



Does Institutional Quality Matter for Equity Foreign Portfolio Inflows? Evidence from Developing Economy of Sri Lanka

Ambepitiya Wijethunga Gamage Champa Nilanthi Wijethunga &
Debaherage Athula Indunil Dayaratne

Sabaragamuwa University of Sri Lanka, Belihuloya, Sri Lanka

Abstract

This study examines the effect of the institutional quality on equity foreign portfolio (EFPI) inflows in Colombo Stock Exchange (CSE) for the period of 1992–2017. The Autoregressive Distributive Lag (ARDL) approach is adopted for the analysis. The institutional quality is measured through a composite index which was derived from the four measures of corruption, law and order, democratic accountability and bureaucratic quality by controlling economic growth, interest rate, exchange rate, and inflation rate. The study confirms that a linear combination exists between the variables and finding insufficient to support the argument that the institutional quality matters in EFPI inflows in long run for the market. Conversely, short run dynamic model reveals that institutional quality has a positive impact on EFPI. This suggests that foreign investors are mindful about the prevailing governance mechanism before committing their excess monetary resources to Sri Lanka via stock market. Result implies that in short run governance mechanism highly impactful on macro-economic stability in Sri Lanka. It has also established that apart from good governance the interest rate matters for EFPI in Sri Lanka.

Key words: Institutional Quality, Equity Foreign Portfolio Inflows, Colombo Stock Exchange

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Introduction

Over the last three decades, the emerging stock markets grew phenomenally while these markets played a prominent role in attracting foreign investments into the respective emerging economies. It is generally believed that, stock market of an economy reflects the country's economic performance and particularly foreign investors frequently attempt to leverage the potential benefits by seeking cross border investments in these markets. Comparatively, the foreign investors are looking beyond the domestic investors when they select their investment grounds in overseas countries. In addition to the stock market activities and other viability of economic indicators, they are very much concerned about the host country's political and governance mechanism or the institutional quality. Attracting foreign portfolio investments to

developing nations are essential to fill the gap between savings and investments and it acts as an engine of economic growth in a globalized world economy context. Basically, the foreign investors are much concerned majorly about economic fundamentals and firm specific fundamentals as well as the stock market performance of the home country and host country before capitalizing their funds in the host country's stock markets.

Importantly, foreign capital flows play an immense role and have a diverse impact on the economic structure of the both developed and developing economies. Thus, Foreign Portfolio Investment (FPI) has become as a major driver of the global economy and it largely enlarges the investment activities of both developed and developing nations (Chi-chi & Linus, 2013). The fund allocation decision of the foreign investors is based on the information availability for them about the host economy. Therefore, both FPI and Foreign Direct Investment (FDI) flows are highly sensitive to the host nation's information availability (Hashimoto & Wacker, 2012) for the investors. However, some scholars believe that the host country's economic performances will be the major determinants of FPIs (Kreicher, 1980; Calvo et al., 1993) and others argue that the host nation's institutional quality plays a key role in attracting FPIs (Drabek & Payne, 2002; Itay & Razin, 2005; Verrecchia, 2001; Faruqee et al., 2004). The institutional quality of a country plays prominent role in promoting the image of rules and regulations, and for proper surveillance of political, social and economic activities globally. In turn, it accelerates the efficiency of financial markets. Generally, better legal protection of the interest of owners and creditors promotes more capital inflows to the firms from external finance. Further advancing wealth of research in this premise, La Porta et al. (1997, 1998) highlighted that if an economy provides a right to foreign investors in a well enforced market from regulations and laws; it helps to attract more foreign investors to the economy. Conversely, if law and their enforcements are vague, they will lead to malfunctioning of financing mechanism of the country. Furthermore, Bhattacharya & Daouk (2002 & 2009) suggested that weak regulations and its enforcement of the law promotes inner dealing in the market which discourages foreign investments flows into the equity markets.

