VALUE RELEVANCE OF COUNTRY GOVERNANCE AND ECONOMIC FREEDOM FOR FOREIGN PORTFOLIO INFLOWS IN DEVELOPING AND DEVELOPED COUNTRIES

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ABSTRACT

Globalization, country governance, and economic freedom have generally led to stock market liberalization around the world. These factors are considered imperative for financial portfolio investment (FPI). This study investigates the impact of country governance and economic freedom on foreign capital inflows. For this purpose, we analysed data of 81 developed and 58 developing countries using dynamic panel regression model and system generalized method of movements (GMM). We found that governance and its components have positive and significant effects on FPI in all countries. Likewise, the index of economic freedom and its components have positive and significant effects on FPI. Moreover, in developing countries, investors are more concerned about governance than the economic freedom in the host country because the security of short-term investment relies more on the state of governance and rule of law than on the assumed constant economic freedom in the short-term.

Keywords: Economic Freedom, Foreign Portfolio Inflows, Country Governance

INTRODUCTION

Since the 1980s, contrary to the incidents of confiscation, expropriation, and/or domestication of foreign firms' assets as a mean of economic development during the 1950s and 1960s, the growth in globalization and liberalization of stock markets has been accompanied by an increase in FPI (FPI) across the world.[1] The countries now realize that their economic wellbeing is achievable, however, interdependently. Countries across the globe have initiated reforms to augment investments inflows in order to achieve socio-economic development (OECD, 2002, 2003; Mody, Taylor & Kim, 2001; and Singhania& Saini, 2018). Extant literature, in general, shows a positive effect of the reforms on the growth of financial markets in all economies across the globe. Developed economies require foreign capital inflows for a sustainable development, whereas, developing economies require foreign investments to stimulate economic growth and leverage expansion of domestic industries (Al-Smadi, 2018; Singhania & Saini, 2018). Various studies also reveal that the benefits of risk diversification inheritably associated with FPI create more attraction for foreign investors (Grubel, 1968; Harvey, 1991; Dell'Ariccia et al., 2008). This interest and demand for foreign investments needs investigation to identify its significant determinants to be considered to attract such investments by an economy.

Extant literature categorizes determinates of foreign portfolio inflows into pull (country-specific) and push (global) factors (Mody et al., 2001). Pull factors include stock market returns, liquidity, tax on income & capital gain, investor protection, strength of regulatory environment, rule of law and governance of a country (Boyer & Zheng, 2009; Chuhan, Claessens & Mamingi, 1998; and Chakrabarti, 2001). It is important to note that several studies have shown the relevance of rule of law and judicial efficiency in determining the investment (Shah & Shah, 2016) and financing decisions (Shah, Shah, Joe & Smith, 2017) of firms in a host country. Whereas, push factors include exchange rate stability, GDP growth, inflationary trends, innovation, savings and global crisis (Byrne & Fiess, 2011; Calvo, Leiderman & Reinhart, 1993; Kim, 2000; and Mody et al., 2001). Rai and Bhanumurthy (2004) and Portes and Rey (2005) reported that stable historical returns and exchange rate stability have positively attracted foreign capital inflows.

Scott (2001) suggested that the interaction of regulative, normative, cultural-cognitive and other institutional factors shape a country's economic and political environment. However, the value relevance of governance for attracting foreign capital inflows was first hypothesized by the Zedillo Report (OECD, 2003). Soon after, Wu, Li and Selover (2012) demonstrated that capital inflows increase in countries with a stable political environment. Similarly, Ghosh and Herwadkar (2009), Garg and Dua (2014), and Srinvasan and Kalaivani (2015) have also concluded that stable economic policies, scope diversification and economic growth in the BRICS countries have attracted the foreign capital inflows. Consistent with the view, Wei (2009) reported a negative association of foreign capital inflows and corruption and political risk, however earlier Wheeler and Mody (1992) had reported an insignificant association.

[1]Portfolio inflows of developing countries increased from $6.2 billion in 1987 to $46.9 billion in 1993 (UNDP, 2013). Similarly, the increase in private investment inflows to the Africa is $6.8 billion in 2011 and $12.2billion in 2013, (IMF, 2013).

Interestingly, Egger and Winner (2005) concluded that institutional quality has a positive effect on foreign investments as it facilitates and reduces hindrance in good governance. To attract foreign capital, the host country is required to create a governance environment somewhat similar to that of the foreign investors' country (Portes & Rey, 2005). Investors value familiarity and similarity of the rules regarding investors' protection in the foreign capital market. Thus, the intuitional and governance environment of a country is said to shape the investment behavior of foreign investors in that country.

