How Does Foreign Institutional Investment Affect Market Efficiency in Developing Stock Markets?

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Abstract

In this study, we investigate how foreign institutions add value to markets and therefore contribute towards developing stock exchange efficiency. Through increased globalization, this has led to an influx of funds flowing into emerging markets that can be both beneficial and detrimental to market liquidity, price discovery, and the speed with which news gets reflected in equity prices. Hence, we will analyze whether these foreign institutions improve efficiency through increased liquidity / enhanced price discovery / faster incorporation of information into equity prices or create inefficiency via volatility, speculative trading behavior, or herding behavior. We will evaluate market efficiencies using various statistical techniques through a review of data from various emerging stock exchanges, over a specified period of time, utilizing various measures of autocorrelation of returns, volatility measurements, as well as the time it took for equities to adjust to new information. In addition, the findings of this research will expand the current literature regarding how FII affects emerging market efficiency by providing more specific evidence for developing countries. Finally, we will provide evidence relevant to policymakers concerning how capital markets can be better managed through liberalization of capital markets, regulatory oversight of capital flows, and managing FII flows into stable efficient and resilient equity markets to assist with long-term financing development objectives on a worldwide basis.

1. Introduction

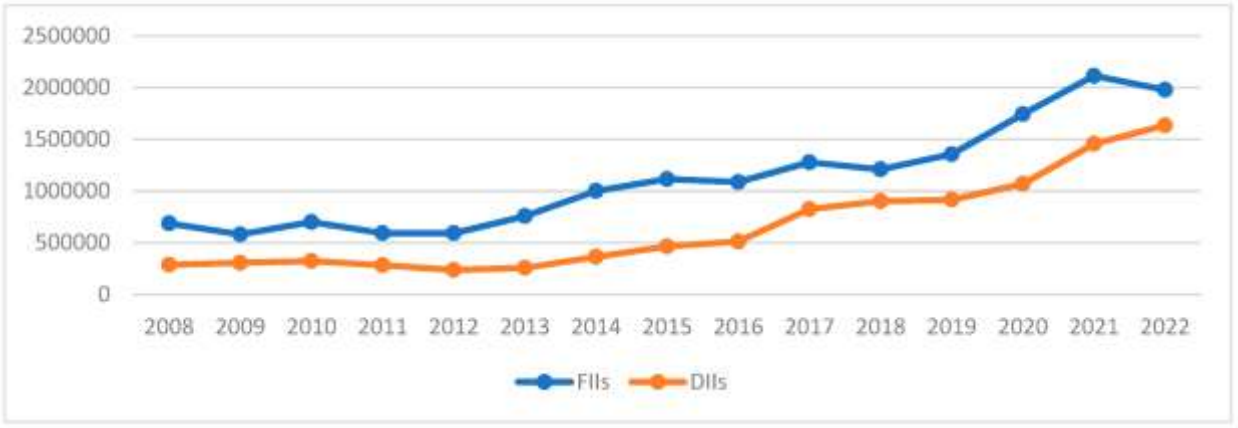
Background on Developing Stock Markets and Globalization

The globalisation of finance has put pressure on emerging stock markets to undergo significant transformation. As countries liberalised their capital accounts, experienced significant technology progression, and have made major reforms to their financial regulation. Financial Globalisation has thus allowed for the increasing integration of new economies into the global financial markets. Those financial markets have transformed through increased size, trading activity and international participation. Although they have expanded, these markets face a number of challenges (i.e., asymmetrical information, insufficient liquidity and higher volatility) that will affect their efficiency and stability.

Growth of Foreign Institutional Investment (FII)

Institutional Investment has grown in importance as a source of capital flow into emerging economies. Regulatory reforms that have removed restrictions on foreign institutional investor expenditure and the development of better market infrastructure has made it attractive for mutual funds, pension funds and hedge funds to invest in the emerging financial markets. The impact of these investments has increased the depth and liquidity of those financial markets and has made these institutions influential participants in the price formation and market dynamics of the emerging financial markets.

Gross buying of FIIs and DIIs on NSE Nifty Index Options (INR in crores).



Source:MDPI

Both foreign institutional investors (FIIs) and domestic institutional investors (DIIs) have increased their gross buying activity in India's equity markets; this incremental increase indicates that there has been increasing participation in the market over time. In addition, the FII investments are consistently higher than those of the DIIs, demonstrating how they contribute substantially toward enhancing the liquidity and price discovery in the equity markets, thus supporting the study's conclusion that FIIs provide a benefit to the efficiency of the equity market.

