

# Impact of Foreign Institutional Investor on Indian Stock Market

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Country: India

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## **Abstract:**

For any economy to progress, it needs business to support its growth and improve its trajectory in achieving its goals. For a business to grow, it needs all its resources at its disposal to help reach a certain level of output. The primary resource any business need is capital. Without capital, a business can't continue operating, impacting the economy's overall growth. Since the Indian economy opened its door to foreign investors, the change has been positive, propelling India to become the world's 5th largest economy. India has been a hotbed for investors over the past two decades, and a variety of investors have dumped billions of dollars into the Indian stock market, i.e., BSE & NSE. In the eye of expecting a healthy return on their investments. This research investigates whether these investors can explain market movement and its influence on capital markets. Because of their short-term nature, FIIs can have a bidirectional effect on the returns generated from other financial markets such as the money market, stock market, or Forex.

**Keywords:** FIIs, stock market, BSE, Nifty, Indian Capital Market, Correlation, the impact of FIIs on the Indian stock market

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## **I. Introduction:**

The majority of developing countries have low levels of income & capital accumulation. Despite the lack of investment, those countries have established a strong desire for rapid industrialization and expand their economies. As we all know, a need for foreign investment emerges owing to a lack of domestic capital and other factors. On numerous occasions, the economy of India has faced a capital shortage.

Due to a lack of resources, it has enlisted the help of foreign countries to build capital-intensive businesses under government supervision.

FII's increased involvement has resulted in a significant increase in the share prices of the stock listed on the BSE and the NSE. However, it is said that there is a strong positive link between FIIs investment & market capitalization, as well as FIIs investment and the BSE and NSE indices, indicating that FIIs flows have a significant impact on liquidity and volatility.

Furthermore, it has been established that FIIs' investments were a substantial component in the capital market's high liquidity and volatility. The research intends to examine the influence of foreign institutional investors (FIIs) on the Indian capital market, focusing on the BSE.

Foreign Institutional Investment refers to an investor registered in a country other than the one in which it is currently investing. Institutional investors include hedge funds, insurance firms, pension funds, and mutual funds. The word is most widely used in India to refer to foreign corporations investing in the country's financial sector.

For FIIs, to invest in the stock market, they must register with the regulator SEBI (Securities and Exchange Board of India) to engage the market. Limiting FII shareholding in Indian companies is one of the most critical market rules affecting FIIs.

## **Foreign Institutional Investors (FIIs)**

FII A foreign institutional investor (FII) is an entity established outside of India to invest in the Indian securities market following SEBI laws. Overseas pension funds, banks, mutual funds, nominee companies, universities, endowments, charitable trusts, trustees, or power of attorney holders, incorporated or formed outside India, offering to make proprietary investments on behalf of funds, are all examples of FIIs. FIIs may invest their funds with their worldwide customers registered with SEBI.

### **Background of FIIs in India 1992 to 1999**

Significant investment inflows from foreign portfolio investors (FPIs) or foreign institutional investors (FIIs) began in 1992-93. Since liberalization, many things have changed in India, particularly in the Indian capital market, where a large amount of foreign capital has begun to come in.

For the first 4-5 years, the equities sector saw the most inflows, i.e., stock market inflows. Fixed security investments began in 1996-97 when foreign institutional investors (FIIs) began investing in fixed-income securities issued by Indian companies and government securities.

We experienced negative flows for the first time in 1998-99. The cause of this was the Asian currency crisis. We experienced rupee withdrawals of roughly 717 crores in stock and about 867 crores in debt, totaling nearly 1,584 crore rupees from our capital market.

### **2000-2011**

We noticed a tiny outflow of roughly 273 crore rupees in the debt market in 2000-01. In 2003, 2004, and 2005, we experienced significant inflows. In 2005-2006, we saw outflows of roughly 7,334 crore rupees in the loan sector, but equity was an attractive asset class, with inflows of around 48,801 crore rupees that year due to the encouraging market trend.

