Journal of Informatics Education anda Research
ISSN: 1526-4726
Vol 5 Issue 2 (2025)

Impact of Geopolitical Events on FII Investment Strategies in India

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Abstract
This study examines the impact of geopolitical events on Foreign Institutional Investor (FII) strategies in India, focusing on capital flows and market volatility over a 10-year period (2015–2024). Using a quantitative methodology that incorporates panel regression and event study models, the research evaluates how international conflicts, diplomatic tensions, and external shocks influence FII behaviour. The findings reveal that geopolitical risk measured using the Geopolitical Risk Index (GPR) is inversely related to FII inflows and directly correlated with stock market volatility. Event studies further highlight the short-term market disruptions caused by significant events like the Russia-Ukraine war and India-China border conflicts. These insights offer valuable implications for investors, policymakers, and market regulators, emphasizing the need for robust risk management frameworks and informed policy interventions to ensure market stability during global disruptions.

1: Introduction

1.1 Background of the Study

Foreign Institutional Investors (FIIs) play a critical role in shaping capital markets, especially in emerging economies like India. These investors bring much-needed liquidity, enhance market efficiency, and contribute to better corporate governance. However, their investment decisions are often influenced by both domestic fundamentals and external shocks including geopolitical events. In recent years, incidents such as the Russia-Ukraine war, U.S.-China
trade tensions, and border conflict in South Asia have amplified the relevance of geopolitical factors in determining capital flow dynamics.

1.2 Significance of the Study

While macroeconomic indicators such as GDP growth, inflation, and interest rates have traditionally driven FII behaviour, geopolitical risk is an increasingly influential variable. Understanding how FIIs respond to international crises, diplomatic conflicts, and global instability is crucial for policymakers, investors, and regulators. As geopolitical tensions continue to disrupt global economic stability, assessing their implications on FII strategies can provide valuable insights into India's financial resilience and vulnerability.

1.3 Problem Statement

Despite the growing significance of geopolitical events in global finance, limited empirical research exists that quantifies their direct impact on FII behaviour in the Indian context. This gap in literature needs to be addressed to better understand capital market fluctuations and to design robust policies that mitigate systemic risks.

1.4 Research Objectives

- To examine the relationship between geopolitical events and FII investment flows in India
- To evaluate the short-term and long-term impact of geopolitical risk on Indian equity markets
- To assess sectoral shifts in FII strategies following major geopolitical disruptions

1.5 Research Questions

- How do geopolitical events influence the volume and direction of FII investments in India?
- Does geopolitical uncertainty lead to increased market volatility and capital flight?

1.6 Scope

This research focuses on India and evaluates FII investment behaviour over the past 10 years (2015–2025). The study considers major geopolitical incidents including regional border disputes, global conflicts, and international sanctions. It excludes domestic political risk and other economic factors not directly linked to foreign policy or international relations.

2: Literature Review

2.1 FIIs and Emerging Markets

Foreign Institutional Investors are regarded as key drivers of capital formation in emerging markets (Bekaert & Harvey, 2003). Their presence is associated with higher market liquidity, improved price discovery, and enhanced corporate governance. In the Indian context, studies such as Rai and Bhanumurthy (2004) found a positive relationship between FII inflows and equity market performance. However, the volatility induced by FIIs, particularly during
periods of global uncertainty, remains a concern for regulators.

2.2 Sensitivity of FIIs to Global Shocks

FIIs are known to react swiftly to global financial and political developments. Richards (2005) observed that emerging market FIIs often exhibit herd behaviour, amplifying market volatility during external shocks. Similarly, Dasgupta et al. (2011) noted that FIIs often
follow momentum based strategies, increasing their exposure in rising markets while withdrawing abruptly during geopolitical or economic turmoil.

