



The Nexus of Foreign Capital Flows and Stock Index: Evidence from Indonesia

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Received : September 15,
2025

Revised : September 16,
2025

Accepted : September 29,
2025

Online : October 14, 2025

Abstract

The relationship between foreign capital flows and the stock index is mutually influential, creating a cycle. Economic growth and market stability, indicated by rising stock indexes, attract foreign capital inflows, which in turn strengthen the stock index. This study aims to explore the relationship between foreign capital flows and the Jakarta Composite Index (JCI) in Indonesia from 2010 to 2024. Based on Granger causality, foreign capital flows influence the Jakarta Composite Index (JCI), but not vice versa. This finding is supported by the VECM model analysis, using impulse response function analysis and variant decomposition. Maintaining the stability of foreign capital flows in Indonesia is crucial, as large fluctuations in foreign capital inflows or outflows can trigger or exacerbate stock market volatility. Significant capital outflows, often driven by global sentiment such as rising US interest rates or geopolitical uncertainty, can cause foreign investors to withdraw funds from the stock market, leading to weakened stock prices and a negative impact on the Jakarta Composite Index (JCI). Conversely, capital inflows can support the stock market and indicate investor optimism about a country.

Keywords *Foreign Direct Investment, Portfolio Investment, Capital Market, Stock Index*

INTRODUCTION

Foreign capital plays a crucial role in the economy by driving economic growth, creating jobs, improving infrastructure (Ameliana & Soebagyo, 2023), facilitating the transfer of technology and knowledge, and diversifying the economy (Shaldehi et al., 2020). Furthermore, foreign capital also contributes to increasing the competitiveness of domestic industries through competition and innovation (Sethi et al., 2022). An underdeveloped financial sector can be a cause of foreign capital outflow as investors seek more promising investment instruments and more stable markets in other countries (Topaloglu et al., 2019). An underdeveloped capital market lacks diverse and attractive investment instruments, making it challenging for foreign investors to allocate their funds and achieve the expected returns. An underdeveloped financial sector can hinder companies' ability to secure long-term funding, thereby preventing them from expanding and offering attractive investment opportunities to foreign capital.

Portfolio investment flows can influence a country's money and capital markets through the use of capital market instruments (Ngobe & Emenike, 2020). The influx of foreign capital can benefit the capital market. One benefit is driving up stock prices in a country (Ahmad & Yusniar, 2018). Foreign investors influence stock prices through buying and selling activities in the Indonesian capital market. Mayzan and Sulasmiyati (2018) stated that foreign investment (net foreign funds) in Indonesia is one indicator that can move the Jakarta Composite Index (JCI),

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because inflows and outflows represent opportunities or threats for investors. The increase in net foreign purchases of shares in Indonesia by foreign investors demonstrates foreign investor optimism regarding the Indonesian stock market.

Although local investors still dominate the Indonesian capital market, the presence of foreign investors continues to show an increasing trend. Despite their small number, foreign investors control 41.96% of assets in the capital market. Meanwhile, the remaining 58.04% of assets in the capital market are controlled by local investors (OJK, 2024). This suggests that investment in the Indonesian capital market remains attractive to foreign investors. On the one hand, this benefits the Indonesian economy by increasing funding for domestic development. However, on the other hand, there is a risk factor associated with foreign capital reversals that can be detrimental to the Indonesian economy, including depreciation of the rupiah exchange rate, increased inflation, and hindered economic growth. Studies by [Shabbir and Muhammad \(2019\)](#) in Pakistan and [Sanusi and Koekemoer \(2025\)](#) in South Africa indicate that foreign capital investment is a key driver of stock market development. However, it can also lead to instability and significant financial distress if domestic macroeconomic conditions and a policy framework designed to protect the stock market from external shocks are not well coordinated.

This study aims to analyze the relationship between the stock price index and foreign capital flows (foreign direct investment and portfolio investment) in Indonesia. This research provides empirical evidence to inform the development of key strategies that can enhance capital market performance amid the dynamics of foreign capital flows. Furthermore, the study examines the impact of stock price index determinants and foreign capital, thereby assisting decision-makers in developing long-term policies. This study also offers a comprehensive policy framework to optimize the benefits of the global economy to support domestic development funding.