The dismal year for equities markets was 2008-09, which everyone remembers as the Lehman Brothers crisis.

The vast majority of investments were unsuccessful. The equity market had outflows of almost 47,706 crore rupees that year, but the debt market remained positive, with assets of around 1895 crore rupees. As a result, India's net outflow was over 45,811 crore rupees.

### **2012-2020**

The RBI increased the interest rate from 2.5 percent to 3 percent in 2013-14. As a result, negative capital flows from the debt market were 28060 crore rupees. However, with inflows of 79,709 crore rupees, equity remained net positive. 2014-15 was the election year with a strong, full-majority administration at the Centre. We had the biggest inflow in India that year, totaling over 2,77,460 crore rupees. (1,11,333 crores in equity and 1,66,127 crores in debt). Both the equities and debt markets had negative flows in 2015-16. The debt market was the net attractor in 2017-18, attracting investment of 1,19,036 crore rupees. Foreign portfolio investors (FPI)/foreign institutional investors (FII) have been one of the most important drivers of financial markets, with roughly Rs. 2.17 trillion invested.

### **Investment limits for FII**

The portfolio investment scheme (PIS) allows foreign institutional investors (FIIs) to invest in India's primary & secondary capital markets. FIIs can buy shares/debentures in Indian companies through stock markets in India under this program. The overall investment limit for FIIs is 24 % of the Indian company's paid-up capital. The maximum limit for banks, such as the State Bank of India, is 20% of their paid-up capital. With the board's approval and a special resolution approved by the company's general body, Regulators can lift the FII investment ceiling of 24 percent to the industry cap/statutory ceiling.

Daily, the Reserve Bank of India reviews the FII/NRI and PIO investment ceilings in Indian enterprises. The Reserve Bank has set cut-off points for foreign investment ceiling limitations that are two percentage points smaller than the actual ceilings to monitor them effectively. For firms in which NRIs/PIOs can invest up to 10% of the company's paid-up capital, the cut-off point is set at 8%, the cut-off level for companies with a ceiling of 24%, and firms with a ceiling of 30% are 28%, and so on. Similarly, public sector banks (along with the State Bank of India) have an 18% cut-off limit.

The Reserve Bank of India cautions all identified bank branches not to purchase extra equity shares of the respective company on behalf of FIIs/NRIs/PIOs without prior Reserve Bank approval.

Once the company's aggregate net purchases of equity shares by FIIs/NRIs/PIOs reach the cut-off point, which is 2% below the overall limit. The Reserve Bank will then be notified of the total number and value of equity shares/convertible debentures of the company that the link offices intend to purchase on behalf of FIIs, NRIs, and PIOs.

The Reserve Bank clears such plans on a first-come, first-served basis until such investments in enterprises reach the 10% / 24% / 30% / 40% / 49 % limit or the sectoral caps/statutory ceilings, as applicable. The Reserve Bank encourages all designated branch offices to halt purchases on behalf of their FIIs/NRIs/PIOs clients once the aggregate ceiling limit is reached. The Reserve Bank also issues a press release informing the public about certain enterprises' caution and stop-purchase order.

### **Need for Foreign Capital**

The need for foreign investment/ foreign capital arises for the following reasons:

**1. Basic infrastructure development:** The development of almost any economy depends on the infrastructure available in the particular country. Roads, seaports, railways, warehouses, financial products, and insurance are all major participants. Individuals would not go forward to build infrastructure businesses due to the extended gestation time. The Indian government has been unable to raise the requisite funds. Foreign capital is an excellent way to bridge the gap.

**2. Rapid industrialization:** The requirement for foreign investment comes from the government's policy measures to accelerate industrialization. For example, India's government is gradually opening sectors to foreign finance to boost the manufacturing sector.

**3. To assume the initial risk:** Private investors are in short supply in many emerging countries. By allowing foreign capitalists to invest, the vulnerability can be shifted to them. The Indians, as we all know, are relatively risk-averse. Foreign investors can be exposed to the same risk by permitting them to invest in higher-risk areas.

