

Determinants of Foreign Portfolio Investment and Its Effects on China

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Abstract

Foreign portfolio investment consists of securities and other capital inflows of assets possibly held by other foreign countries. Foreign Portfolio Investment (FPI) provides the investor with indirect ownership of financial assets. This study intends to investigate the economic factors which attract the investors to invest in the host country. We observed what the impact of FPI determinants on the Chinese economy. To elaborate our results we used multiple regression models by using E-views. This study investigates the effects of FPI and its determinants of the economic structure of China. The data of FPI, GDP, FDI, EXD and P has been taken from the World Bank. GDP and External Debt are the strong determinants of the FPI, the Exchange Rate, Population shows that these variables have a significant impact on the FPI. The investors speculate the high returns, more secure investors' rights and feel safer to invest in the country.

Keywords: foreign portfolio investment, economic structure, economic growth, Chinese economy

1. Introduction

Foreign portfolio investment means the capital inflow in the country or foreign investment came into the country. Basically, foreign portfolio investment is the investment in the stocks and shares of the host country by the foreign investors. Foreign portfolio investment is very hot and the debateable topic of the last decade among the economists. The trend of foreign portfolio investment changes in the last century and foreign investors shifts their investments towards the emerging economies. As seen, the foreign portfolio investment has significantly increased in the CHINA since 1997. The decisions of the foreign investors to invest in the foreign countries depend on upon the different factors. Mainly, economic growth, the political and social stability of the country.

Our major concern is to study the economic factors which attract the foreign investor to invest in the host country. The foreign portfolio investment becomes a very common phenomenon because it's a short term investment as compared to the FDI. The foreign investor speculates the boom in the market and made the investment by keeping in view the economic indicators. The concept of FPI grows very much because it's a short-term investment and contains a handsome amount of returns.

Investment in the host country by the foreign investor is a good source of the income and it's helpful for the host country to fulfill the capital needs of the country. According to the Daly and Xuan 2013 still, the foreign investor is most likely to invest in their domestic market. This phenomenon is known as home biasness. The host countries need to take the different steps to attract the foreign investors to invest in their country. Like, less restriction on the capital inflow and outflow and attractive opportunity for the investment with the significant growth rate of the economy.

The intention of work is to find the determinants of foreign portfolio investment and its effect on the economy of CHINA. After, the introduction and background the next section is the literature review of the selected literature on this topic. Section 3 explains the contribution of this paper. Section 4 contains the data, methodology and the results obtained from the empirical analysis and discussion on the results and last section conclusion and recommendations for the policy maker.

2. Literature Review

According to (Faruquee, Li, & Yan, 2004; Portes & Rey, 2005; Duca, 2012) the capital inflow and outflow are very important nowadays and the geographical component is very vital for the international flow of the capital.

The capital inflow depends on the transaction cost and the market size of the host country. According to the IMF survey the transaction cost, asymmetric information, and the market size are the vital determinants of the capital flow in the country. These major determinants are the driving factors of the portfolio investment. The crucial market events and the shocks change the portfolio investment driving factors. The foreign investors are very much concerned about the regional development after the overcome of the market tension. The extreme tension in the region made the investors panic and they started to move their funds out of the country or region.

According to the Ducca 2012, the major factors affecting the capital inflows are GDP growth rate, market efficiency, and higher returns expectation. These factors play an important role in attracting the foreign investment. All these factors raise the macroeconomic level of the country by brought in the foreign investment which helps the country to rectify the deficit of the current account of the country. That leads the economy towards the growth. On the other side because of the volatility of this kind of investment, it can cause the economic crisis in the country. In the normal circumstances the foreign portfolio investment is very beneficial but when it flew out of the country it has the very disastrous effect on the economy.