LITERATURE REVIEW

Foreign capital flows can influence stock prices by altering the demand for specific financial assets ([Sethi et al., 2022](#)). According to the Capital Asset Pricing Model (CAPM), a financial model used to estimate the expected return on an investment, such as stocks, based on systematic risk (market risk) that cannot be diversified away. This model relates the rate of return to beta (a measure of systematic risk), the rate of return on a risk-free asset, and the equity risk premium. Market efficiency theory states that security prices (such as stocks) fully reflect all available information, making consistent abnormal returns impossible for investors ([Shah, 2023](#)). This theory is divided into three forms based on the type of information reflected in prices: the weak form (using past price and volume data), the semi-strong form (using past data and all public information), and the strong form (using all information, including confidential information) ([Pham et al., 2022](#)).

The push factors (causing stock prices to rise) and pull factors (causing stock prices to fall) of stock price changes originate from internal (company performance and policies) and external (macroeconomic conditions, market sentiment, industry news, government policies, and global factors) factors that influence the demand and supply of shares in the market. A study by [Oyerinde \(2019\)](#) found evidence that increased foreign portfolio investment improved domestic stock market performance in Nigeria. However, according to [Irandoust \(2021\)](#), foreign capital inflows were not found to have an impact on financial development in eight former communist countries. Foreign capital inflows can potentially create asset bubbles, namely, drastic and speculative increases in the price of an asset beyond its fundamental value, which risk bursting and causing significant losses for investors ([Sanusi & Kapingura, 2022](#)). The two can be interrelated, where capital flight can occur from countries experiencing asset bubbles, or asset bubbles can encourage capital flight due to investor distrust.

This study fills a research gap and complements existing research related to foreign capital inflows and stock prices. Most studies only analyze one type of foreign capital flow: foreign direct investment (e.g., [Shaldehi et al., 2020](#); [Sethi et al., 2022](#); [Pham et al., 2022](#); [Shah, 2023](#)) or portfolio investment (e.g., [Oyerinde, 2019](#); [Shabbir & Muhammad, 2019](#); [Sanusi & Koekemoer, 2025](#)). This study provides a more comprehensive analysis of foreign capital flows, encompassing both foreign direct investment and portfolio investment.

RESEARCH METHOD

Data

The research utilized time series data from 2010 Q1 to 2024 Q4, sourced from the Jakarta Composite Index (JCI), portfolio investment (PORT), and foreign direct investment (FDI) data, published by Bank Indonesia. The JCI or Jakarta Composite Index is an indicator that describes the overall movement of stock prices listed on the Indonesia Stock Exchange (IDX). Simply put, the JCI serves as a measuring tool to assess whether the national stock market is strengthening, weakening, or remaining stable. Portfolio investment is the purchase of financial assets, such as stocks and bonds, by foreign investors in the financial markets of other countries, without the aim of gaining management control over the companies issuing the assets. This investment is passive, aims to diversify the portfolio, and differs from direct investment, which involves ownership and control of the business. Foreign Direct Investment is a long-term investment by a foreign investor in a company or business in another country, where the investor has significant influence or control over the company. This investment involves acquiring a controlling stake (at least 10%), establishing a new company, or acquiring an existing one, and aims to transfer technology, management, and promote economic growth in the recipient country.