**4. Global imperatives:** The world is becoming increasingly globalized. Foreign capital is also a result of international relations between countries. Multinational corporations are growing their presence in various countries, and they will bring their capital with them when they do so. The World Trade Organization (WTO) principles and other regional organizations bind member governments to allow foreign investment.

**5. Comparative advantage:** Variations in capital costs, such as interest rates, are another major reason for attracting foreign capital. For example, when compared to developed economies, India's interest rates are so high. Companies/organizations are now looking for foreign money to lower their capital costs. Interest rates range from 1 percent to 3 percent in some countries, while they range from 8 percent to 10 percent in others.

**6. Bridge the technological divide:** When compared to developed countries, emerging economies have a very inadequate level of technology. On the other hand, these emerging economies have a strong desire to industrialize to improve their economies and escape the low-level trap wherein they find themselves. This necessitates the importation of technologies from sophisticated countries. When technology is acquired through private foreign investment or international collaboration, it generally comes with foreign capital.

### **Government policies:**

In any country, the government in power holds everything at its hand. The public policies rolled out for the people have a weighted effect on the outcomes of various business activities in the country. Any new policy change has the potential to be beneficial to the economy or to tighten the economy. This raises the prospect of the stock market being impacted by any government modifications or implementation of new policies. For example, a rise in corporation taxes significantly affects the sector since earnings suffer while stock prices plummet.

The Stock market is one entity on which public policies substantially impact.

### **Monetary Policies:**

In India, RBI is the apex authority to regulate economic policies in India. The RBI is constantly evaluating its monitoring policies. Any change in Repo and Reverse Repo rates influences stock prices. When the RBI raises key interest rates, it affects bank liquidity. This makes borrowing more expensive for them, raising lending rates. As a result, borrowing becomes prohibitively expensive for the business community, and debt payment may become impossible.

Investors perceive it as a barrier to the development of commercial operations and begin selling shares of the company, lowering its stock price. When the RBI adopts a dovish monetary policy, the opposite occurs. Banks lower lending rates, resulting in credit expansion.

### **Regulatory policies:**

The Security and Exchange Board, i.e., SEBI, is the apex body regulating the Stock market and other securities in India.

**Economic factors:**

**Global & Local Politics:**

As we know, India is the world's largest democracy comprising various states and territories the regional politics play a crucial role in influencing public sentiment across the nation. Elections, budgets, government involvement, stability, and other factors significantly influence the economy and financial markets. Political events and budget releases cause enormous volatility, heavily impacting the stock market.

**Natural Disasters:**

Natural catastrophes have a negative impact on both people and the economy. It influences the company's success and people's ability to spend money. This will result in reduced consumption and decreased sales and revenues, ultimately negatively impacting the company's stock performance.

**Black Swan events:**

Events that are not foreseen or natural can be adjudged as black swan events. Events like Wars, emergencies, covid pandemics and recessions considerably impact the stock markets.

**Objectives:**

- To find out the impact of FII on the Indian capital market.
- To determine the behavior and trend of FIIs on the Indian stock market (2011-2021).
- To determine the factors that influence the investment decision of FIIs.
- To examine whether FIIs have any influence on BSE Sensex and Nifty.

## **II. Literature Review:**

**Mukherjee, P., Bose, S., & Coondoo, D. (2002)** used a time series of daily data from January 1999 to May 2002 to investigate the relationship between foreign institutional investment (FII) flows and the Indian equity market as probable confounders.

**Acharya, V. et al. (2015)** discovered that foreign institutional investors (FIIs) have a negative impact on Indian stock market volatility. The collective trading activity of foreign institutional investors (FIIs) reduces market volatility, whereas the collective trading volume of domestic investors increases market volatility. Positive shocks influence aggregate trading activity more than adverse shocks; this imbalance is higher for aggregate domestic transactions. FIIs do not increase stock volatility, but it is increased when FIIs trade with the domestic client and when domestic clients trade between themselves.