As Garg and Dua 2014 the foreign portfolio investment increases five times in the developing countries in last five years. The figure of foreign portfolio investment reached up to 128 billion dollars till 2010. The major share of foreign portfolio investment has been shared by the CHINA, INDIA, BRAZIL and SOUTH AFRICA. CHINA, INDIA, and BRAZIL receipt seventy percent of the total foreign portfolio investment invested in the whole world. CHINA get the largest part of the foreign portfolio investment because of the remarkable growth of last thirty years. The Chinese reforms started in 1978 in the agricultural sector and ultimately it spreads in the whole economy. The private sector of the China flourished tremendously in the era of 1978-2005.

According to Fayyaz et al. (2015), the main determinants of the foreign portfolio investments are the GDP growth, market size and market efficiency and higher expectation of returns played a vital role in the movement of the foreign portfolio investment. If these factors of any country are in a stable form that country get the smooth and stable capital inflows from all over the world. In the case of China, the external debt is the most significant factor to drive the foreign portfolio investment in the country. The GDP growth, exchange rate, and FDI are among the important determinants of the foreign portfolio investment.

According to Waqas et al. (2015) foreign portfolio investment mainly depends on the macroeconomic factors of the host country. They studied the relationship between the macroeconomic factors and foreign portfolio investment volatility in CHINA, PAKISTAN, INDIA and SRI LANKA. The study shows a significant impact of macroeconomic factors on the foreign portfolio investment volatility. If the host country had a High-interest rate, foreign direct investment, Currency depreciation and lower inflation and higher GDP growth rate than the foreign portfolio investment volatility is less in those countries. The depicts that the stable macroeconomic condition of the country attracts more foreign portfolio investors to invest in the country and volatility of the foreign portfolio investment is very less due to stable economic conditions of the host country.

The Chinese government took huge measurements to made China an open economy in the late 90s, to make a China open economy. For this, the Chinese government privatizes the almost all the public owned enterprises except some monopolies to private investors to attract foreign portfolio investment in the country. During the period of 2001-2004 China reduced state-owned enterprises by 48%. Chinese government joined the World Trade Organization, reduce tariffs abolish the trade barriers and modified the trade regulations to led the massive foreign portfolio investment in the country. These measures were proven to be very beneficial to the China. China is the world second largest economy now a day after the United States of America. (Shen, 2006).

Regarding the source of finance in the emerging markets, Net portfolio investment is also an imperative basis (Rangarajan, 2000). FDI is to be considered as the steadiest capital. However, both net portfolio investment and banking flows were volatile. Through the linkages between foreign and domestic financial markets, portfolio flows are rendering the financial markets more volatile (Kohli, 2001, 2003). Capital flows depiction the potential susceptibility of the economy to unexpected withdrawals of foreign depositor from the financial market, which will have an effect on liquidity and give to financial market precariousness. According to estimation amalgamation by the outer sector throughout the capital, outflows could be explored in the capital inflow surge. The rationale of the capital flow to immature countries is to speed up their economic growth to a point where an acceptable growth rate can be achieved on a self-supporting base. The principal ways by which possessions can come from affluent to inferior countries is by Capital flows in the form of private investment, foreign investment; foreign aid and private bank lending. The transmission of technology, ideas, and knowledge can be referred as the additional particular types of resource transfer. According to an argument made by (Krugman, 1993) that according to the neo-classical framework, though, nor the differences in the levels of growth crosswise countries

by the capital neither large capital flows make any momentous disparity to the growth rate that a country could attain. In the succeeding renaissance of the approach known as two-graph, the prominence has usually laid on the preconditions that could make foreign capital more prolific in mounting countries. The important preconditions comprised the presence of excess labor and surfeit industrious demand for foreign exchange. According to an overriding observation is that due to what command cross-border capital flows is that in any country where capital is in short supply the marginal productivity of capital is elevated in that country. Similarly as being there of capital flows shortfalls in domestic cutback should not confine speculation, if marginal productivity of capital extensively differed across countries. The decisive verdict (Feldstein & Horioka, 1980) that domestic saving and investment rates are exceedingly interrelated, on the other hand, indicated that the degree of capital mobility crossways countries may not be high. Along with the valuable impacts of capital flows, it also has on the country's growth and development of an economy, some unfavorable impacts. In order to minimize the unpleasant effect associated with the capital flow on domestic savings, inflation and so on, the suitable course of action has to be taken into consideration.