Granger Causality

The Granger causality equation model is an econometric model that tests whether past values of an independent variable (X) have additional predictive power to explain the dependent variable (Y), in addition to using past values of Y itself. The null hypothesis (H0) is that past values of X do not Granger-cause Y. If the p-value is smaller than the significance level (e.g., 0.05), then H0 is rejected, and it is concluded that X Granger-causes Y, meaning X can help predict Y. The Granger Causality Model can be written as follows:

$$Y_t = \sum_{i=1}^n \alpha_i Y_{t-i} + \sum_{i=1}^n \beta_i X_{t-i} + e_{1t} \dots (1)$$

$$X_t = \sum_{i=1}^m \gamma_i X_{t-i} + \sum_{i=1}^m \lambda_i Y_{t-i} + e_{2t} \dots (2)$$

Vector Error Correction Model (VECM)

Engle and Granger first popularized the Vector Error Correction Model (VECM) analysis method to correct short-term imbalances relative to long-term imbalances in time series data. Therefore, the VECM method can be used to examine short-term and long-term relationships within a time series. VECM is a Vector Autoregression (VAR) analysis designed for use with non-stationary data known to exhibit cointegration. In other words, VECM can be considered a restricted form of VAR. If parameter estimation uses the Vector Autoregressive (VAR) method with non-stationary data at the level, the resulting equation will be biased (a spurious model). The assumptions that must be met when using the Vector Error Correction Model (VECM) method are that the time series

data must be stationary at the first level of differentiation for all variables and that there is cointegration (a long-term relationship).

$$\Delta y_t = \mu + \sum_{i=1}^v \Gamma_i \Delta y_{t-i} + \alpha \beta^t y_{t-1} + u_t \dots (3)$$

Where,

μ is the average vector of each variable with size $N \times 1$

Γ_i is the first parameter vector difference of the dependent variable with lag i

Δy_t is a vector of differences between the values of the dependent variable at time t and $t-1$, with a size of $n \times 1$

Δy_{t-i} is a vector of differences between the dependent variable and lag v , with a size of $n \times 1$.

α, β is a cointegration matrix with a size of $N \times r$.

u_t is a vector of errors from the short-run equation with a size of $n \times 1$.

Where N is the number of research variables, r is the degree of cointegration, and n is the number of observations.

FINDINGS AND DISCUSSION

The stationarity test is performed to determine whether the statistical properties of a time series (such as the mean and variance) are constant over time, which is an important requirement for time series analysis models, such as regression, to produce valid conclusions and avoid spurious regression. Non-stationary data can lead to meaningless regression results, so it is necessary to transform (for example, with first differences) to make it stationary before further analysis.

Table 1. Unit Root Test

I(0)				
Method		Statistic		Prob.**
ADF - Fisher Chi-square		71.1132		0.0000
ADF - Choi Z-stat		-6.47308		0.0000
Series	Prob.	Lag	Max Lag	Obs
PORT	0.0000	0	10	59
FDI	0.0000	0	10	59
JCI	0.3363	0	10	59
I(1)				
Method		Statistic		Prob.**
ADF - Fisher Chi-square		122.953		0.0000
ADF - Choi Z-stat		-10.3078		0.0000
Series	Prob.	Lag	Max Lag	Obs
D(PORT)	0.0000	1	10	57
D(FDI)	0.0000	5	10	53
D(JCI)	0.0000	0	10	58

A common method used to test data stationarity (unit root test) is a statistical test, such as the Augmented Dickey-Fuller (ADF) test. This test is performed by checking for the presence of a unit root in a time series. Stationary data has a constant mean and variance over time, so it needs to be tested with the ADF test before building a time series model. The results of the statistical test indicate that the data is stationary at the first difference, $I(1)$, as indicated by the Fisher Chi-square ADF probability value less than the 0.05 significance level (Table 1).

Table 2. Johansen Cointegration Test

Unrestricted Cointegration Rank Test (Trace)				
Hypothesized No. of CE(s)	Eigenvalue	Trace Statistic	0.05 Critical Value	Prob.**
None *	0.369637	50.78764	29.79707	0.0001
At most 1 *	0.306179	24.02299	15.49471	0.0021
At most 2	0.047484	2.821625	3.841466	0.0930