**Bhattacharya et al. (2012)** looked into the preferences of foreign institutional investors (FIIs) and domestic institutional investors (DIIs) in the Indian stock market. FII and DII prefer larger, more widely spread firms and do not seek high returns. However, the author discovered evidence of a significant difference in FII & DII behavior. The literature on this subject is continually developing, with evidence coming from country-specific and multi-country research. This research adds to the field by looking at evidence from FII and DII shareholding trends in an emerging market like India.

**Fama, E. F. (2014)** presented the "random-walk model" theory before putting the concept to the test. The major conclusion would be that the data provide consistent and robust model support. Of course, this suggests that chart reading, while a fun activity, is no real benefit to a stock market investor. This is an outlandish remark to which the reader is free to object. The counterarguments to the chart will be entirely lacking in weight when the empirical work does not equally effectively support them as the empirical data generated by this and another research support the random walk.

**Aydemir, O., & Demirhan, E. (2009)** showed the impact of macroeconomic variables on stock prices & investment decisions. Much empirical research has revealed the connection between macroeconomic variables like interest rates, exchange rates, and money supply. However, both theoretically and empirically, the path of casualty remains unsettled. According to the findings of an empirical study, the exchange rate, as well as all stock market indices, have a bidirectional causal link. While there is a negative causal association between the

national 100, services finance, and industrial index and the exchange rate, technology indices have a favorable causal relationship with the exchange rate.

**Rajnarayan, G. (2010)** investigated the factors that influenced the Sensex movement. The researcher analyzed the data using an Empirical estimate model and a unit root test. According to the author's study of the data, the stock market's direction is influenced only partially by foreign capital, so the country's economy also influences its efficiency.

**Loomba, J. (2012)** the purpose of this research is to understand better the effects of FII trading behavior and its impact on the Indian equities market. The research is based on daily data from the BSE Sensex & FII activities for ten years, from January 1, 2001, to December 31, 2011. It shows that FII activity has a considerable positive link with the effects on the Indian capital market. The analysis also discovers that FII net inflows adequately explain the changes in the Indian capital market.

**Bose, S. (2012)**, the significance of the stock market returns in influencing mutual fund flows can be eclipsed by the effect of FII investments. The study also shows evidence that FIIs' net investments have a causal impact on stock market returns, despite the fact that no causal relationship exists between domestic mutual funds' net investments & domestic stock returns.

**Bok Baik and Joonhe Lee (2012)**, whereas existing institutional ownership is favorably connected to future returns, international institutional ownership has a minimal relationship with returns. For companies with more information asymmetries, the negative relationship between change in ownership of foreign institutions & future returns is especially evident. The negative relationship is much more pronounced when FIIs come from nations with bigger information disadvantages. Finally, the author discovered that non-hedge fund international institutional investors have a very poor ability to estimate returns.

**Shrikanth, M., & Braj, K. (2012)**. in their paper, investigated a cause-and-effect relationship between FII and the Indian capital market. They observed that FIIs carried the institutional flavor regarding market expertise and fund management by pooling small savings from retail investors. The main objective of FIIs is maximizing returns and minimizing risk while keeping the liquidity of the investments intact. They concluded that net FII inflows positively impacted the Indian stock market and foreign exchange reserves.

**Hypothesis:**

- There is a close relationship between BSE Sensex and Foreign Institutional investments.
- There is a close relationship between Nifty and Foreign Institutional investments.