Importance of Market Efficiency for Economic Development

Market efficiency is important to economic development because efficient markets promote resource allocation, reduce the costs of capital and build confidence with investors. In addition, developing equity markets that are efficient help promote the formation of capital by improving the allocation of capital to productive investments thereby supporting long term economic growth and financial stability.

Research Objectives

- The purpose of this study is to explore the influence of foreign institutional investment (FII) on developing world's stock markets efficiency.
- Assess the impact of FII's contribution to market efficiency, liquidity and information price discovery.
- Establish both short-term and long-term impacts that the FIIs will have on the stability/volatility of select developing countries' stock markets.

2. Conceptual Framework & Definitions

Foreign Institutional Investment: Meaning, Types, and Channels

Foreign Institutional Investment is defined as an investor from one country investing money at a given time into the financial assets of another country. Institutional investors include mutual funds, pension funds, insurance companies, hedge funds, and sovereign wealth funds, among others. FIIs mainly invest in equities, bonds and derivatives on domestic stock exchanges, while developing countries stock markets usually involve FIIs using their investments to purchase shares or equities, government bonds and the derivatives. FIIs may be classified into two groups based upon the length of time they expect to retain their investment; this may be long term (such as pension and mutual funds) or short term (such as hedge funds). The four channels through which FIIs can influence the stock market are through;

Capital Inflows; Trading Activity; Information Flow; Other Corporate Governance. FIIs influence liquidity, price discovery and overall market volatility through their trade activities or portfolio rebalancing.

Market Efficiency: Weak, Semi-Strong, and Strong Forms

Market Efficiency is defined by three types of market; weak form; semi-strong form; strong form. Market Efficiency is determined based on how quickly the stock price reacts to new information (as through the Efficient Market Hypothesis). The weak form states that the share price reflects all past effective price & trading (volume) information and therefore there are no abnormal profit opportunities by using technical analysis. The semi-strong form claims that prices will quickly reflect & adjust for any publicly available information and therefore there will be no abnormal profit opportunities through fundamental analysis. The strong form states that stock price includes both private and public information and thus, no abnormal profit opportunities exist to either technical analysis or fundamental analysis.

Importance of Market Efficiency in Developing Economies

Efficient markets are important for emerging economies because capital markets are the main way to raise funds and provide the capital for a country's economic activity. If a country has a well-functioning stock market, then information asymmetries will be reduced, there will be lower transaction costs, and investors will have more confidence in the efficiency of the market. Increased efficiency of the stock market will create more capital, stimulate the inflow of foreign capital, and thus help to foster ongoing economic growth and financial stability.

3. Theoretical Link Between FII and Market Efficiency

Information Transmission and Price Discovery

FIIs are generally viewed as being better informed and more sophisticated than local investors because they have better access to global information and use more advanced analytical processes and skill sets than the typical domestic investor. As a result, FIIs are generally much quicker than domestic investors to incorporate new information about macroeconomic conditions, firm-specific earnings releases, and international developments in the global capital markets into stock prices. This rapid response of FIIs to macroeconomic news and firm-specific announcements leads to stock prices being a truer reflection of all available information, thereby improving the price discovery process. Furthermore, FIIs improve the informational efficiency of developing capital markets by providing additional channels for information to flow into those developing markets.

Liquidity Enhancement and Reduced Transaction Costs

FIIs enhance liquidity in stock markets by increasing the number of trades being executed and the amount of participants in stock exchanges. As a result of improved liquidity, the bid-ask spread, and the transaction costs for investors in a given security, are reduced creating more efficient markets for investors to make trades without creating significant price movement. In addition, FIIs provide liquidity that allows for smoother price adjustments in stock prices and less friction in the capital markets; thus helping to ensure the efficient operation of capital markets. In developing countries, where liquidity is often constrained, FII investment in capital markets can play a significant role in enabling and improving the overall operation of capital markets.