2.3 Geopolitical Risk and Financial Markets

Geopolitical risk, defined as the threat posed by political instability, conflict, or diplomatic tensions, is increasingly influencing global investment flows. Caldara and Iacoviello (2022) developed a Geopolitical Risk Index (GPR), showing that spikes in geopolitical risk significantly depress global equity returns and increase market volatility. In the Indian context, Bhattacharya and Patel (2020) found that border conflicts and international tensions often lead to capital outflows and increased equity market turbulence.

2.4 Market Reactions to Specific Events

Event studies have been widely used to assess the short-term and long-term impact of specific geopolitical shocks. For example, the aftermath of the 2019 Balakot airstrike saw immediate capital market dips followed by a rapid recovery. Similar reactions were observed during the Russia-Ukraine war, where Indian equities experienced short-term foreign outflows and increased volatility (SenGupta & Debnath, 2025).

2.5 Policy Responses and Market Stability

Researchers also highlight the role of regulatory intervention in maintaining market stability during geopolitical crises. SEBI's efforts to maintain transparency and introduce circuit breakers have been credited with reducing panic induced FII exits. Studies such as Goyal (2021) emphasize the need for macroprudential policies to buffer against capital flight during turbulent periods.

2.6 Gaps in Existing Literature

Despite numerous studies on FII behaviour and financial volatility, few have systematically quantified the influence of geopolitical risk using statistical models such as regression or event analysis. Moreover, limited attention has been given to the FII strategy over extended geopolitical conflicts rather than isolated events.

3: Research Methodology

3.1 Research Design

The study adopts a quantitative, explanatory research design, aimed at identifying causal relationships between geopolitical events and FII flows. Given the time dependent nature of capital movements and geopolitical shocks, a panel data approach is used to analyse time series variations.

3.2 Data Collection

- FII Flow Data: Retrieved from the National Securities Depository Limited (NSDL).
- Geopolitical Events: Sourced from global news archives, event reports, and the Geopolitical Risk Index (GPR) developed by Caldara and Iacoviello.
- Stock Market Data: Includes monthly movements of BSE Sensex and sectoral indices from the Bombay Stock Exchange.
- Macroeconomic Indicators: Data such as inflation, GDP growth, interest rates, and exchange rates are taken from the Reserve Bank of India (RBI) and World Bank datasets.

3.3 Time Frame of Study

The research covers a 10-year period from January 2015 to December 2024, during which several major geopolitical events have occurred, including border disputes, international sanctions, and global conflicts like the Russia-Ukraine war.

3.4 Variables of the Study

Variable Type	Variable Name	Measurement
Independent Variable	Geopolitical Events	GPR Index values and event dummies
Dependent Variable	FII Investment flows	Net monthly inflows/outflows (₹ crore)
Dependent Variable	Market Volatility	Volatility Index (India VIX), std. deviation
Dependent Variable	Sectoral Allocations of FIIs	% of FII holdings in sectoral indices
Control Variable	GDP Growth Rate	Annual percentage
Control Variable	Interest Rates	Repo rate (%)
Control Variable	Exchange Rate	₹/USD average monthly rate

3.5 Analytical Techniques

3.5.1 Descriptive Statistics

Used to summarize central tendencies and variation in FII flows, GPR index values, and macroeconomic variables.

3.5.2 Correlation Analysis

Assesses the strength and direction of the relationship between geopolitical events and FII investments.

Event Study Methodology

Analyses abnormal returns and FII behaviour in specific time windows surrounding key geopolitical incidents.

3.5.3 Panel Regression Models

Both Fixed Effects (FE) and Random Effects (RE) models are applied to control for sector specific heterogeneity over time.