Moreover, with the advent of globalization concept, the investors sought cross boarder investments to maximize the returns for their investments. During 1970s, several emerging economies adopted open market economic policies in view of coping with trade barriers and restricted capital flows across nations. Sri Lankan economy embraced open market policies in late 1970s and later, relaxation of barriers for capital flow across borders, stimulated the foreign equity portfolio investment flow in Sri Lankan market. However, Sri Lankan market has failed to sustain the expected growth momentum of foreign equity portfolio investment due to prolonged civil turmoil which expanded for more than 30 years. During the war period, the rule of law in the country was vandalized and the ruling government could not maintain investor friendly governance mechanism. The ruling government and the authorities always state the fact; that the main barrier for the investor attraction to the market is civil war. Now, the so-called barrier has ended, and it passed through almost one decade. However, country has failed to win the minds of investors, establishing conducive institutional quality, which leads to good governance framework within the country. Thus, an empirical investigation is required to establish whether institutional quality matters for the foreign equity portfolio inflows in Sri Lankan context and this paper aims to analyze the impact of country's institutional quality on foreign portfolio inflow in Sri Lanka.

Review of Empirical Studies

Voluminous studies contend that quality institutions ensure a stable business environment and strict enforcement of law and order lead to the improvement of transparency of the economy. For example, Drabek & Payne (2002) discovered that transparency of the economy is essential for

reducing additional cost, because non-transparency incurs additional costs (a) to tackle the lack of information; (b) to facilitate cross border mergers and acquisitions, (c) to protection of the property right, (d) to influence on the business attitudes, and it establishes favorable conditions for capital inflows. Furthermore, Itay & Razin (2005) stated that FPI is more attractive to developed countries rather developing nations due to the high transparency in economic activities in developed countries. The transparency is the most suitable remedy for asymmetric information and which promotes efficient allocations of investment funds among alternative investment avenues. Information asymmetry leads to inefficient allocation of investment funds within the economy. Moreover, Verrecchia (2001) revealed that other than, information asymmetry that provoked by low institutional quality, it leads for adverse selection and insider trading. Adding more evidences in this premise, Itay & Razin (2005), established that the transparency level of the economy is more vulnerable when the economy is in a crisis period. On the other hand, Faruqee et al. (2004) proved that the low level of transparency will lead to widen the distance between withdrawal rate of FDIs and FPIs. Moreover, Mohd et al. (2016) revealed a negative relationship between asymmetric information and FPIs.

More interestingly, Cao (2009) examined that political environment, geographical distance, language, level of bilateral trade are significant determinants of FPIs in OECD countries. According to Cao (2009), countries with greater transparency and stronger democracy are preferable for the foreign portfolio investors. Furthermore, Cao's (2005) findings suggested that less transparent and less democratic countries should be fine-tuned their domestic economic policy to be more advantageous to foreign portfolio investors. Similarly, Cao & Ward (2014) re-established the findings of Cao (2009) and stated that more stable investment environments are being created by democracies. It leads to attraction of more FPIs as democracies translate into better property rights protection.

Giving new thought to Ex-ante literature, Wu et al. (2012) discovered that rule-based countries attract least number of FDIs compared to FPIs. In the other words, more FPIs are attracted to the rule-based countries or well governed countries rather than weakly ruled countries (relation based) countries. Moreover, they revealed that the rule-based countries have relatively developed large Stock Exchanges. Accordingly, it implies that developed countries attract more FPIs than developing countries due to their strong rule of law prevails in the countries. Another important argument is the corruption level of an economy indicates low institutional quality in the country which determines the degree of asymmetric information and investors' uncertainty. Ultimately, total trading volume decreases due to the declining of trading volume and Jain et al (2017) also suggested a positive relationship between corruptions and FPIs. Further, Jain et al. (2017) revealed that a high transparent economy has a lower level of corruptions and moderate level of corruption in a higher risky and severely asymmetric information prevailing environment.

As noted above, most of the scholarly works are focused on analyzing the role of host country's institutional quality level attracting FPIs. Contrary to the above, Abdioglu et al. (2013) analyze the firm level and macro level institutional quality in the investment preferences of foreign institutional investors in the home country is perspective. The findings revealed that macro level institutional quality level of foreign institutional investor's home country is determined their investments on US market. Further, it indicated that most of the institutional investors who came from countries which have similar institutional quality as US and findings are consistent with the argument of flight to quality.

Further to the extending the body of knowledge in the field, Alfaro et al. (2008) provided empirical justification for the lack of capital inflow to poor countries from rich countries due to

institutional quality. They noted that low institutional quality is making disparity of capital inflows between rich and poor countries. Further they suggested that in view of increasing capital inflows the governments should improve stability, improve property rights, reduce corruption, and improve law and order in an economy. A study of Mengistu & Adhikary (2011) found that out of six governance indicators four (04) such as political stability and absence of violence, rule of law, the control of corruption and government effectiveness to be strong determinants in attracting a high level of FDIs in 15 Asian countries (including Sri Lanka) during the period of 1996–2007. The country's voice, accountability and regulatory quality play an insignificant role in attracting FDIs. Current global trend is to encourage more FDIs to the transitional economies and well governed countries tend to invest their funds in poorly governed countries. The wealth of the unexploited natural resources in those countries encourage more investors (Bellos & Subasat, 2012; Subasat & Bellos, 2013).