Trace test indicates 2 cointegrating eqn(s) at the 0.05 level

* denotes rejection of the hypothesis at the 0.05 level

**MacKinnon-Haug-Michelis (1999) p-values

In relation to data that is non-stationary at the level or $I(0)$, but stationary at the first difference or $I(1)$, a cointegration test is required. The Johansen Cointegration Test is a statistical procedure used to examine and identify long-term (equilibrium) relationships between two or more non-stationary time series variables. This method enables the detection of multiple cointegration relationships and is based on the calculation of trace statistics or maximum eigenvalue statistics (max-eigen statistics). If the test results indicate cointegration, then the Vector Error Correction Model (VECM) can be continued. This test is used when the variables being analyzed are non-stationary (i.e., they exhibit a trend). Cointegration means that, although the variables exhibit erratic movements in the short term, they tend to move together in the long term. The test results in Table 2 indicate that the statistical value (trace or max-eigen) is greater than its critical value, so the null hypothesis (no cointegration) is rejected, indicating the presence of cointegration.

Determining the optimum lag in a Vector Autoregression (VAR) model involves selecting the appropriate number of lag periods to capture all system dynamics, avoid autocorrelation, optimize prediction accuracy, and produce efficient and unbiased parameter estimates. The optimal lag is determined using information criteria such as the Akaike Information Criterion (AIC), the Schwarz Criterion (SC), or the Final Prediction Error (FPE), with the lag chosen that produces the smallest criterion value or has the most asterisks in its output. In the model, lag 3 was found to be the optimal lag (Table 3)

Table 3. VAR Lag Order Selection Criteria

Lag	LogL	LR	FPE	AIC	SC	HQ
0	-997.8824	NA	6.71e+11	35.74580	35.85430	35.78787
1	-923.6852	137.7949	6.54e+10	33.41733	33.85133*	33.58559*
2	-917.4329	10.94145	7.24e+10	33.51546	34.27497	33.80992
3	-903.4994	22.89085*	6.12e+10*	33.33926*	34.42427	33.75992
4	-896.8060	10.27917	6.74e+10	33.42164	34.83215	33.96849

* indicates lag order selected by the criterion

LR: sequential modified LR test statistic (each test at 5% level)

FPE: Final prediction error

AIC: Akaike information criterion

SC: Schwarz information criterion

HQ: Hannan-Quinn information criterion

The relationship between the Jakarta Composite Index (JCI) and foreign capital inflows is positive: an increase in foreign capital inflows tends to drive the JCI up, while an outflow often causes the JCI to decline. This is because foreign investors entering the country increases demand for shares, which in turn drives up share prices and ultimately the JCI. Conversely, if foreign

investors exit, demand for shares decreases, and the JCI tends to fall (Surasni et al, 2019). The influx of foreign capital into the Indonesian stock market indicates foreign investor interest in shares on the IDX, leading to increased demand for shares. This increased demand drives up share prices, ultimately reflected in an increase in the JCI's value. Conversely, a foreign capital outflow means foreign investors are selling their shares and withdrawing funds from Indonesia. This large-scale stock sell-off will increase the supply of shares in the market, reduce demand, and generally lower share prices and the JCI.

Table 4. Pairwise Granger Causality Tests

Null Hypothesis:	Obs	F-Statistic	Prob.
FDI does not Granger Cause PORT	58	0.41044	0.6654
PORT does not Granger Cause FDI		2.84514	0.0670
JCI does not Granger Cause PORT	58	1.92194	0.1564
PORT does not Granger Cause JCI		3.63728	0.0331
JCI does not Granger Cause FDI	58	0.22361	0.8004
FDI does not Granger Cause JCI		3.30615	0.0444

The Jakarta Composite Index (JCI) is a key indicator of national economic stability, as it reflects investor confidence in the capital market. If the index falls sharply, companies will struggle to obtain funding for business expansion, while investors will become more cautious about investing. A weakening JCI also encourages investors to withdraw funds and shift to safer assets (Suhaidi et al, 2022). If a massive sell-off occurs, the capital market will be under further pressure and can slow economic growth. A healthy capital market allows companies to obtain funding for business expansion. A decline in the JCI not only impacts investors but also impacts national economic stability, thus encouraging capital outflows. However, research indicates that foreign investment, including both portfolio investment and foreign direct investment, can lead to fluctuations in stock indices, but not vice versa. Stock price fluctuations do not significantly impact foreign capital inflows, for either short-term or long-term investments.