Extant literature also identifies the economic freedom of the host country as an important factor that affects foreign capital inflows (Ullah, Anees, Ali & Khan, 2018). The Heritage Foundation (2004) defines economic freedom as "the absence of government coercion or constraint on the production, distribution, or consumption of goods and services beyond the extent necessary for citizens to protect and maintain liberty itself." Researchers have recognized the importance of freedom to trade, competition in business, secure property rights, and monetary freedom as important factors for economic development (Doucouliagos & Ulubasoglu, 2006). Several studies have suggested the importance of variation in economic freedom in cross-countries economic performance (See De Haan ,Lundström & Sturm, 2006). However, some of the studies show that components of economic freedom have different effects in different countries (Heckelman & Stroup, 2000).

This current study on the association of country governance and economic freedom with FPI in developing and developed countries is different from the previous studies and contributes to the empirical literature on institutions and FPI in several ways. Firstly, most of the studies have examined either the effect of country-specific factors (see Byrne & Fiess, 2011; Kim, 2000; and Mody et al., 2001) and/ or global factors on the foreign capital portfolio inflows (see Boyer & Zheng, 2009; and Chakrabarti, 2001), while this study takes into account additional variables of governance and economic freedom as determinants of the FPI and thus adds to the framework of Portfolio Balance Theory. Secondly, existing studies have followed an aggregate approach for measuring FPI (Al-Smadi, 2018; Hakeem & Suzuki, 2017); whereas, this study follows both aggregate and disaggregate approach for measuring FPI. The disaggregate measure constituted the FPI into foreign equity, foreign debts, foreign long-term debts, and foreign short term-debts. Thirdly, most of the studies conducted on the determinates of FPI are regional specific such as in Jordon by Al-Smadi (2018), in emerging markets by Byrne and Fiess (2011), in China and Pakistan by Haider, Gul, Afridi and Batool (2017), in European Union countries by Hakeem and Suzuki (2017), in South Asian countries by Ullah, Anees, Ali & Khan (2018), and have considered push and pull factors only. Fourthly, this research study adds institutional factors such as governance and economic freedom in the theoretical framework of the Dunning electric paradigm theory, which suggests different modes of entry into the foreign markets such as exporting, FDI and licensing location and internationalization (Dunning, 1977). Following Holsapple, Ozawa and Olienyk (2006), this study intends to include the FPI as a mode of entry to foreign markets with ownership and portfolio advantage as explained by Dunning (1999) ILO approach (Internationalization, Location, and Ownership). Moreover, this study further investigates the

value relevance of governance and economic freedom of the host country for FPI within the aforementioned framework.

THEORETICAL LENS

The current study follows a multi-theoretical perspective to analyze various institutional level determinants of FPI. This study envisions extending the Dunning electric paradigm theory of FPI as a mode of entry into a foreign market as the theory provides a valuable analytical framework to investigate the value of foreign capital inflows (Dunning, 1977). According to this paradigm, the firm must have some competitive advantage in the home market such as transferability of ownership to the foreign markets, the location, and the internationalization advantages. Holsapple, Ozawa and Olienyk (2006) introduced the FPI into the Dunning (1977) ILO approach as a mode of entry to the foreign real estate market. Moreover, the study also aims to extend the balanced portfolio approach by including country governance and economic freedom as institutional factors that are expected to have a significant effect on FPI. Portfolio balanced framework is based on domestic and global factors that determine the flow of foreign capital among different countries (see e.g., Boyer & Zheng, 2009; Byrne & Fiess, 2011; Grubel, 1968; and Harvey, 1991). Review of literature identifies country-specific factors to include market capitalization, stock turnover, trading volume, strength of legal and regulatory index and business development index, while global factors to include economic growth, inflationary trends, exchange rate volatility, population growth, trade openness and global liquidity (Mody et al., 2001; Ullah et al., 2019). In addition, the international financial theory demonstrates the fundamental endeavors of foreign investors to invest in equity and debt instruments across the world. The most common benefits discussed in the literature are the diversification of risk and the fulfilling gap between the saviors and financiers across different countries. Moreover, there are many benefits of foreign capital inflows for the host country such as contributing towards economic growth, social wellbeing, stock market development, and liquidity management (Dell'Ariccia et al., 2008; Ullah & Jan, 2020). Similarly, the capital allocation theory suggests a mechanism of allocation of funds in developed and developing countries markets with the aim to diversify their risk and earn optimal profits.

The current study intends to include the FPI as a mode of foreign entry by extending the Dunning electric paradigm on one hand and also intends to investigate the value relevance of country good governance and economic freedom for FPI. In addition, the study also follows a balance portfolio approach in devising research models, which suggests various host country factors that can play an important role in attracting FPI such as market size, interest rate, exchange rate fluctuations, stock market liquidity, and investors' protections.