According to a study by (Fosu & Magnus, 2006) and (Omisakin et al., 2009), in which they figured out appropriately that for amplifying the hoard of treasuries for local speculation foreign capital inflow is considered to be an essential means of transference. Another argument made by (Ngowi, 2001) that developing countries including African countries want ample influx of foreign capital in order to plug the gaps between saving and foreign exchange concomitant with a swift ratio of capital accretion and progression required to overawed the prevalent insufficiency in these developing countries. An analysis made by (Ghose, 2004; Knill, 2005; Vita & Kyaw, 2008) that for the reason that higher rate of return in these emerging countries, these countries are favored to established countries by foreign investors. Though maybe the foreign investors are eager to take advantage of this high ratio of yield in the aspect of high fabrication cost and slanted venture inducements is utterly alternative dispute entirely. As we consider the in the present situation Foreign Portfolio investment (FPI) is becoming a renowned type of investment in various countries of the world. The main aim of investing in any foreign country is both that is to earn source and on the other side and the risk also diversified for the investors. Regardless of the aforesaid remunerations of foreign portfolio investment or foreign capital inflow in the congregation country, numerous authors have contended in contradiction of it in the collected works. For occurrence, even though the verdicts of (Kulshrestha, 2014) signpost that Foreign Institutional Investors have appeared as the utmost prevailing financier clutch in the native capital market, portfolio capital flows are unvaryingly short term and notional and are frequently not connected to economic rudiments then slightly to urges and vogues ubiquitous in transnational financial markets. According to a study by (Kargi, 2014) and (Busse & Hefeker, 2005) in which they dispute that portfolio investments track the jeopardy of abrupt snag if the economic environment or the perspicacity of depositors alter, providing upsurge to fiscal and pecuniary catastrophes. The advantageous corporate atmosphere and sturdy lawful structure have been acknowledged as a foremost allure of foreign investment. According to an argument made by (Masoud & Abu Sabha, 2014) in which they discovered that stability of the monetary market and situation impact financiers' portfolio investment verdicts and eventually portfolio investment drifts. Regardless of how vivacious a capital market may possibly be, a non-beneficial business environment and feeble legitimate structure would not entice FPI.

Foreign portfolio investment shifted massively from developed to developing countries before the financial crises of 2008. The capital inflows and outflows have positive and long term relationship with the market capitalization and degree of openness of the host country. The FPI are also affected by the neighboring countries of the host country either in the positive and negative way. The foreign investor is very keen about the safety of its funds. The expected rate of return is also connected with the political stability of the country. Foreign investor mostly prefers the political stable country for the investment as compared to the less political stable country. The foreign investors shift their fund from politically unstable to politically stable country to ensure the safety of the funds. The cultural characteristics of the investing country and the host country also an important factors to determine the foreign portfolio investment in the host country (Chukwuemeka, Stella, Odhu, & Onyema, 2012; Smimou, 2014).

According to (Egily, Johnk, & Liston, 2010; Forbes, 2010; Gwenhamo & Fedderke, 2013). The main determinant of the foreign portfolio investment in the United States of America is the financial development of the country. The countries mostly invest in the United States because of less financial development. The countries internal factors affect the capital inflow and outflow of the country. The country institutional and domestic risks have a direct relation with the capital inflows and outflows. If the countries have good institutional setup and less domestic risk is more likely to have more foreign portfolio investment. Like, South Africa have more strong institutional setup have secure property rights and low domestic risk affects positively to the volume of capital

flows in the South Africa both the FDI and FPI.