Finally, review of literature explored that in Sri Lankan context modeling the FPIs against the institutional quality perspective was still lacking. As such, a useful scientific inquiry is essentially, required to establish objective consciences on the subject area for the use of policy makers of Sri Lanka.

Definition of Variables

This study applied institutional quality to model the EFPIs by controlling stock market development and selected macro-economic variables. The World Bank Governance Indicators which are defined by the World Bank and it is a most popular and widely used measure for governance and institutional quality among academics and scholars in different standpoints. Due to the data limitation of worldwide governance indicators, this study derived separate composite index to measure institutional quality. This procedure condensed four sub indicators of International Country Risk Guide (ICRG), namely; corruption, law and order, democratic accountability and bureaucratic quality. These are the dimensions of good governance which are recommended by the World Bank.

Stock market development is one of the key reform activities of economy. It provides an efficient market where both domestic and foreign investors able to put their surplus funds for higher return with a minimum risk. It provides an avenue for private companies to raise long term capital at lower cost. For example, Solow (1956) explained how finance can boost the capital stock of an economy through steady state of closed economy. Further, Solow (1956) stated that when stock market is liberalized to access foreign capital flows, it will lead to reduce the cost of capital. Finally, agents will respond to the market cost of capital by bringing down the marginal products of capital. However, it is temporary in nature under a condition of capital stock grows faster than labor force. In other terms, Solow's growth model simply explains that stock market liberalization will encourage a temporary raise in capital stock through foreign capital flows. SMD reduces the risk that is associated with investment and increases the average investment rate of all listed firms (Stulz, 1999a, 1999b). In addition, it affects specific firms through the "beta" effect. This implies that firms whose equity premium fall should increase their investment by even more than those whose premium rise.

On the other hand, stock market size is identified as a major indicator of stock market development. This study employed Stock Market Capitalization to GDP as a proxy to measure stock market size. Apart from the institutional quality and stock market development as proxies, this study utilized economic growth, interest rate, inflation rate and exchange rate as control variables to exclude the impact of those variables on the outcome of the model. Secondary data

were collected over the period from 1992 to 2017. Data related to the foreign portfolio investment and stock market capitalization ratio were gathered from the Data Library of Colombo Stock Exchange and macro-economic data were obtained from Annual Reports of Central Bank of Sri Lanka.

Econometric Modeling

Autoregressive Distributive Lag Model (ARDL) is a superior estimate of long run coefficient which claims numerous advantages (Gerrard & Godfrey, 1998). The core analysis tool of this paper is ARDL approach which is most appropriate to enhance the defined objectives of this study. Before applying the ARDL approach, it is a pre-requisite to confirm the integrated order of variables in the ARDL approach. This is required to specify whether the individual regressors are integrated of the order I (0) or I (1), regardless of stationary. The Augmented Dickey Fuller Test (ADF) is used to confirm the integrated order of data series. Then, estimate ARDL model and the optimal lag selection for the cointegrating equation based on the Akaike Information Criterion (AIC). The bound testing is employed to examine the existence of long run relationship among variables by conducting F-test for the joint significance of the coefficients of the lagged levels of the variables (null hypothesis of $H_0: \beta_1 = \beta_2 = \beta_3 = \beta_4 = \beta_5 = \beta_6 = \beta_7 = 0$ against alternative hypothesis of $H_1: \beta_1 \neq \beta_2 \neq \beta_3 \neq \beta_4 \neq \beta_5 \neq \beta_6 \neq \beta_7 \neq 0$). After confirming cointegration with the bound test, the long run regression coefficients and short run coefficients are derived from specified model by applying equation 1 and 2 given below.