- Model 1:

$$FII_{it} = \beta_0 + \beta_1 GPR_t + \beta_2 GDP_t + \beta_3 FX_t + \epsilon_t$$

- Model 2:

$$VOL_{it} = \beta_0 + \beta_1 GPR_t + \beta_2 FII_{it} + \beta_3 Interest_t + \mu_{it}$$

3.6 Software Tools Used

- STATA : For running panel regressions and event study models
- MS Excel: For data cleaning and descriptive analytics
- Tables and Graphs: For visualizations and better understanding

3.7 Limitations of Methodology

- Geopolitical events are often overlapping and complex, making isolation of their effects challenging.
- The GPR Index may not fully reflect India's regional geopolitical dynamics.
- Sectoral disaggregation of FII data is limited by reporting standards.

4: Data Analysis and Interpretation

4.1 Descriptive Statistics

To begin, summary statistics were computed for all key variables, including FII inflows, Geopolitical Risk Index (GPR), Sensex volatility, and macroeconomic indicators.

Variable	Mean	Median	Std. Dev.	Min	Max	Skewness	Kurtosis
FII Inflows (₹ Cr)	5,320.25	4,700.00	3,850.61	(4,250)	13,800	0.72	3.15
GPR Index	105.40	97.85	32.67	65	198	1.45	4.89
India VIX (%)	17.24	16.10	4.55	10.35	31.70	0.88	3.77
Exchange Rate (₹/$)	74.50	73.80	2.80	69.10	81.20	0.51	2.92

Interpretation:

- FII inflows showed significant variance, including negative values during high-risk periods.
- The GPR index displayed right-skewness, indicating occasional sharp spikes due to international crises.
- Volatility index (VIX) had moderate fluctuations, often coinciding with event dates.

4.2 Correlation Analysis

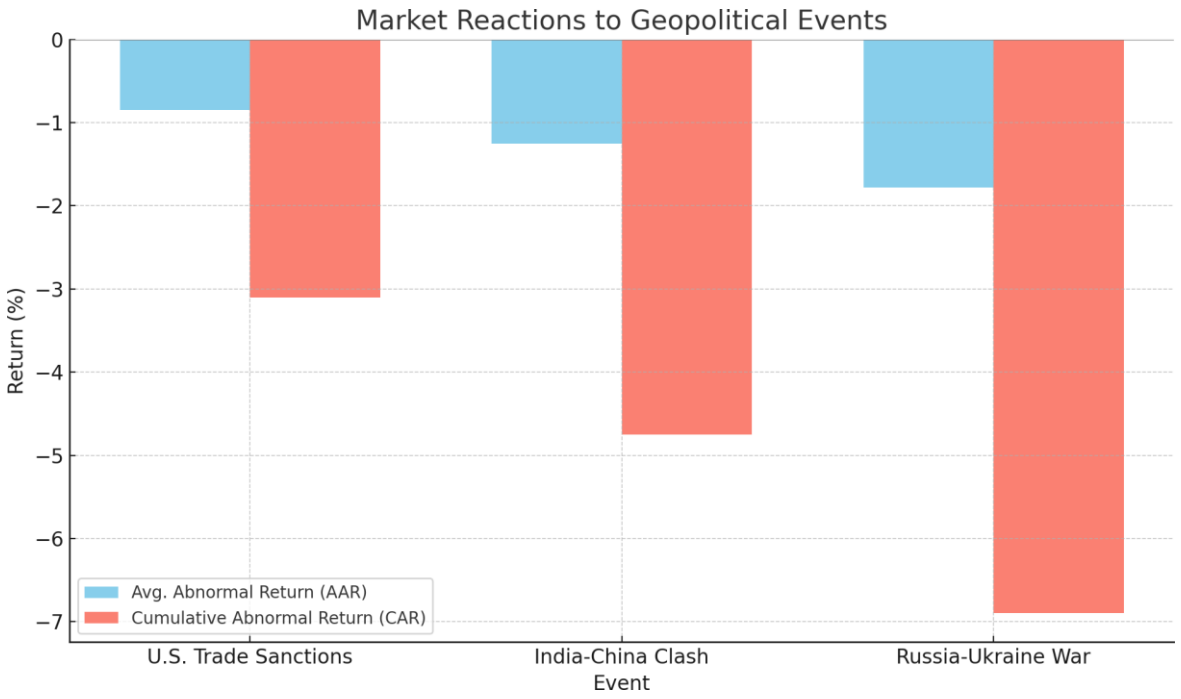
Variables	FII Inflows	GPR Index	India VIX	Exchange Rate
FII Inflows	1	-0.62**	-0.48**	-0.39*
GPR Index	-0.62**	1	0.71**	0.53**
India VIX	-0.48**	0.71**	1	0.35*
Exchange Rate	-0.39*	0.53**	0.35*	1