**III. Data Analysis:**

Data:

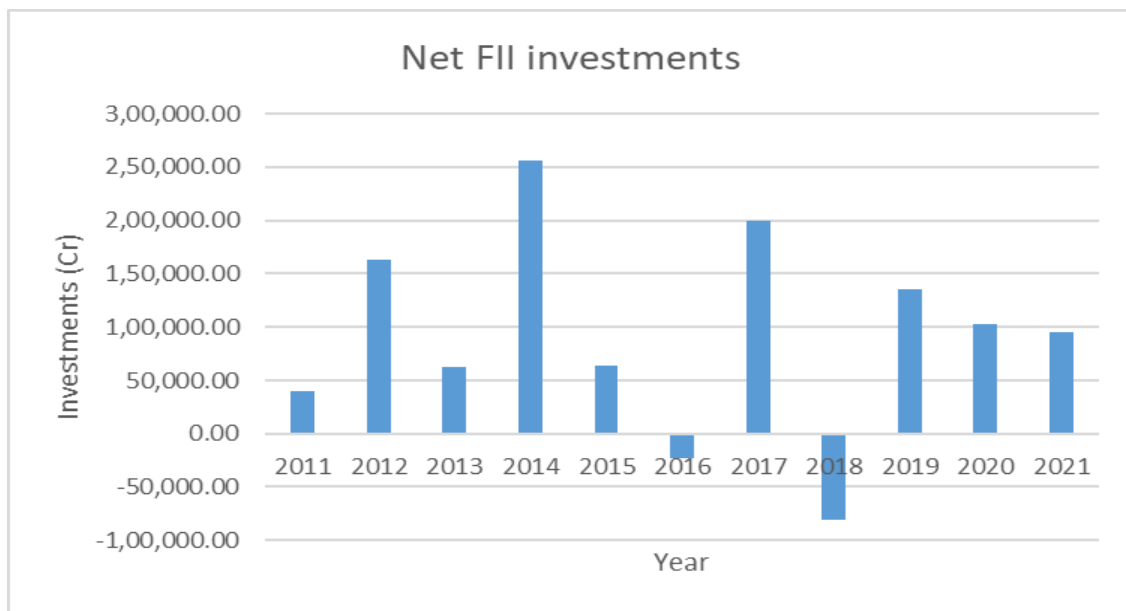
Year	Sensex	Nifty	Net FII investments (In Crore Rs)
2011	19445.2	4624.3	39,352.80
2012	17404.2	5905.1	1,63,349.90
2013	18835.8	6304	62,286.00
2014	22386.3	8282.7	2,56,213.00
2015	27957.5	7946.35	63,663.00

2016	25341.9	8185.8	-23079.12
2017	29620.5	10530.7	200048.12
2018	32968.7	10862.55	-80917.23
2019	38672.9	12168.45	135993.59
2020	29468.5	13981.75	103158.04
2021	49509.2	17354.05	94846.29

**Table 1:** Values of Sensex, Nifty & FII investments in India (2011-2021)

Source: <https://www.cdslindia.com/> , <https://www.bseindia.com/>

Data Interpretation:



**Figure 1:** FII investments through the years (2011-2021)

The investments over the years (2011-2021) are volatile and have been fluctuating, with the years 2016 & 2018 being the outliers where the net flow of investments was negative, i.e., was an outflow of capital from the markets For Data Refer Table 1