$$\begin{aligned}
 LFPI = & \beta_0 + \sum_{i=1}^p \beta_1 LFPI_{t-i} + \sum_{i=0}^p \beta_2 LIQ_{t-i} + \sum_{i=0}^p \beta_3 LSMCR_{t-i} \\
 & + \sum_{i=0}^p \beta_4 LPCI_{t-i} + \sum_{i=0}^p \beta_5 LTBR_{t-i} \\
 & + \sum_{i=0}^p \beta_6 LEXCR_{t-i} + \sum_{i=0}^p \beta_7 LINF_{t-i} + \varepsilon_t
 \end{aligned} \tag{1}$$

$$\begin{aligned}
 \Delta LFPI = & \delta_0 + \sum_{i=1}^p \delta_1 \Delta LFPI_{t-i} + \sum_{i=0}^p \delta_2 \Delta LIQ_{t-i} + \sum_{i=0}^p \delta_3 \Delta LSMCR_{t-i} \\
 & + \sum_{i=0}^p \delta_4 \Delta LPCI_{t-i} + \sum_{i=0}^p \delta_5 \Delta LTBR_{t-i} \\
 & + \sum_{i=0}^p \delta_6 \Delta LEXCR_{t-i} + \sum_{i=0}^p \delta_7 \Delta LINF_{t-i} + \psi ECT_{t-1} + \varepsilon_t
 \end{aligned} \tag{2}$$

Where, LFPI is the foreign portfolio inflow, LIQ and LSMCR denote institutional quality and stock market capitalization ratio. LPCI stands per capita income, LTBR, LEXCR, LINF represent Treasury bill rate, exchange rate and inflation rate respectively.

Results and Discussion

Descriptive statistics are important to describe the basic features of the selected data as it provides the simple summary about the sample and the measures. Table 1 stretches the

descriptive statistics such as mean, median, standard deviation, skewness, kurtosis, and Jarque-Bera (JB) test of normality for all the considered variables. The reported results in Table1 indicates that FPI is moderately skewed towards right, per capita income (PCI) is moderately skewed towards left. Further, institutional quality (IQ), stock market capitalization ratio (SMCR), exchange rate (EXCR), and Treasury bill rate (TBR) showed approximately symmetrical distribution. Interest rate (INF) is strongly skewed towards the right.

Table1 : Descriptive Statistics of the variables

Variable	Mean	Median	Std. Dev.	Skewness	Kurtosis	JB	Prob.
FPIInflow	37931.72	21092.7	36680.01	0.6416	1.967	2.94	0.229
IQ	1.88	2.25	1.32	0.1772	1.9548	1.3195	0.516
SMCR	20.59	22.55	8.64	0.2329	2.1563	1.0063	0.604
PCI	1806	1153	245	-0.945	5.5077	10.685	0.004
INF	8.79	7.63	4.62	1.0906	4.3122	7.0197	0.029
TBR	12.04	10.05	4.76	0.4977	1.8088	2.6106	0.271
EXCR	95.58	100.85	32.42	-0.092	1.9133	1.3158	0.517

Before proceeding to advanced econometric modeling of ARDL approach, it is necessary to test the time series for stationarity to confirm integrating order of data series. To determine the integration order of variables, the study occupied Augmented Dickey Fuller (ADF) test, formulating the null hypothesis of $H_0: \beta = 0$ and the alternative hypothesis of $H_1: \beta < 0$. The result of the ADF test is given in Table 2 and it shows that all variables have unit root (non-stationary) at level series except LPCI, LTBR, and LINF. However, other variables indicate stationary features at first difference level. Thus, LPCI, LTBR, and LINF are integrated in order of order zero, I (0) and rest of variables are integrated of order one, I (1). In conclusion, all variables are integrated of I (0) and I (1), none of the variables are integrated above order one and selected variables are preferred for modeling ARDL approach.

Table2: Unit Root Test Results for the Variables

Variable	Level series	1st difference series	Order of integration
LFPI	-2.4397	-5.3308***	I (1)
LIQ	-3.0717	-4.4609***	I (1)
LSMCR	-3.0501	-4.4468***	I (1)
LPCI	-4.5082***	-7.7396***	I (0)
LEXCR	-1.4828	-4.8076***	I (1)
LTBR	-4.3476**	-5.0333***	I (0)
LINF	-3.6282**	-4.5518***	I (0)

Notes: ***, ** & * significant at 1%, 5% and 10% level respectively

According to the ARDL modeling, the selected numbers of lags are summarized as follows. Therefore, AIC criterion verifies that optimal lag length is 1,1,0,0,0,1,0 for ARDL model which is fitted to explain the foreign portfolio inflows.