Examining the IRF results (Figure 1), the stock index responds positively to foreign capital inflows, including both portfolio investment and FDI. Conversely, portfolio investment responds negatively to shocks in the capital market. When stock prices fall, foreign investors are more likely to enter the stock market due to the lower prices. In the world of stock investing, a down market is often considered frightening for novice investors. However, for experienced investors, falling stock prices can actually be a golden opportunity to acquire quality stocks at discounted prices. Buying stocks during price declines is a profitable strategy if done with proper research and planning. By understanding market conditions, analyzing company fundamentals, and implementing a gradual buying strategy, investors can capitalize on corrections as opportunities, not threats. In this case, investors hope to achieve capital gains when stock prices rebound. Meanwhile, FDI does not respond permanently to shocks in the capital market, as reflected in the Jakarta Composite Index.

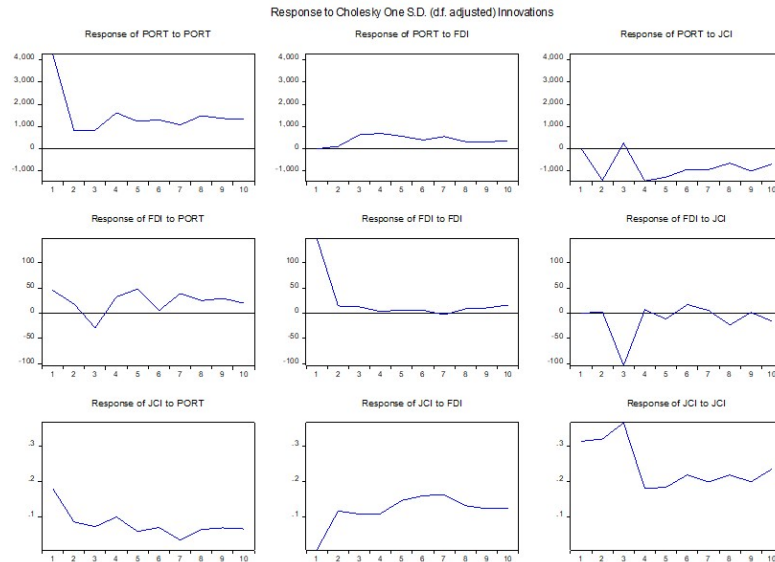


Figure 1. Impulse Response Function

The decomposition variant of the VAR (Vector Autoregressive) model is useful for predicting and describing the percentage contribution of variance (change) in each variable due to shocks from the variable itself and shocks from other variables in the VAR system, so that it can measure the relative importance of each variable in the system due to the shock. This decomposition divides the variance of a variable into components originating from shocks from the variable itself and shocks from other variables in the VAR model (Table 5).

Table 5. Variance Decomposition

Period	Variance Decomposition of PORT:			
	S.E.	PORT	FDI	JCI
1	4242.057	100.0000	0.000000	0.000000
2	4546.240	90.25201	0.054838	9.693147
3	4670.564	88.70307	1.821093	9.475835
4	5195.501	81.30595	3.246205	15.44784
5	5515.959	77.06528	3.905395	19.02933
6	5755.688	75.89683	4.055348	20.04782
12	6992.525	73.05812	4.720564	22.22131
18	8064.112	71.27064	5.088299	23.64106
24	9003.051	70.28433	5.297698	24.41797

Period	Variance Decomposition of FDI:			
	S.E.	PORT	FDI	JCI
1	154.7939	8.581020	91.41898	0.000000
2	156.5821	9.776011	90.19688	0.027105
3	190.2777	8.949442	61.51709	29.53347
4	193.1674	11.50428	59.72205	28.77367
5	199.4867	16.59617	56.10312	27.30071
6	200.3765	16.51356	55.68926	27.79718
12	215.8335	24.04348	49.59497	26.36155
18	226.2084	28.75796	46.29282	24.94922
24	236.3881	32.70603	43.51952	23.77445