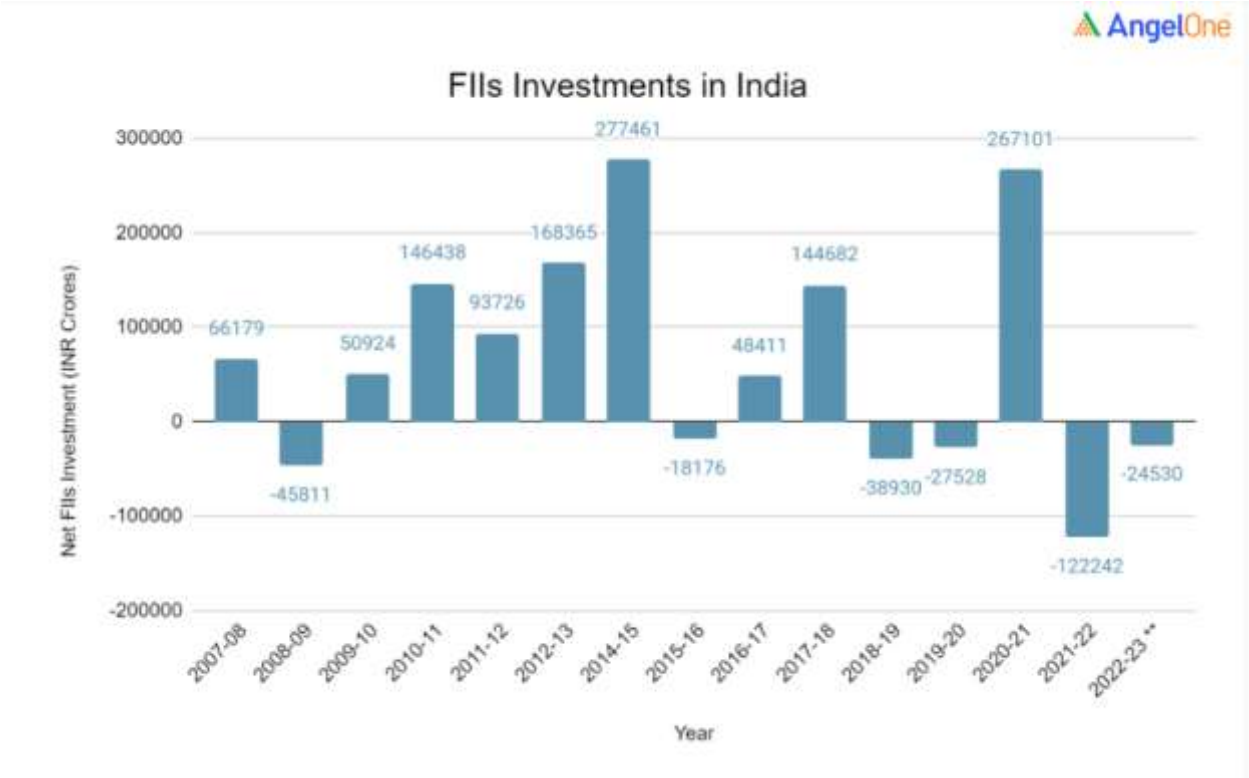
Corporate Governance and Monitoring Effects

FIIs (Foreign Institutional Investors) commonly invest in companies outside of their home country, and as a result, can be expected to monitor the performance of the companies that they have invested in on an ongoing basis. Furthermore, the presence of FIIs in a firm may also enhance the corporate governance practices of that firm due to the fact that FIIs generally require their portfolio investments to adhere to good corporate governance practices and are required by law to disclose all material information, as well as to be transparent in their dealings. In addition, they may exert influence

on the decisions made by the firm's management through shareholder activism or exercising their voting rights to encourage the firm to implement policies that create value. Enhanced corporate governance reduces agency conflict and information asymmetry, which provides for more accurate pricing of equity securities and leads to greater efficiency in the capital markets.

Possible Destabilizing Effects: Herding and Volatility

While FIIs may add to the efficiency of developing equity markets, they can also have negative effects such as contributing to the volatility in developing equity markets. For example, herding (where investors follow or copy the trading strategies of others) can exacerbate price movement and create asset price bubbles. In addition, sudden reversals in the capital flows into or out of developing equity markets during times of global uncertainty may increase the volatility of the equity market and disrupt equity prices. The potential for herding behavior creates a short-term inefficiency and negates the positive effect of FIIs on the overall efficiency of the capital markets.