Variable	LFPInflow	LGG	LSMCR	LPCI	LEXCR	LTBR	LINF
No of lag	1	1	0	0	0	1	0

ARDL bound test is applied in assessing the cointegration between variables following the procedure adopted by Pesaran et al. (2001). The null hypothesis which is no cointegration exist among variables was tested against the alternative hypothesis of cointegration that exists among the variables. The result of the ARDL bound test is summarized in Table 3.

Table3 : Results of ARDL Bound Test for inflows and outflows from 1992 to 2017

Test statistic	Value	Sig.	I (0)	I (1)
F statistic	8.673160***	10%	2.334	3.515
		5%	2.794	4.148
		1%	3.976	5.691
k	6			

Note: *** denotes significant at 1% level

The results of portfolio inflows demonstrate that the calculated F-statistic (8.673160) exceeds the upper bound, I (1), at 1% significance level. Accordingly, the null hypothesis was rejected and confirms the existence of cointegration or the long run association among examined variables. Moreover, it confirms that a linear combination exists between log series of foreign portfolio inflow, institutional quality, stock market capitalization ratio, per capita income, exchange rate, Treasury bill rate and inflation rate. Though the long run association or linear combination among the variables is established in the model, the long run economic impact can be positive or negative. Therefore, the presence of long run association confirms need of testing long run coefficients of the model to examine the long run impact. The estimated results for long run illustrated in Table 4 present the long run estimates of equations 1.

Table 4 : Estimates of Long-run coefficients for inflows and outflows from 1992 to 2017

Variable	Coefficient	Std. error	t-statistic	Prob.
LIQ	0.0473	0.2239	0.2114	0.8354
LSMCR	1.9139	0.5972	3.2047	0.0059***
LPCI	0.171	0.1996	0.8568	0.405
LEXCR	2.7610	0.5632	4.9021	0.0002***
LTBR	0.1501	0.6357	0.2362	0.8164
LINF	0.6294	0.3787	1.6619	0.1173
C	-1.245	3.2156	-0.3871	0.7041

Note: *** & ** indicates significant at 1% & 5% level respectively

Table 4 summaries the results of the long run coefficients that examine the impact of institutional quality on foreign portfolio inflows in Sri Lanka. The findings depict that only stock market capitalization ratio (LSMCR) and exchange rate (LEXCR) are statistically significant at 1% significance level and other regressors are statistically insignificant. The coefficient of LSMCR is 1.913 and it is like the model reality, meaning that if stock market capitalization ratio increases by 1%, equity foreign portfolio inflows increased by 1.913%. In other words, 1% increase in stock market size will attract 1.913% of foreign portfolio investments to the country. This indicates that development of stock market is encouraging the foreign portfolio investors to inject their excess money to Sri Lankan capital market. The development of stock market brings more market participants resulting the low risk driven by high liquidity, transparency and new market regulations. The low risk features of stock market can encourage more foreign as well as domestic

investors to the market. In Sri Lankan context as well stock market development ensures the lower risk and attracts risk adverse foreign investors.

The finding further verifies that stock market plays a vital role in attracting equity foreign portfolio inflows to Sri Lanka. The results also contend that the macro-economic stability is not a leading cause for portfolio flows to the country with an exception to exchange rate. The finding corresponds with the assessment of Kaminsky & Schmukler (2001), Durham (2002) and Kaleem & Shahbaz (2009) in developing countries that provides evidence that stock market development is a major determinant of foreign portfolio inflows. Similarly, the coefficient of exchange rate (LEXCR) is positive (2.7610) and probability value supports to reject the null hypothesis and accept the alternative hypothesis which means that exchange rate positively impacts equity foreign portfolio inflows in long run. This implies that the violation of prior expected direction and it indicates that appreciation of Sri Lankan Rupee against foreign currency attracts more equity foreign portfolio investments to Sri Lankan market. More importantly, long run relationship perceived between exchange rate and foreign portfolio inflows in Sri Lanka is somewhat contradictory with the theory. However, the findings are aligned with the work of Kumara & Dayaratne (2015) that established theoretically varied relationship among exchange rate and foreign portfolio inflows.

On the other hand, the long run coefficient of Institutional quality (LIQ) confirms the anticipated positive relationship, despite the fact that the coefficient value is statistically insignificant. Moreover, the findings confirm that the institutional quality is not an important determinant in attracting foreign portfolio inflows in Sri Lanka. Putting in other perspective, long run investment decisions are not induced by the institutional quality in Sri Lanka. Further, statistically insignificant long run positive relationship is revealed between the regressors of per capita income (LPCI) interest rate (LTBR), inflation rate (LINF) with an inward flow of equity foreign portfolio investments as well.