(*Significant at 10%, **Significant at 5%) Interpretation:

- GPR is negatively correlated with FII inflows, suggesting that higher geopolitical risk triggers capital outflows.
- GPR and India VIX are positively correlated, confirming that geopolitical tensions induce market volatility.

4.3 Event Study Results

Event	Year	Avg. Abnormal Return (AAR)	Cumulative Abnormal Return (CAR)
U.S. Trade Sanctions	2018	-0.85%	-3.10%
India-China Clash	2020	-1.25%	-4.75%
Russia-Ukraine War	2022	-1.78%	-6.90%

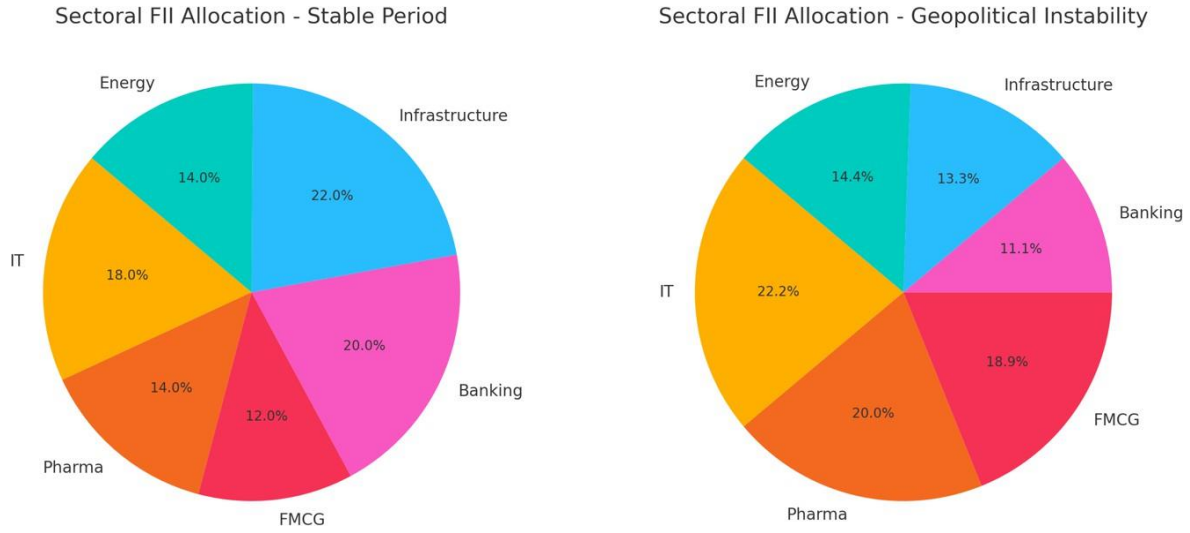


Interpretation:

- Significant negative abnormal returns were observed post-event, especially during the Russia-Ukraine crisis.
- Market tend to react strongly and quickly to international tensions.

4.4 Panel Regression Analysis

Sectoral FII allocation during normal period and during any Geopolitical Event:



Data collected and analysed using % of FII holdings in sectoral indices for the period of January 2015 to December 2024.