Source: AngelOne

The chart demonstrates the volatility of FII flow into India as a function of changing economic and global market conditions. Increasing inflows into the Indian equity market enhance the liquidity and the level of confidence that investors have in the market. In addition, the sudden decrease of inflows from FIIs will have a detrimental effect on the stability of the equity markets and will cause increased volatility in the short term. This supports the study's conclusion that FIIs provide benefits to market efficiency, while at the same time may contribute to short-term market instability.

4. Literature Review

The literature review demonstrates the mixed impacts of foreign institutional investment (FII) on market efficiency across developed and developing countries. Thus, research from developed markets has produced consistent results that indicate FIIs lead to enhanced price efficiency. For example, (Kacperczyk et al. , 2020) found that the increased ownership of stocks by foreign investors (increased FII) resulted in more informative stock prices and increased stock liquidity which indicated FIIs provide new information and improve informational efficiency through sophisticated trading and reducing stock mispricing in the developed markets. In addition, there are further studies conducted in Japan

that indicate that the increased presence of foreign investors has led to stock prices that better reflect the fundamental value of stocks, thereby indicating increased informational efficiency.

On the other hand, there are also examples in emerging markets of the mixed effects of FIIs on market efficiency. Evidence from the Central and Eastern European stock market indicated that the presence of FIIs positively affects informational efficiency, but not all CEE countries are the same in this regard. For example, a study conducted in Saudi Arabia during the liberalization phase that allowed FIIs to participate indicated this had a positive impact on weak-form market efficiency, but it differed by stock.

Additionally, there is evidence that indicates that FIIs may have a negative effect on market liquidity and contribute to market volatility in emerging country contexts. The study conducted by (Prasanna & Bansal, 2014) in India showed that the trading conducted by FIIs may negatively impact liquidity and have a volatile impact on emerging markets when other trading volumes are increasing. Furthermore, other studies on dynamic interactions have also indicated that FIIs may play a role in determining how prices are set by establishing a correlation between stock prices and their fundamental values, which is referred to as price lag.

The largest capital market in Latin America is in Brazil, which serves as a point of reference for understanding the interplay between FII and market efficiency. Reforms implemented by B3 (Brasil Bolsa Balcão), including the new corporate governance segment Novo Mercado, have increased transparency, standards of disclosure and protection of shareholders, consequently improving confidence in foreign investors. The inflow of foreign institutional investment has resulted in increased liquidity in the market, an improvement in the accuracy of price discovery, and enhanced corporate governance in the Brazilian capital market. While FII activities have contributed to increased efficiency of the capital market over time, Brazil's dependence on commodity exports, political risk and volatility of exchange rates create a highly volatile capital market that can result in severe short-term price fluctuations, even in an environment of long-term efficiency.

The South African capital market provides a unique perspective regarding FII and its relationship to capital market efficiency. The South African capital market has one of the most developed financial markets in Africa through the Johannesburg Stock Exchange. The existence of high levels of regulatory compliance and transparency as well as strong corporate governance has facilitated an increase in FII, contributing to greater liquidity and increased efficiency in the capital market as a result of more accurate price discovery. The participation of foreign investors has been crucial to the improvement in transparency and accountability in the financial markets. However, South Africa's capital market is also affected by significant levels of volatility caused by sudden fluctuations of the exchange rate, political risk and changes in global investor sentiment, leading to frequent temporary capital market dislocation and capital flight.

Country	Major Benefits	Key Challenges
India	Higher liquidity, efficient price discovery, stronger governance	Volatility during global crises
Brazil	Improved corporate governance, higher foreign participation	Commodity dependence, political uncertainty
South Africa	Strong transparency, institutional maturity	Exchange-rate volatility, capital outflows

According to the literature reviewing the impact of FII participation on developing market efficiency, there appears to be evidence of efficiency gains as well as instability concerns regarding the role of FII participation. There are already significant studies examining FII and developing market efficiencies, however, gaps in knowledge remain particularly regarding the effects of FIIs' strategic investment horizon, regulatory environment and the stock market development structure on FII market efficiency should be studied further empirically. A more complete view regarding whether FII participation is positively enhancing developing country markets is needed through additional research.

5. Methodology

The purpose of this research is to consider the role played by Foreign Institutional Investment (FII) in improving market efficiency within developed countries' markets. The research used a variety of secondary sources (financial statements, regulatory publications, market reviews and academic studies) to provide a means of assessing both FII investment levels and their relationship with the overall efficiency of the investor in specific global markets of developing nations.