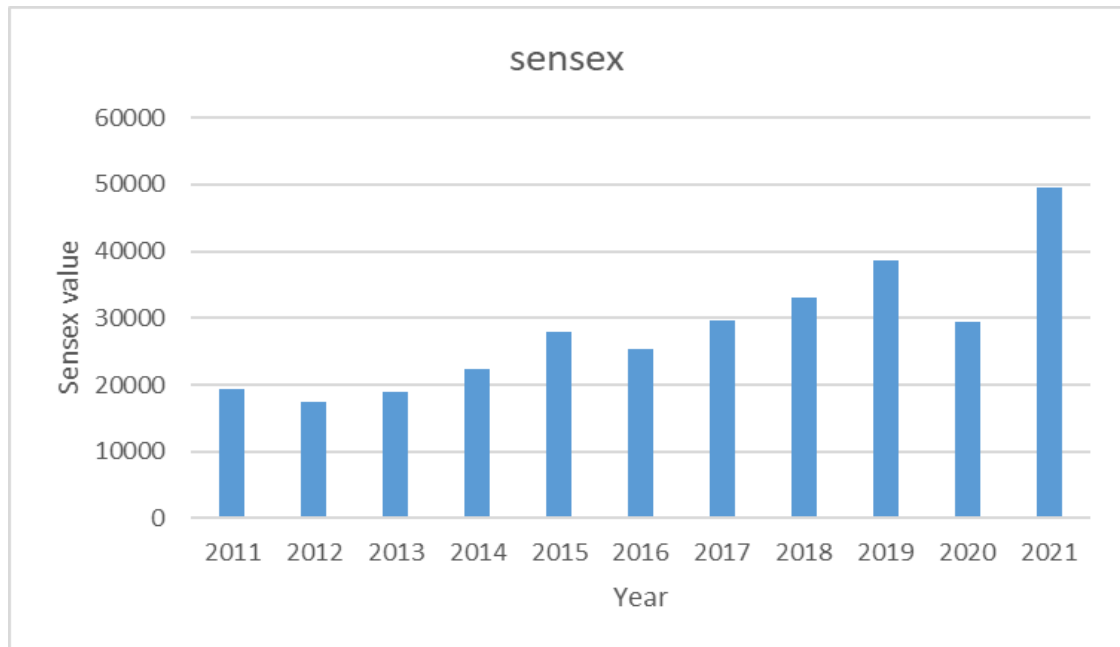


Figure 2: BSE Sensex through the years (2011-2021)

After the 2008 recession that engulfed the whole world, the investor started diversifying their investments into other markets such as India, China, South Africa, Brazil, etc. with the view that these economies were developing economies and had the considerable upside to the ROI. Western money started pouring in, leading to increased activity in the Indian stock markets resulting in the BSE Sensex rallying y-o-y, breaking its records, as we can see from the figure. For Data, Refer to Table 1,

a Similar Case for Nifty, where there is a constant rise in the index y-o-y. For Data, Refer to Table 1

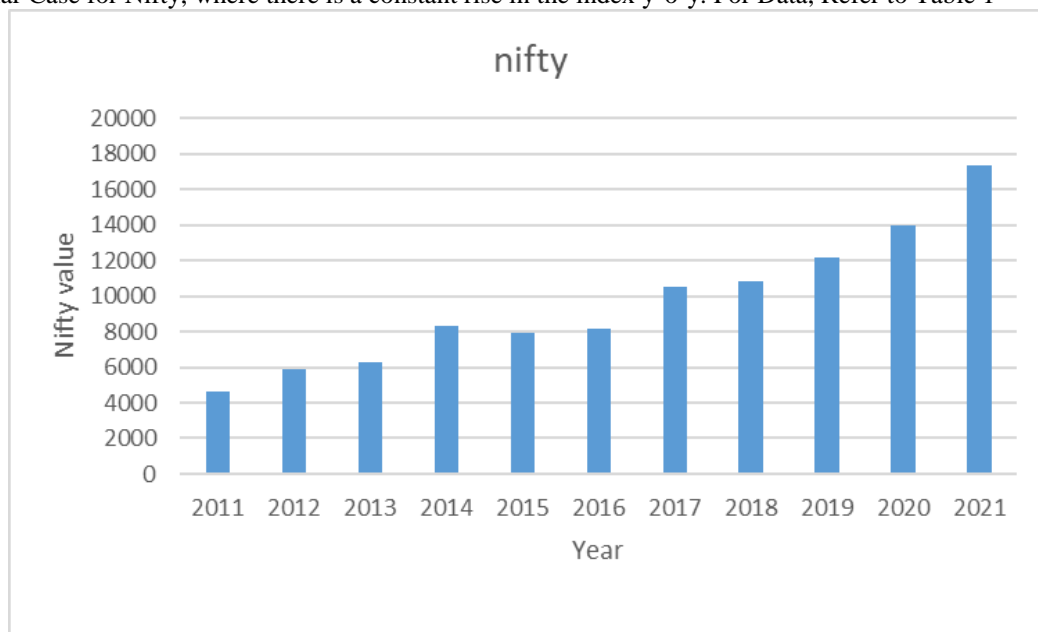


Figure 3: Nifty index through the years (2011-2021).