Specifically, international capital flows into foreign direct investment and foreign portfolio investment was broken down by the authors. The results they got show that there was the hostile effect of portfolio investment on growth but Foreign Direct Investment was absolutely associated with economic growth. FDI have a negative impact on growth in Pakistan economy. An analysis from the study by (Gee, Chan Sok, & Karim, 2011) they made an argument that as the FDI flows from urbanized economies to a concentrated sector that is rich regarding research and development possibly will have affirmative impacts on developed sector through the conduit of expertise relocation. There was an examination made by (Aurangzeb & A. Ul Haq, 2012) on the impact of international capital inflows on the growth of Pakistan economy, they found that external debt, remittances and FDI had an optimistic impact on GDP. There was another analysis by (Qayyum & Haider, 2012) they focused on the impacts of governance, foreign debt and external aid on the development of Pakistan economy. Pakistan economy is one of those mounting economies that has accumulated an enormous quantity of external debt and practiced FDI and remittances inflows. The facts and figures we acquired from the previous studies we come to know, Pakistan economy has shown slower growth over the years in spite of the huge amount of debt accretion and significant inflows of remittances. According to a study by (Mobolaji, 2008) that foreign portfolio investment abandonments and preservation in order to examine financial problems the local level, as well as the viewpoint of abridged foreign direct investment (FDI), are a vault to impinge on investors' poise and the economic well-being of any country. As per (Parthapritam, 2006) in order to attract foreign portfolio investments there has also been competition among the emerging markets, through this it reached to a position at where it become important for the developing countries for portfolio investors they must have to ensure attractive returns for them, frequently it means that they offer an increase in the operational flexibility. According to a study by (Osita, 2002), (Tokunbo, 2004), Rose and Sara (1998) in which they examined the trend towards promoting stock market and economic growth but fail to consider the fact as per another study by to (Adeleke, 2004) regarding foreign portfolio investment that is believed to facilitate economic growth and development which in result escort to economy's industrialization. An argument made by capital flow liberalization supporters that foreign portfolio investment is predisposed to enhance the liquidity and the efficiency to local markets. A alleges made by them that the expected return decreases in the long -run, which in result of market amalgamation. The analysis' (Henry, 2000), (Bekaert & Harvery, 2000) and (Kim & Singal, 2000) tackle this problem and the atypical following market liberalization. By these studies, it was analyzed that the startup companies along with the existing companies effortlessly can hoist capital with the help of an additional foreign investor. With the entrance of foreign investors in the local market, it will lead to boost the liquidity of the local market and makes the support of investors broader and also risk sharing will increase.

According to an argument made by (Khan, 1996) that portfolio investment is the most conspicuous trait of private capital flows into Pakistan, non-resident foreign currency deposits, and other short-term capital, there a potential risk of a hitch of flows in a very short-term. This reversal flows further lead to creating a banking crisis and due to which in the end precariousness observed in both exchange rate and interest rate. If the State Bank be short of a passable stock of international reserves to meet the outflow, it may than grounds for the balance of payments crisis. Portfolio investment flows into Pakistan are best understood in the context of changes in the formation of international capital flows. Foreign portfolio investment has played a major role in the shift towards non-bank financing. Prospects for high economic growth rates in developing countries, usually reflected in higher returns on portfolio investment, is one of the major reasons for increased portfolio flows to promising markets. According to an analysis made by (Khan, 1996) due to their innately capricious nature, the portfolio inflows have proved to be reversible more than other forms in developing countries. Their potential volatility is great in Pakistan as well since portfolio investment in Pakistan is directed mainly towards short-term and some medium-term public debt instruments and the stock exchanges, while admittance to capital markets through the use of external instruments has been inadequate.

3. Contribution of This Paper

This paper contributes to finding the determinants of the foreign portfolio investment in the case of China. China needs special focus because foreign portfolio investment has significantly increased in the country since the late 90s.

4. Methodology and Results

The data of FPI, GDP, FDI, EXD and P has been taken from the World Bank site eighteen observations have been observed under the analysis from 1997 to 2014. Foreign portfolio investment consists of total investment inflow in the country. The data has been taken on the annual bases and the currency unit used is U.S Dollar.