The case studies of India, Brazil and South Africa were chosen because they are geographically diverse examples of emerging markets with significant foreign institutional investor involvement and well-developed stock markets. In addition to regional diversity across Asia, Latin America and Africa, they allow for a larger comparative view of the impact of foreign institutional investment on efficiency in one or more of the participants' markets.

Although Brazil, India, and South Africa have each undergone financial liberalisation and regulatory reforms to encourage foreign investment, they are also structured economically, governed, developed and exposed to financial risk in very different ways; therefore they can be analysed comparatively and allow for both common and unique national patterns to be Identified as to how foreign institutional investment has impacted efficiency within each country's respective stock market.

The research utilised three examples of the major developing markets India, Brazil and South Africa, between 2010 and 2023, because of their high level of FII investment and availability of qualitative information regarding FII investment impact. FII is evaluated using descriptive measures including types of foreign investors, investor holding patterns, portfolio strategy, and regulations impacting FII investment decisions. The efficiency of the stock markets analysed is evaluated using three measures of market efficiency; price responsiveness, volatility and transparency. The research document the variables identified through comparative assessments of various cases and expert analysis of the stock markets and wuse thematic analyses to identify related themes related to FII's impact on market efficiency. The findings of this research demonstrate how FII affects developing stock market efficiency and have the potential for providing insight about how and why FII affects the efficiency of developing markets.

Criteria	**India**	**Brazil**	**South Africa**
Region	Asia	Latin America	Africa
Emerging Market Status	Strong	Strong	Strong
Major Stock Exchange	NSE & BSE	B3 Exchange	Johannesburg Stock Exchange

Regulatory Authority	SEBI	Comissão de Valores Mobiliários (CVM)	Financial Sector Conduct Authority (FSCA)
Level of Foreign Institutional Participation	High	High	High
Distinctive Characteristic	Rapid financial liberalisation and digital trading	Commodity-driven economy with governance reforms	Highly developed African financial market
Purpose in Study	Benchmark emerging market	Latin American comparison	African comparison

6. Empirical Results and Analysis

Qualitative analysis provides insight into the ways that foreign institutional investment (FII) enhances efficiency of developing stock markets. FII improved the ability of stock markets in Brazil, India and South Africa to efficiently discover prices and disseminate information, especially those with lower levels of domestic ownership. Findings from various studies reported and reviewed describe improvements in short-term price responsiveness of developed stock markets following increases in FII, thus enhancing informational efficiency.

However, qualitative analysis points out major differences between the short term and long term. In the short run, increased amounts of FII entering or exiting stock markets can create volatility spikes and temporary inefficiencies, such as during global financial crises when many markets were affected. In the long run, increased levels of FII have contributed to improved transparency, liquidity and corporate governance for stock markets leading to greater pricing stability and efficiency.

Differences among the three countries were evident as well. India experienced the most positive impact from FII investments on liquidity and governance followed by Brazil and South Africa experiencing positive and negative impacts from FII investments with some evidence of destabilizing effects caused by speculative flow in these two countries. In conclusion, while in the long run FII has generally been proven to improve the efficiency of securities markets, authorities must continue to monitor and regulate FII so as to minimize the negative effects of FII on the stability of securities markets in the short run.

Brazil: Empirical Insights

Based on the qualitative data analysed, it appeared that Brazil has improved its liquidity, price efficiency and corporate governance as a result of foreign institutional investment into the country. Certain regulatory initiatives implemented by the B3 Exchange such as improving disclosure standards and improving corporate governance requirements have increased international institutional investor involvement within the Domestic capital markets, increasing domestic market activity.

However, Brazil continues to be very reactive to the price of commodities and the state of global financial markets resulting in periodic capital inflows and outflows, causing temporary increases in domestic market volatility. Even with all of the short-term fluctuations experienced in the country's equity market; the long-Term trend will increase as investments from foreign institutions continue to grow and improvements in the structure of Brazil's equity market are realised.