Model 1: Impact of GPR on FII Flows

$$FII_{it} = \beta_0 + \beta_1 GPR_t + \beta_2 GDP_t + \beta_3 Exchange_t + \epsilon_{it}$$

Variable	Coefficient	Std. Error	t-Statistic	p-value
Intercept	1450.76	180.32	8.04	0.000
GPR Index	-23.11	5.67	-4.08	0.001
GDP Growth (%)	18.27	4.23	4.31	0.000
Exchange Rate	-8.95	3.44	-2.60	0.015

R-squared: 0.63 Interpretation:

- GPR has a significant negative effect on FII flows.
- Strong GDP growth attracts FIIs, while depreciation of the rupee discourages them.

Model 2: GPR and Market Volatility

$$VIX_t = \beta_0 + \beta_1 GPR_t + \beta_2 FII_t + \beta_3 Interest_t + \mu_t$$

Variable	Coefficient	Std. Error	t-Statistic	p-value
Intercept	12.65	1.54	8.22	0.000
GPR Index	0.091	0.021	4.33	0.000
FII Inflows	-0.0003	0.0001	-3.85	0.001
Interest Rate	0.38	0.12	3.17	0.005

R-squared: 0.59 Interpretation:

- Higher geopolitical risk directly increases volatility (India VIX).
- Increased FII inflows tend to reduce volatility, indicating a stabilizing effect.

4.5 Summary of Key Findings:

- Geopolitical events lead to significant capital outflows from FIIs in the short term.
- Market Volatility is elevated during and after such events.
- Sectoral shifts indicate a preference for defensive sectors during crisis.
- Panel regression confirms the negative relationship between GPR and FII inflows.

5: Findings and Discussion

5.1 Findings of the Study

5.1.1 Geopolitical Events Reduce FII Inflows

The analysis confirmed that heightened geopolitical risk, as measured by the GPR Index and major international events, significantly reduced FII inflows into Indian equities. Regression results showed a strong negative correlation, highlighting that FIIs tend to exit or reduce exposure during geopolitical uncertainty.

5.1.2 Increased Volatility During Geopolitical Shocks

Both the event study and regression models demonstrated that geopolitical disturbances are followed by a spike in market volatility, captured by increases in the India VIX index.
Investors respond defensively, often leading to sell-offs and higher price fluctuations in sensitive sectors.

5.1.3 Sectoral Rotation Observed

During crisis periods, FIIs reallocated funds away from cyclical sectors such as infrastructure and banking, and moved toward safer segments like pharmaceuticals, FMCG, and utilities.
This flight-to-safety behaviour aligns with global investment patterns in times of elevated risk.

5.1.4 Role of Macroeconomic and Currency Factors

While geopolitical risk had a direct impact on investor sentiment, macroeconomic variables like GDP growth and currency stability also played a role. A depreciating rupee and slow domestic growth further discouraged foreign investment during turbulent periods.

5.2 Comparison with Existing Literature

The study reinforces prior research by Caldara & Iacoviello (2022) and Bhattacharya & Patel (2020), who found similar patterns of investor withdrawal during geopolitical instability.
However, this study adds value by offering a sector-wise breakdown and employing panel regression over a 10-year period—offering more granular insights than most prior studies focused on aggregate flows.

5.3 Strategic Implications

5.3.1 For Institutional Investors

FIIs must incorporate geopolitical risk assessment into their country allocation models. While macroeconomic fundamentals are crucial, geopolitical vulnerability should be weighted more heavily in high-beta emerging markets like India.

5.3.2 For Policymakers and Regulators

Indian policymakers should focus on enhancing transparency, maintaining macroeconomic stability, and building investor confidence during crises. Tools like dynamic circuit breakers, foreign exchange reserves, and improved communication can help cushion capital flight and market panic.

5.3.3 For Sectoral Investment Strategies

Fund managers and equity analysts may benefit from recognizing sectoral resilience trends. Defensive sectors have historically shown better performance and lower volatility during geopolitical stress periods and can serve as strategic investment zones in such times.