Period	Variance Decomposition of JCI:			
	S.E.	PORT	FDI	JCI
1	0.361501	24.59934	0.027245	75.37341
2	0.503547	15.49716	5.293006	79.20983
3	0.635288	10.99577	6.173819	82.83041
4	0.676192	11.83332	8.033073	80.13360
5	0.717906	11.14800	11.22033	77.63167
6	0.770139	10.48578	14.01446	75.49976
12	1.004513	8.474489	18.77040	72.75511
18	1.195163	7.798135	20.55968	71.64219
24	1.360090	7.415469	21.43749	71.14704

Cholesky Ordering: PORT FDI JCI

The results of the variance decomposition show the percentage contribution of each variable shock to the variance of the target variable. For example, in the first month of a shock, the variance of a variable may be 100% explained by the variable itself; however, in subsequent months, contributions from other variables begin to emerge (Table 5). For the PORT variable, the shock to portfolio investment in the first month was determined by the variable itself at 100%, with the percentage decreasing until the second year (month 24), when the percentage dropped to 70.28%. The Jakarta Composite Index (JCI) variable, as a significant contributor to portfolio investment fluctuations, accounted for 24.42%, with the remainder coming from FDI at 5.30%.

The shock to the FDI variable in the first month was determined by the variable itself at 91.42%, and it experienced a significant monthly decline. In the second year, the variable's contribution decreased to 43.52%. The fluctuation in FDI was contributed to by fluctuations in PORT (32.71%) and the JCI (23.78%). In the JCI, the shocks that occurred in the variable were also primarily determined by shocks in the variable itself, accounting for 75.37% in the first month. In the second year, the JCI shock was determined by the FDI variable by 21.48% and PORT by 7.41%. The implication of this research result shows that the variance of a variable is mainly explained by shocks from itself, indicating that its internal factors are more dominant than the external influences of other variables in the system. However, the contribution of other variables in influencing the variable cannot be ignored, as they account for a contribution above 20%. The fluctuations in the POT variable, starting in the sixth month, were determined by fluctuations in the JCI by 20.05%. The fluctuations in FDI, starting in the third month, were influenced by fluctuations in the JCI by 29.53%. Conversely, the fluctuations in the JCI were determined by fluctuations in PORT by 24.60% in the first month, although their contribution decreased in the following period.

CONCLUSIONS

The relationship between foreign capital flows and the stock index is one-way and non-reciprocal. Foreign capital inflows can drive up the stock index, while high stock indexes (attractive market returns) are not enough to attract more foreign investors to the Indonesian capital market. A large capital outflow increases demand for the US dollar, potentially weakening the rupiah. If this pressure persists, people's purchasing power may be affected, potentially leading to instability in the capital market. This, in turn, impacts the real sector, particularly investment. Companies struggling to obtain funding tend to delay business expansion. If this situation persists, the risk of layoffs could increase, ultimately slowing economic growth.

Although such incidents are rare, it is important to understand whether this decline is merely a temporary shock or will persist over the long term. If it is a temporary reaction, the market will likely recover quickly. However, if the situation persists, the impact could be more serious on the economy. As a mitigating measure, the Indonesia Stock Exchange (IDX) can implement a share buyback policy without shareholder approval, allowing companies to repurchase their shares to maintain price stability. Furthermore, the government needs to ensure a more convincing fiscal policy to maintain investor confidence. If the investment is long-term, holding onto shares may be a better option for investors. However, for those who need funds in the near future, selling, with the risk of loss, should be considered. The best decision depends on market conditions and the investor's financial strategy. Therefore, JCI fluctuations depend on foreign investors' responses to global economic conditions and government policies.

Further research could explore in more depth the impact of macroeconomic factors such as economic growth, inflation, interest rates, and currency exchange rates on foreign capital flows and stock indices simultaneously. Research could also focus on analyzing market sentiment on social media or news as pull or push factors for foreign capital into the stock market. Furthermore,

research could examine the influence of monetary and fiscal policies, as well as political and economic stability, on foreign investment and stock indices in developing countries.

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