South Africa

The South African example showcases how having robust financial institutions and effective regulation of markets can derive maximum advantage from Foreign Institutional Investors (FIIs) while limiting the potential for associated risks. The Johannesburg Stock Exchange (JSE) has consistently attracted foreign investors by virtue of its superior standards of governance compared with other exchanges globally, as well as having an accessible and transparent regulatory framework within which these firms operate. As more foreign investors have participated in the market, liquidity has improved, the price discovery process has been strengthened, and there has been a move towards more robust standards associated with disclosures of companies listed on the exchange. However, risks to the market continue to be posed by external factors including fluctuations in exchange rates, global investment sentiment, and domestic economic difficulties. Overall, the South African example suggests that strong institutional quality can facilitate positive foreign institutional investor contributions to long-term market efficiency and remain resilient to short-term market shocks.

Table — Impact of IPO activity on market development: comparative analysis

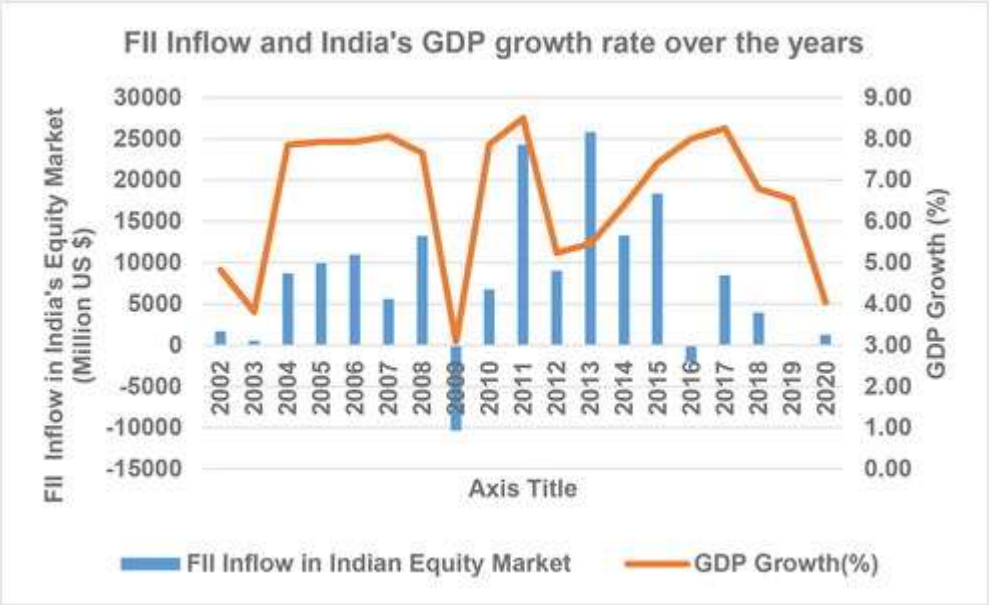
Aspect	India	Brazil	South Africa
Liquidity	Significant improvement	Moderate improvement	Moderate improvement
Price discovery	Strong	Improved	Improved
Corporate governance	Strengthened through regulatory reforms	Improved through B3 governance initiatives	Enhanced through JSE governance framework
Short-term volatility	Moderate	Relatively high	Moderate
Overall impact	Highly positive	Positive with cyclical risks	Positive with external vulnerabilities

Note: Assessment based on aggregated market indicators across the study period. B3 = Brasil, Bolsa, Balcão; JSE = Johannesburg Stock Exchange.

Collectively, these findings demonstrate that foreign institutional investors do provide positive contributions to all three countries' long-term market efficiency, though their degree of impact varies according to both the domestic macroeconomic and institutional environment. India benefitted most from regulatory reform and technology development, resulting in the highest improvements. Brazil also experienced improvements through improved

governance and increased liquidity but suffers from greater cyclical volatility as its economy is heavily reliant on commodity exports and political instability. Lastly, South Africa has demonstrated that strong institutional quality and regulatory oversight enable efficient long-term market performance, despite external economic challenges.