**1. 2014 Effect:**

When we look at figure 1 with the FII investment in 2014, we can see that it was the highest-ever net FII investment. The premise behind this is that in 2014, India went into the general election wherein the change of baton took place, and a new government came into power, drawing positive investor sentiments and bringing a vast capital flow into the capital markets.

**2. 2016 demonetization effect:**

At 8 pm on 8th Nov 2016, two significant events took place worldwide. Donald Trump became the President of the USA against all odds, while in India, the GOI declared the old 500 & 1000 denomination rupee notes invalid. This was a landmark decision by the GOI as no government since the independence had decided against recalling the Rupee notes in such a manner. This created a sense of volatility and uncertainty about the future and how the GOI would reintroduce the notes to maintain liquidity in the market.

**3. Covid-19 effect:**

The world had not seen a similar pandemic in more than 100 years; the major takeaway of Covid-19 was the pandemic swept across the globe affecting all major and minor economies. The world had come to a standstill; businesses were forced to shut down, travel ban made it even worse since no human could travel to other places impacting the livelihoods of people around the globe; amidst this, the investment kept pouring into the Indian stock markets with all major indexes facing their worst period except the BSE Sensex & Nifty which was rallying due to increased capital inflow from the investors'

**Analysis:**

Calculating the Standard Deviation and determining the correlation between Sensex & FII investments for data refer **Appendix 1**

Karl Pearson's coefficient of correlation=

$$R = \frac{\sum dxdy}{N * \sqrt{\frac{\sum dx^2}{N} * \frac{\sum dy^2}{N}}}$$

$$= \frac{-1733960914}{8465399152}$$

$$= \mathbf{-0.2048}$$

Calculating the Standard Deviation and determining the correlation between Nifty & FII investments for data refer to **Appendix 2**

Karl Pearson's coefficient of correlation=

$$R = \frac{\sum dxdy}{N * \sqrt{\frac{\sum dx^2}{N} * \frac{\sum dy^2}{N}}}$$

$$= \frac{-189225957.9}{3363373161}$$

$$\mathbf{R = -0.0562}$$

**IV. Conclusions:**

Karl Pearson's correlation coefficient is defined as a linear correlation coefficient that falls in the value range of -1 to +1. A value of -1 signifies a strong negative correlation, while +1 indicates a strong positive correlation.

While the above analysis uses Karl Pearson's Coefficient of Correlation to find the relation between BSE Sensex & FII investment, we arrive at the R-value of **-0.2048**, which signifies the negative correlation between the two entities.

Still, the value of **-0.2048** indicates an insignificant relation since the value tends toward 0.

While we look at the R-value when we compare Nifty Index with FII, we arrive at a value of **-0.0562**. The -ve sign indicates that the Nifty index & FII are negatively correlated. At the same time, the value of 0.0562 signifies that the R-value is insignificant when we compare the Nifty Index & FII investments value.



Other macroeconomic factors influence the stock market, but FII is unquestionably one of them.

In the absence of other significant forms of capital inflows, the potential negative consequences of the drop in FII flows into the Indian economy can be substantial, as seen during the Demonetization & election of Donald Trump as President of the USA.

This study's findings also show that Foreign Institutional Investors have emerged as the most powerful Investors in the domestic capital market, namely in the firms that comprise the BSE Sensex and Nifty. They will continue to be an important factor contributing to the rise of the Indian Stock market

**Limitations:**

The study's major objective is to determine whether there is a connection between FIIs and the Indian capital market because the topic is so broad. It primarily relies on information found on numerous websites. the effect brought about only by the performance during the previous eleven years.