Looking at short-run dynamics of the variables in all the factors which were considered in the model cannot be changed in the meantime. Therefore, ARDL error correction regression is used to analyze the short-term behavior of a variable with its long-term behavior over time. The result of the ARDL error correction regression is summarized in Table 5 and it reports short run coefficients of equation 2 which is explained in the section 4.

Table 5 reports the short run modalities of the behavior of institutional quality towards foreign portfolio inflows. The result reports that the coefficient of Error Correction Term (ECT) is negative (-0.7189) as expected, and it is also statistically significant. It suggests that the speed of adjustment of foreign portfolio inflows (LFPI) to changes in institutional quality (LIQ) and stock market capitalization (LSMCR) and other determining variables is about 71.89% within the first year to ensure full convergence to its equilibrium level.

Table 5 : Estimates of Short-run Model for Inflows and Outflows over the Period from 1992-2017

Variable	Coefficient	Std. Error	t-Statistic	Prob.
D(LGG)	0.3537	0.0880	4.0157	0.0011***
D(LTBR)	-0.5980	0.1954	-3.0593	0.0080***
CointEq(-1)	-0.7189	0.0712	-10.087	0.0000***

Further, statistically significant error correction term verifies the conclusion of bound test for cointegration, that is a long run relationship between foreign portfolio inflows and regressors. In short-run, the coefficients of institutional quality (LIQ) and Treasury bill rate (LTBR) are

statistically significant. The estimated coefficient for institutional quality (LGG) is 0.3537 which confirms that rise in the institutional quality will attract foreign portfolio flow to Sri Lanka. In short run, foreign investors become aware about the quality mechanism of institutional framework before funding their excess monetary resources to Sri Lanka via stock market. This is because in short run, governance mechanism is highly impactful on macro-economic stability of developing nations. Good governance is not the only factor that can contribute to creating a favorable climate for foreign portfolio inflows in short run and other important variable is short term interest rates as found in the results.

Conversely, the results also suggest that the impact of short-term interest rate is negative on foreign portfolio inflows. Generally, stock market securities and government securities are investment alternatives and investors adjust their investments on those securities to earn higher return. If Treasury bill rate increases, both domestic and foreign investors prefer treasury bills rather than equity securities because investors can earn high return at lower risk. This finding confirms that upward movement of Treasury bill rate attracts foreign investors to government security market rather than stock market. Therefore, it can be concluded that, upward movement of short-term interest rates causes a decline in foreign portfolio inflows to the equity market in short run.

Moreover, the R-squared value of the fitted short run model is 0.8188 which indicates that 81.88% of total variation in the foreign portfolio inflow (LFPI) can be jointly explained by the regressors which are considered in the analysis. Further, the R-squared value is less than the Durbin Watson statistics, confirming the fitted model is not a spurious model.

Conclusion

The objective of this study is to analyze the role of institutional quality in equity foreign portfolio inflow in Sri Lanka. To enhance the objectives, the study employed ARDL modeling approach for the data from 1992 to 2017. As per the ARDL results, institutional quality does not impact on foreign portfolio inflows in long run while a significant impact is established in short run. It shows a positive impact towards inflows verifying that improvement in institutional quality affects in attracting more foreign investors. This is due to low risk, investors' confidence and assurance. However, improvement of institutional quality improves the procedures and regulation in the stock market. Investors who trade on volatility will discourage to invest in the market as the improved governance reduces the risk. Moreover, the findings suggest that stock market development positively influence towards portfolio inflows which means that stock market development attracts more foreign portfolio inflows to the country in the long run.

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Authors' Profile

A W G C N Wijethunga is a Lecturer in Financial Management at the Department of Accountancy & Finance, Faculty of Management Studies, Sabaragamuwa University of Sri Lanka. She obtained her first degree, B.Sc. in Financial Management (Special) from the Sabaragamuwa University of Sri Lanka in 2014. Currently, she is following master's in economics from University of Colombo.

D A I Dayaratne, Ph.D is a Professor of Financial Management, Department of Accountancy & Finance, Sabaragamuwa University of Sri Lanka, Belihuloya, Sri Lanka. He has completed his Ph.D at University of Colombo, Colombo, Sri Lanka in the area of Financial Economics. His research and literally presentations mainly encompass special interest investment analysis, capital market theories and capital markets.