FII inflow and India's GDP growth rate over the years



Source: Tandfonline

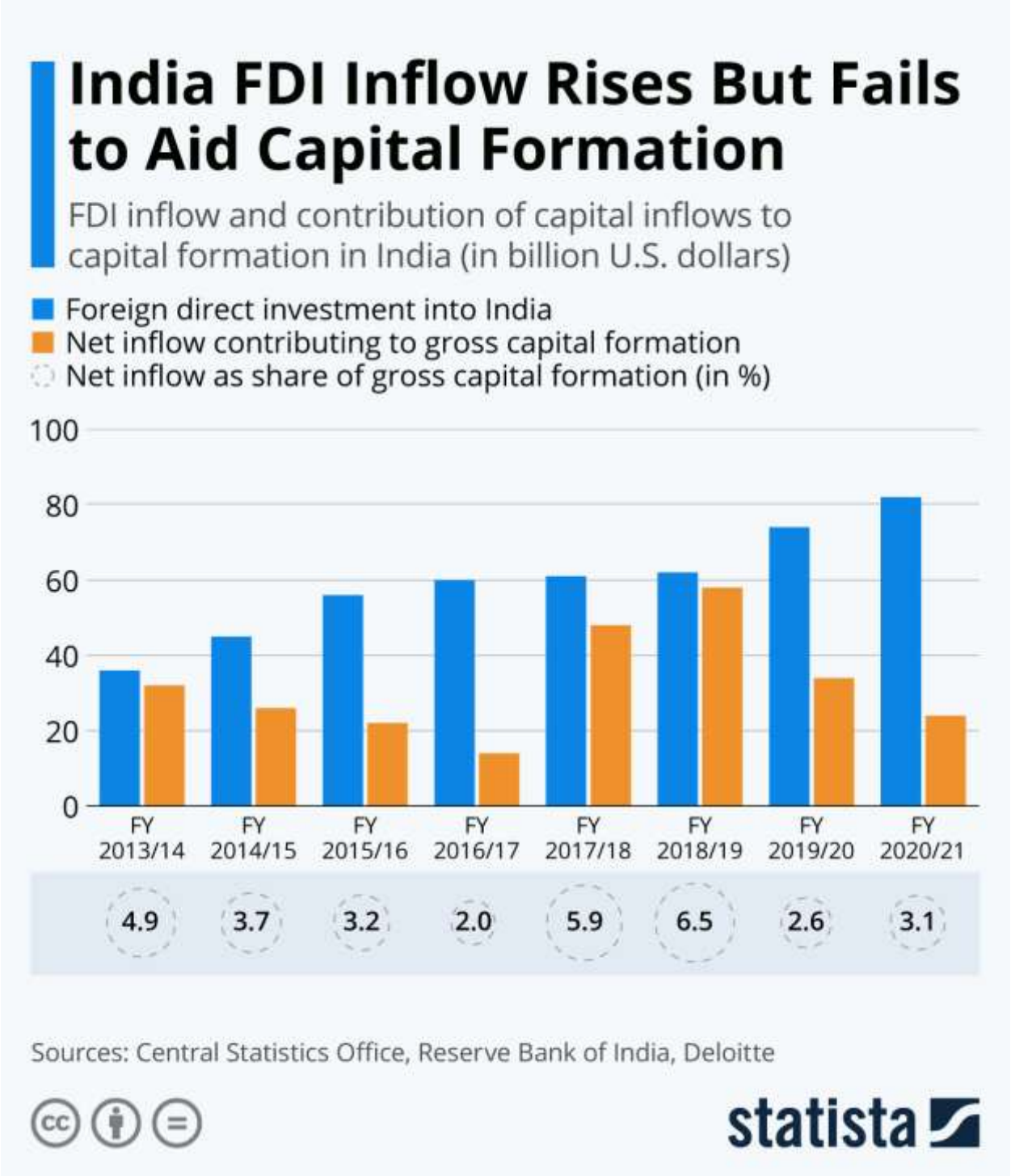
It is clear from the graph provided that increases in Foreign Institutional Investment (FII) are generally associated with periods of better GDP growth for India. This observation indicates that the better the economy, the more FII is willing to contribute. Although, as a result of other events occurring in both international and domestic markets, there will be considerable variation in FII's weekly inflows (contributing to improved liquidity of Australian capital markets and increasing investor confidence), opportunities for international investment remain even in the face of volatility over the medium term (providing evidence to support the conclusion of this study). FII has the ability to enhance overall market efficiency through its investment in establishing strong capital markets, assisting with pricing developments, and assisting in the creation of long-term capital development despite short-term volatility at times.

7. Discussion

According to the qualitative analysis, FIIs have a positive impact on stock market efficiency, especially when examined over a longer time horizon in regards to developing stock markets. Theoretical support for these results is provided through the Efficient Market Hypothesis (EMH), which states that FII participation facilitates quicker dissemination of information within markets; therefore, they also enhance the efficiency of price discovery and liquidity in relatively immature capital markets by reducing information asymmetry between large institutional investors and individual investors. Although short-term volatility is evident through results of the short-term price fluctuations experienced in some of the studied countries, the underlying reason for these price fluctuations can be attributed to the fear that large volumes of foreign funds coming into a stock is going to cause instability to the stock as a result of the so-called "herding" behavior theorized to exist in developing stock markets due to feedback trading from multiple large institutional investors.