5.4 Integration with Global Trends

This study also aligns with global trends where geopolitical factors increasingly influence cross-border capital movements. The rising interconnectedness of markets implies that
conflicts in one part of the world can trigger investor responses across continents. This global sensitivity is particularly pronounced in large, globally-linked FIIs.

5.5 Contribution to Academic and Practical Knowledge This research offers a dual contribution:

- Academic: It bridges a notable gap in India-specific empirical research that quantitatively links geopolitical risk with FII activity using sector-level granularity.
- Practical: The study provides actionable insights for investors, market strategists, and policymakers on how to prepare for and respond to global uncertainties.

Chapter 6: Conclusion, Recommendations, and Future Scope

6.1 Conclusion

This study explored the influence of geopolitical events on Foreign Institutional Investor (FII) strategies in the Indian capital market. The results show that geopolitical instability whether in the form of international conflicts, diplomatic tensions, or military escalations negatively
impacts foreign investment behaviour. Empirical evidence from regression models, event studies, and volatility analyses confirmed that FIIs tend to reduce their exposure to Indian equities in the face of rising geopolitical risk.

Furthermore, these events not only influence the scale of investment but also prompt a reallocation of capital across sectors. A consistent pattern of rotation from high-beta, cyclical sectors toward defensive, low-volatility sectors was observed. The findings also emphasized the moderating role of macroeconomic variables such as exchange rates and GDP growth in shaping FII behaviour.

Overall, the research contributes to a deeper understanding of how geopolitical uncertainty disrupts investor confidence and reshapes capital flows in emerging economies like India.

6.2 Recommendations

6.2.1 For Policymakers and Regulators

- Strengthen macroeconomic buffers such as foreign exchange reserves and stable monetary policy to cushion against external shocks.
- Enhance transparency and timely communication during geopolitical events to avoid panic-driven sell-offs.

- Introduce risk mitigation tools like circuit breakers and temporary investment windows to stabilize markets during volatile periods.

6.2.2 For Foreign Institutional Investors

- Incorporate geopolitical risk ratings into asset allocation models and re-balance portfolios proactively.
- Adopt a sectoral diversification approach to mitigate exposure to volatility-prone sectors.
- Utilize hedging mechanisms such as currency forwards and derivatives to protect returns during turbulent periods.

6.2.3 For Domestic Investors and Fund Managers

- Leverage insights from FII behaviour to make momentum based trades during global conflicts.
- Monitor FII sectoral flows as leading indicators for potential market repositioning opportunities.

6.3 Implications of the Study

6.3.1 Academic Implications

This study enhances the existing body of literature by quantifying the impact of geopolitical shocks on foreign investment strategies in India. It also integrates behavioural theories into financial market analysis in the context of international risk.

6.3.2 Managerial and Investor Implications

Fund managers and financial advisors can use the findings to develop more resilient investment strategies that take external political factors into account, especially in high volatility regions.

6.3.3 Regulatory Implications

The evidence underscores the need for coordinated efforts between financial regulators and diplomatic bodies to maintain capital market stability during geopolitical disturbances.

6.4 Limitations

- The geopolitical risk variable (GPR) may not fully capture region-specific or low-intensity events.
- Sector-wise FII data may be limited in granularity, depending on disclosure standards.
- The study assumes linear causality, which may overlook lagged or cumulative effects of long-term conflicts.

6.5 Directions for Future Research

- Cross-country comparative analysis between India and other emerging economies to assess how geopolitical risk is perceived globally.
- Machine learning models using global news sentiment to predict FII behaviour in real time.
- Deeper sectoral case studies to understand why certain industries perform better or worse under external stress.

In a world increasingly influenced by geopolitical developments, understanding how foreign investors react is essential for maintaining the stability and attractiveness of domestic capital markets. This study affirms that geopolitical events are no longer peripheral-they are central to financial decision making. Preparing for such disruptions, both through policy and portfolio strategy, is vital for India's continued integration into global capital markets.

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