Some control variables are also taken into the account for a comprehensive study and those variables are chosen on the basis of previous literature which may influence the FPI. The analysis consists of the five variables from 1997-2014. The following are the main variables for the analysis.

FPI = Foreign Portfolio Investment	DEPENDENT VARIABLE
GDP = Gross Domestic Product	INDEPENDENT VARIABLE
EXD = External Debt	INDEPENDENT VARIABLE
FDI = Foreign Direct Investment	INDEPENDENT VARIABLE
EXR = Exchange Rate	INDEPENDENT VARIABLE
P = Population Growth	INDEPENDENT VARIABLE

The following Hypothesis has been developed on the basis of previous literature.

H0 = FDI / GDP / EXR / P / EXD is not significant in determining the FPI inflows in China.

H1 = FDI / GDP / EXR / P / EXD is significant in determining the FPI inflows in China.

The main focus of this paper is to find the main determinant of Foreign Portfolio Investment in the CHINA. FPI of China has been taken as the dependent variable and FDI, GDP, P, EXD and EXR has been taken as the independent variables. FPI is the function of all these variables then it can easily be written as;

$$FPI_t = f_1(u_t^{fdi}, u_t^{gdp}, u_t^{exd}, u_t^{exr}, u_t^p) \quad (1)$$

$$FPI_t = f_2(u_t^{fdi}, u_t^{gdp}, u_t^{exd}, u_t^{exr}, u_t^p, u_t^{itr}, u_t^{ifn}) \quad (2)$$

First equation contains the five main variables which includes; foreign direct investment, u_t^{fdi} , gross domestic product, u_t^{gdp} , population growth, u_t^p , exchange rate, u_t^{exr} , and external debt, u_t^{ed} .

Frequently used variables in previous literature contain inflation and interest rate. The second equation explains that FPI is a function of main and control variables, which includes interest rate u_t^{itr} , and inflation u_t^{ifn} .

Multiple regression models have been used to get the empirical analysis of data. The model consists of more than one independent variable, in this case, if simple regression model is used for the empirical analysis than the results are not satisfactory. The simple regression model is used where only one independent variable is in the model. Multiple regression model is the tool to deal with one dependent and multiple independent variables.

$$Y = a + b X + b X_2 + \dots + b_n X_n \quad (3)$$

Third equation depicts that to predict variable Y a multiple independent variable has been used. After adjusting the variables the final mathematical form of our model is represented in equation (4).

$$Y = a + b_1 + fdi_1 + b_2 gdp_2 + b_3 exd_3 + b_4 exr_4 + b_5 p_5 \quad (4)$$

5. Findings and Discussions

This section discusses the empirical analysis and implications of the findings. Table 1 discusses the statistics summary of dependent and independent variables for the same period. The skewness > 0 which indicate the distribution is rightly skewed.

5.1 Descriptive Statistics

	FDI	GDP	EXD	FPI	P
Mean	3.625431	9.473557	26.48550	22.89781	0.632105
Median	3.464990	9.230219	26.42805	22.98662	0.573250
Maximum	4.882165	14.19496	27.58969	24.67289	1.023450
Minimum	2.590357	7.268461	25.69295	20.23224	0.479150
Std. Dev.	0.701620	1.847407	0.659072	1.417569	0.172300
Skewness	0.339717	1.075027	0.305940	-0.650740	1.087321
Kurtosis	1.870809	3.650943	1.739278	2.258293	2.927360
Jarque-Bera	1.302527	3.784845	1.472864	1.682986	3.550756
Probability	0.521387	0.150706	0.478819	0.431067	0.169419
Sum	65.25777	170.5240	476.7390	412.1606	11.37788
Sum Sq. Dev.	8.368600	58.01950	7.384380	34.16155	0.504687
Observations	18	18	18	18	18

The value of Kurtosis is <3 which indicates that the distribution is flatter than normal with wider peak. While the value of Jarque-Bera test is also not very high.

