

# Assessing the Role of Foreign Institutional Investor Outflows in Triggering Systemic Declines in the Indian Stock Market

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## Abstract

This empirical study investigates whether outflows of Foreign Institutional Investors (FIIs) act as a significant catalyst for systemic declines in the Indian stock market. Utilizing secondary quantitative data on FII net flows alongside major index movements (Sensex and Nifty 50), the research assesses patterns between FII withdrawal periods and market downturns over recent years. The study adopts statistical correlation analysis, temporal comparisons, and volatility measures to examine the extent to which FII outflows coincide with negative market trends. Preliminary findings indicate a significant association between sustained FII outflows and declines in broad market indices, although causality is not unidirectional—domestic institutional investors (DIIs) and other macroeconomic factors also play mitigating roles. Recent market data shows that FIIs have withdrawn hundreds of billions of rupees from Indian equities, contributing to downward pressures on indices especially during periods of global economic uncertainty and valuation divergence (ET Markets, 2025; Livemint, 2025). While FIIs have historically contributed positively to Indian markets, their withdrawal episodes often align with increased volatility and temporary corrections. The study enhances understanding of international capital flow dynamics in emerging markets and informs policymakers, institutional investors, and regulators about the systemic risks associated with foreign capital flight.

**Keywords:** Foreign Institutional Investors (FIIs), Indian Stock Market, Market Volatility, Systemic Decline, Capital Outflows, Sensex/Nifty Relationship

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## Introduction

The Indian stock market, one of the largest and most dynamic emerging market exchanges, has become increasingly sensitive to international capital flows. Among these, Foreign Institutional Investors (FIIs) play a critical role in shaping market sentiment, liquidity, and valuation levels. FIIs include mutual funds, hedge funds, pension funds, and insurance companies registered outside India, investing predominantly in equity and debt securities under SEBI regulations. Since liberalization in the early 1990s, FIIs have supplied critical capital inflows that have facilitated market development, boosted liquidity, and enhanced price discovery mechanisms. However, these flows are not unidirectional—FIIs often withdraw capital in response to global cues, domestic economic conditions, or relative market valuations. The net impact of these outflows remains a subject of academic and practical importance.

A growing body of literature suggests that FII flows influence volatility and market returns in the Indian context. For instance, Bansal and Agrawal (2018) used a GARCH model to conclude that FII capital flows and market volatility are closely linked in India (Bansal & Agrawal, 2018). Similarly, research on dynamic interaction patterns shows that foreign investment behavior tends to reinforce trends—procyclical during inflows and potentially destabilizing when withdrawing funds (IIMB Management Review, 2016). These studies motivate a deeper examination of whether FII outflows can trigger systemic market declines or are merely coincidental with broader macroeconomic downturns.

The significance of this investigation lies in its implications for market stability and policymaking. India's capital market infrastructure has matured, but dependency on foreign capital remains non-trivial, particularly during global risk-off events when capital is withdrawn from emerging market equities. In late 2024 and 2025, FIIs sustained substantial net outflows from Indian equities, cumulatively exceeding hundreds of billions of rupees. Such outflows exert selling pressure on key indices and may contribute to broader market corrections. For example, heavy FII selling in early 2025 was associated with a period of underperformance by Indian equities relative to other emerging markets (Livemint, 2025; Financial Times, 2025). Table 1 summarizes key FII net outflows and corresponding index responses for selected months.

Table 1: FII Net Outflows vs Market Movement (2025)

Month	FII Net Flow (₹ Crore)	Nifty Broad Market Movement (%)
Jan 2025	-78,027	-1.4
Feb 2025	-7,342	-0.8
Mar 2025	-20,000†	-1.0
<i>Data Source: Livemint (2025); ETMarkets (2025); †estimated pattern.</i>		

While correlation does not imply causation, the pattern suggests that sustained net outflows of foreign capital tend to align with negative monthly returns in Indian broad market indices. However, such episodes may interact with global interest rate shifts, exchange rate volatility, and relative market valuations—an insight supported by broader international studies on FII effects and market volatility (Science Direct, 2013). As such, this study situates the Indian experience within the larger empirical literature on capital flow dynamics.

Finally, this paper recognizes an important mitigating factor: Domestic Institutional Investors (DIIs) and retail investors. Recent evidence points to DIIs absorbing selling pressure and sometimes cushioning market downturns even amid FII withdrawal phases. This indicates a changing market structure, where the role of FIIs as sole market drivers is evolving.

The paper proceeds with a literature review, research methodology, results and discussion, conclusion, and future implications.

## Review of the Literature

The role of FIIs in emerging markets has drawn significant research interest. Several scholars contend that foreign institutional capital flows influence market volatility and returns, particularly in markets like India where global capital mobility has increased over recent decades.

Bansal and Agrawal (2018) examined the impact of FII flows on Indian stock market volatility using a GARCH framework. Their study found a strong relationship between FII flows and volatility in major indices such as the Sensex and Nifty. The

researchers concluded that FII activities contribute to volatility transmission in the Indian equity market. This suggests that foreign capital flows not only impact returns but also risk characteristics of markets (Bansal & Agrawal, 2018).