Therefore, the results of this research are consistent with previous studies that have researched emerging markets, such as India, Central/Eastern Europe (Albuquerque et al., 2013; Prasanna & Bansal, 2014), and indicate that a sustained FII presence can positively increase the efficiency of a market's transparency and operation but exhibit temporary inefficiencies and volatility spikes as evidenced in the Brazilian and South African stock markets (Goudarzi & Ramanarayanan 2015). As such, policymakers in developing economies should strongly consider implementing regulations and phased liberalization strategies that provide stable FIIs to increase stock market efficiency while providing for safeguards to manage short-term volatility will promote improved, resilient, and mature capital markets globally.

The comparative analysis of India, Brazil, and South Africa indicate that foreign institutional investment has a positive effect on market efficiencies; however, the impact that it has on market efficiency varies between each country and is directly related to that country's institutional framework and economic conditions. India is the clear leader among the three in terms of improvements to liquidity, market depth and price discovery as a result of the reforms made to the financial sector, advancements in technology, and an increasingly sound regulatory environment. Compared to these other two countries, Brazil illustrates the significance of corporate governance reforms on attracting foreign investors, while also demonstrating how political instability and commodity price volatility can increase the volatility of the domestic markets. In South Africa, the well-developed financial institutions and mature regulatory framework allowed for foreign institutional investment to increase transparency and give investors confidence, even during a period of persistent macroeconomic instability. Collectively, the experience illustrated by the examples of these three countries suggest that foreign institutional investments will maximize their long-term benefits when supported by effective regulation, good governance, and stable macroeconomic policies.



8. Policy Implications

The findings of this analysis raise several important issues for policymakers responsible for developing stock markets within developing nations. One major issue requiring a focus shift from the regulators of capital markets to establishing a stronger regulatory framework governing the performance of foreign institutional investors (FIIs) as they relate to capital market efficiency.

To create more effective regulation, regulatory authorities will need to improve disclosure requirements, implement higher levels of corporate governance standards, and develop greater levels of transparency within trading practices in order to reduce the extent of information asymmetry and enhance the level of investor confidence.

Secondly, liberalization policies designed to attract foreign institutional investment (FIIs) will need to be carefully constructed to attractFIIs that wish to provide stable, long-term capital flows and at the same time, limit the risk arising from speculative short-term capital flow contributions to developing capital markets by FIIs. Gradually opening capital markets; providing more explicit guidelines regarding the size, type, and timing of investments; and distinguishing between long- and short-term investment strategies will create greater positive contributions from FIIs and decrease destabilizing effects caused by FIIs on capital markets.

Finally, the establishment of safeguards against excessive volatility within developing stock markets will be beneficial to capital market participants. Such safeguards include regulatory elements such as: circuit breaker mechanisms; limits on daily net investments by FIIs; and monitoring systems for exceedingly large investments.

9. Conclusion

This research investigated the qualitative way in which Foreign Institutional Investors (FIIs) impact the efficiency of stock markets in developing countries. The primary focus of this research was to determine the impact of FIIs on market efficiency in three developing countries; India, Brazil, and South Africa. The findings of this study demonstrate that FIIs have a long-term positive effect on market efficiency in developing countries through different elements of market efficiency, i.e., price discovery, liquidity, and the quality of corporate governance. It is primarily because many developing countries have relatively low levels of local participation in their equity/capital markets compared to the amount of foreign investment into their local market provided by FIIs. The research demonstrates that FIIs also create short-term volatility at certain times, due to the speculative nature of many foreign investment trades, particularly following extreme levels of current and past foreign trade inflows or outflows. In summary, this study shows that FIIs are not only an additional source of improved market efficiency through the use of intensive amounts of FII trading, but FIIs also increase market risk through the speculative nature of many foreign trade transactions; which can ultimately lead to significant losses to market participants. The results from this type of future research would likely also provide additional knowledge and understanding about developing market economies, by way of using comparative analysis between multiple developing countries, in regards to the FII-to-market value relationship.

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