5.2 Heteroskedasticity Test: ARCH

F-statistic	0.779471	Prob. F(1,14)	0.3922
Obs*R-squared	0.843842	Prob. Chi-Square(1)	0.3583

The ARCH test has been applied to test the heteroskedasticity. The heteroskedasticity is not present in the model according to the results which means the residuals are identically distributed.

5.3 Breusch-Godfrey Serial Correlation LM Test

F-statistic	2.015333	Prob. F(2,9)	0.1891
Obs*R-squared	5.258467	Prob. Chi-Square(2)	0.0721

The LM test has been used to check the autocorrelation in the model and, the test, hence proved that no autocorrelation is present in the model which means the residuals are independently distributed. Because the value of probability is greater than 0.05 in the ARCH test and LM test.

5.4 Estimation

Variable	Coefficient	Std. Error	t-Statistic	Prob.
EXR	-2.885520	1.204075	-2.396461	0.0355
GDP	0.497912	0.193754	2.569808	0.0261
ED	3.958009	1.738542	2.276626	0.0438
P	-5.302825	2.572205	-2.061587	0.0637
FDI	0.349784	0.345235	1.013178	0.3327
C	-97.06924	54.65786	-1.775943	0.1034
R-squared	0.825448	Mean dependent var	22.92379	
Adjusted R-squared	0.746106	S.D. dependent var	1.456773	
S.E. of regression	0.734037	Akaike info criterion	2.490050	
F-statistic	10.40370	Durbin-Watson stat	2.597359	
Prob(F-statistic)	0.000702			

The results of estimation show that the value of almost all the variables is significant at 5% significance level. GDP and External Debt are the strong determinants of the FPI according to the results. The significant results of the Exchange Rate, Population shows that these variables have a significant impact on the FPI. According to the results, FDI is not so much significantly affects the FPI because the value of probability is greater than 0.05.

The aforesaid empirical evidence shows that the independent variables taken for the analysis have the significant impact on the dependent variable. GDP and External Debt have strong positive impact on the Foreign Portfolio Investment. It means the external debt has potentially being used for the economic growth and the potential usage of external debt brings more capital inflow in the country. Progressive usage of foreign loans improves the social and economic condition of the country. GDP has strong positive impact on the FPI, it is obvious because if the economy performs well it attracts the most foreign investors to invest in the country. In the case of CHINA, the GDP growth rate is in the double figure since 1997.

The exchange rate has significantly negative impact on the FPI. If the exchange rate depreciates it leads to the outflow of capital from the country and vice versa. Exchange rate appreciation brought in the confidence of the investors to invest in the country. The investors speculate the high returns, more secure investor's rights and feel safer to invest in the country. This leads to the better infrastructure, efficiency in the economy and more improved investor rights in the country's stock exchange, which leads to the better economic growth. The social and political stability in the country and higher GDP growth rate attracts the investors to invest in the country and minimize their risks by diversified their investment portfolio.

6. Conclusion

The existing literature explains that the determinants affect the FPI of the country varies from country to country.

The most significant determinants are economic growth, interest rate differential, currency exchange rate, country political stability and capital control policy of the country. In this paper, the different factors have been investigated which affected the FPI of the CHINA. Based on the empirical analysis the GDP, population growth, exchange rate, and external debt have significantly affected the foreign portfolio investment of CHINA.

CHINA should keep its economic growth high as it's already been in double figure and highest in the region. CHINA should review its financial policies time to time and pay high attention towards the investor's rights and financial openness to attract more foreign portfolio investment to sustain its economic growth. To pay special attention towards the investor's rights will be helpful in the period of economic recession and helpful to curtail the disastrous conditions.

The stable political condition and good economic policies of the governments will attract more foreign portfolio investment which brings economic prosperity in the country and, living condition of the people of the country get better by high foreign portfolio investment in the country.

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