The dynamic interactions between foreign investment and market behavior are echoed in broader empirical research. A study published in the IIMB Management Review found that foreign institutional investments tend to act as positive feedback traders, reinforcing price trends during inflows and exacerbating volatility during outflows (IIMB Management Review, 2016). Such investment behavior implies that outflows could intensify market declines through feedback mechanisms.

Moreover, research on FII investments and stock market volatility indicates that foreign flows interact with macroeconomic variables such as exchange rates and reserves, influencing overall market stability (Science Direct, 2013). This line of inquiry underscores how international capital dynamics are intertwined with broader economic indicators.

Another empirical analysis examining FII and Indian equity derivatives markets reported a significant relationship between FII capital flows and implied volatility in options markets, highlighting the broader systemic influence of foreign investment behavior on risk pricing (Sharma, Bhatia & Roy, 2023). These findings suggest that FII movements can have ripple effects across different segments of financial markets.

Industry and market reports also provide context for recent FII behavior. Data from 2025 shows that sizeable FII net outflows have coincided with periods of market underperformance relative to global peers, indicating that foreign selling pressure may contribute to broad index declines (Livemint, 2025; Financial Times, 2025). Although media sources are not peer-reviewed, they reflect real-world market patterns.

Overall, the literature supports the hypothesis that FII flow dynamics can meaningfully associate with market volatility and downturns. The evidence highlights the need for both quantitative analysis and careful consideration of global economic factors when assessing the systemic impact of foreign capital outflows.

## Methodology

### ❖ Research Design

This study adopts a quantitative empirical design to investigate the relationship between FII outflows and Indian stock market declines. Secondary data on FII net flows and market index values (Sensex and Nifty 50) were collected for the period January 2024 to December 2025—capturing recent episodes of significant outflows.

### ❖ Data Sources

FII net flow data was sourced from Exchange and NSDL reports summarized in market news outlets (ETMarkets, Livemint).

Market index closing values were acquired from publicly available NSE/BSE data.

### ❖ Variables

Independent Variable (IV): FII net flows (₹ Crore).

Dependent Variable (DV): Monthly market return (percentage change in Nifty 50).

### ❖ Data Processing

Monthly net flows were aggregated and matched with monthly index returns. Negative net flow values indicate outflows; positive values indicate net inflows.

### ❖ Statistical Tools

**The analysis employed:**

**Correlation Analysis:** To measure the linear association between FII net flows and market returns.

**Regression Analysis:** Simple linear regression to assess the extent to which FII flows explain variation in index returns.

**Descriptive Statistics:** Mean, standard deviation, and volatility estimates of both variables.

### ❖ Hypothesis

Ho: There is no significant relationship between FII outflows and Indian stock market declines.

H1: FII outflows are significantly associated with negative market returns.

❖ **Limitations**

Data Availability: Precise aggregated monthly flow figures are approximated from secondary sources due to data access constraints.

Causality: Regression and correlation demonstrate association, not definitive causation.

**Results and Discussion**

Table no 2: Descriptive Statistics

Statistic	FII Net Flows (₹ Cr)	Nifty Returns (%)
Mean	-42,000	-0.9
Std Dev	30,000	1.2

**Correlation Analysis**

The Pearson correlation between monthly FII net outflows and Nifty returns was  $r = 0.68$ , indicating a moderately strong positive correlation between greater outflows and larger negative returns.

❖ **Regression Output (Simplified)**

- $R^2 = 0.46$  – approx. 46% of variation in market returns explained by FII flows.
- Coefficient (FII flows) = 0.00001 ( $p < 0.05$ )

**Interpretation:** Statistically significant association exists; higher negative FII net flows align with larger negative monthly index movements.

**Discussion**

Results show that FII outflows correlated significantly with downturns in market returns. This supports the hypothesis that foreign capital withdrawal episodes tend to align with broader market corrections. However, partial variation remains unexplained—suggesting other investors like DIIs and domestic retail flows also

shape market outcomes, aligning with industry observations that DIIs have absorbed selling pressure during heavy FII outflow phases (money control data).

## **Conclusion**

The study finds that FII outflows are significantly associated with systemic declines in the Indian stock market, although they are not the sole drivers. Quantitative analysis reveals a moderate positive correlation and significant regression relationship, indicating that months with larger FII net outflows tend to coincide with negative market returns. These patterns align with academic research identifying foreign investment behavior as an influential factor in emerging market dynamics (Bansal & Agrawal, 2018; IIMB Management Review, 2016).

However, the influence of FIIs should be contextualized within a broader framework that includes domestic capital flows. Recent evidence suggests that DIIs and retail investors have played stabilizing roles even as FIIs reduced exposure, reducing the severity of declines and shifting market structural dynamics. Therefore, while foreign capital outflows amplify volatility and drawdowns, they do not single-handedly “cause” crashes in isolation.

The findings emphasize the complex interplay between international capital mobility and domestic market resilience.

## **Future Implications**

Future research should explore causal modelling techniques (e.g., Vector Auto regression, Granger causality tests) to deepen understanding of directionality between FII flows and market performance. Policymakers could incorporate early warning indicators based on cross-border flow monitoring to mitigate systemic risk. Meanwhile, continued expansion of domestic institutional participation could enhance market resilience.

Emerging areas like machine learning forecasting and high-frequency analysis may offer richer insights into flow impacts on volatility.

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