**Appendix 1:**

year	Sensex	deviation dx (28328.2)	std dev d <sup>2</sup> x	Net FII investments	deviation dy (88196.06909)	std dev	dx dy
2011	19445.2	-8883.010909	78907882.81	39,352.80	-48,843.27	2385664935	433875292.2
2012	17404.2	-10924.03091	119334451.3	1,63,349.90	75,153.83	5648098300	- 820982771.8
2013	18835.8	-9492.460909	90106814.11	62,286.00	-25,910.07	671331680.3	245950318
2014	22386.3	-5941.960909	35306899.45	2,56,213.00	1,68,016.93	28229689072	- 998350035.5
2015	27957.5	-370.7409091	137448.8217	63,663.00	-24,533.07	601871479	9095412.338
2016	25341.9	-2986.370909	8918411.207	-23079.12	-1,11,275.19	12382167707	332308987.6
2017	29620.5	1292.269091	1669959.403	200048.12	1,11,852.05	12510881293	144542948.1
2018	32968.7	4640.449091	21533767.77	-80917.23	-1,69,113.30	28599307929	-784761655
2019	38672.9	10344.67909	107012385.5	135993.59	47,797.52	2284603005	494450015.1
2020	29468.5	1140.259091	1300190.794	103158.04	14,961.97	223860573.5	17060523.35
2021	49509.2	21180.91909	448631333.5	50088.66	-38,107.41	1452174628	- 807149948.7
total	311611	0	912859544.7	9,70,156.76	0.00	94989650603	- 1733960914
	X= (fx/N)		$\sqrt{(\Sigma d^2 x)/N}$	X= (fx/N)		$\sqrt{(\Sigma d^2 y)/N}$	

*Impact of Foreign Institutional Investor on Indian stock market*

	=311611/11 =28328		= $\frac{=}{\sqrt{912859544.7/11}}$ = 9109.7327	=970156.76/11 =88196.069		= $\frac{=}{\sqrt{94989650603/11}}$ = 8635422782	
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**Appendix 2:**

year	Nifty	deviation dx (28328.2)	std dev d <sup>2</sup> x	Net FII investments	deviation dy (88196.06909)	std dev	dx dy
2011	4624.3	-5025.313636	25253777.14	39,352.80	-48,843.27	2385664935	245452746.2
2012	5905.1	-3744.513636	14021382.37	1,63,349.90	75,153.83	5648098300	-281414544.7
2013	6304	-3345.613636	11193130.6	62,286.00	-25,910.07	671331680.3	86685080.47
2014	8282.7	-1366.913636	1868452.889	2,56,213.00	1,68,016.93	28229689072	-229664634
2015	7946.35	-1703.263636	2901107.015	63,663.00	-24,533.07	601871479	41786284.47
2016	8185.8	-1463.813636	2142750.362	-23079.12	-1,11,275.19	12382167707	162886139.2
2017	10530.7	881.0863636	776313.1802	200048.12	1,11,852.05	12510881293	98551316.8
2018	10862.6	1212.936364	1471214.622	-80917.23	-1,69,113.30	28599307929	-205123670
2019	12168.5	2518.836364	6344536.627	135993.59	47,797.52	2284603005	120394133.8
2020	13981.8	4332.136364	18767405.47	103158.04	14,961.97	223860573.5	64817298.25
2021	17354.1	7704.436364	59358339.68	50088.66	-38,107.41	1452174628	-293596108.3
total	106146	-1.27329E-11	144098410	9,70,156.76	0.00	94989650603	-189225957.9
	X= (fx/N) =106146/11 =9649.4		$\sqrt{(\sum d^2 x)/N}$ =144098410/11 = 13099855.45	X= (fx/N) =970156.76/11 =88196.069		$\sqrt{(\sum d^2 x)/N}$ = $\frac{=}{\sqrt{94989650603/11}}$ = 8635422782	

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