, which can strengthen our domestic capital markets.

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