DETERMINANTS OF FOREIGN PORTFOLIO INVESTMENTS

There is a growing interest in the area of research on FPI and emphasis is given by the policymakers to initiate reforms with the aim to bring strategic competitiveness in the business environment to attract foreign investments (OECD, 2002, 2003). Various studies

identified different global factors that have positive effect on the foreign capital inflows into the developing countries such as economic growth, business opportunities exchange rate fluctuations and interest rate (Byrne & Fiess, 2011; and Kim, 2000). An increase in the FPI is also reported in the case of BRICS and ASEAN countries due to economic growth, efficiency in productivity, savings and innovations (Garg & Dua, 2014; and Holtbrügge & Kreppel, 2012). Similarly, an increase in domestic capital, exchange rate stability and improvement in economic freedom is found to have a positive effect on the FPI, whereas, inflationary trends in the economy are reported to negatively influence FPI (Agarwal, 1997). Moreover, Byrne and Fiess (2011) reported that interest rate is an influential factor in determining FPI (Ghosh, Qureshi, Kim & Zalduendo, 2014). Garg and Dua (2014) found that the stability of the domestic stock market, decrease in the exchange rate volatility, interest rate risk and country risk have positive effect on the FPI in India (Bhasin & Khandelwal, 2013).

Another stream of studies considered the importance of host-country business and economic factors that directly affect inflow of FPI in emerging and developed countries (Chuhan, Claessens & Mamingi, 1998). For instance, globalization and liberalization of the markets hugely attracted foreign investments in both emerging and developed countries. Moreover, the lower tax rate on capital gains is expected to reduce transaction costs associated with investments in stock which could further stimulate foreign investors to invest (Prasad, Rogoff, Wei & Kose, 2003). Higher stock returns, higher level of investor protection, strength of regulatory framework and rule of law are some of the identified country-specific determinants of FPI (Boyer & Zheng, 2009; Chakrabarti 2001; and Rai & Bhanumurthy, 2004). Other researchers consider FPI as a mean of risk diversification (Dell'Ariccia et al., 2008). Whereas, Arora (2016) reported contrary results and found insignificant relationship of historical stock returns with FPI. Moreover, Portes and Rey (2005) suggested that market size, market liquidity, and efficient transaction processing have a positive effect on FPI. Srinivasan and Kalaivani (2015) found a negative association between FPI and the stock market of the host country in short-term horizons respectively.

In addition, several studies recommend the relevance of governance, political, and economic environment of the host country for FPI. Scott (2001) concluded that regulative, normative and cultural-cognitive institutional elements shape the economic and political environment of a country. Thus, it can be inferred that institutional environment and governance of a country could shape the investment behavior of individual investors. In fact, Wu, Li and Selover (2012) reported a positive effect of the political stability of the host country on foreign capital inflows. Wei (2009) suggested that FPI are influenced by corruption and the political risk of the host country. Similarly, Egger and Winner (2005) reported that poor institutional quality adversely affects foreign investments. Portes and Rey (2005) suggested that familiarity and similarity of rules (investor protections etc) in the foreign capital markets act as additional stimulus to make the investment.

Extant literature also shows that economic freedom and FPI are related to each other (see for example Ullah et al., 2018). Earlier, Gwartney, Lawson and Block (1996) defined economic freedom as "the right to acquire and use his property without any coercion, fraud or theft, for the purpose of trade or any other commercial activity stipulated with the condition that all of

his actions are deemed legal." Freedom to trade, competition in business, secure property rights, and monetary freedom are important factors for the economic development of a country (Doucouliagos & Ulubasoglu, 2006). Stable economic policies, economic growth, and scope diversification are considered as important determinants of the FPI (Garg & Dua, 2014; and Ghosh & Herwadkar, 2009). Whereas, several studies recommended the significance of variation in the economic freedom causing variations in the economic performance across the countries (See De Haan et al., 2006). Economic freedom, in general, is measured as an index composed of various components. Interestingly, some studies have used components of economic freedom to report that all components do not have similar effects and that the effects vary country to country (Heckelman & Stroup, 2000). Hence, it is more appropriate to use the different components while studying a sample comprising of different countries.

RESEARCH DESIGN AND METHODOLOGY

This section explains the sample size, data collection, research models, and statistical tests applied to the data.

SAMPLE SIZE AND DATA COLLECTION

The study initially considered all 214 countries on the website of the World Bank; however, based on the availability of data on governance, economic freedom, and FPI, the sample is limited to 139 countries. The analysis period is from the year 2001 to 2017. The full sample of countries is then further divided into 58 developing and 81 developed countries based on the World Bank classification of countries. The FPI data come from the Coordinated Portfolio Investment Survey of the International Monetary Fund. The governance components data come from the Worldwide Governance Indicators on six dimensions from the World Bank website. Data on the Index of Economic Freedom is downloaded from the website of the Heritage Foundation. Data on other variables such as population growth, inflation rate, business development index, financial development index, interest rate, exchange rate, inflation rate, debts rating, market capitalization, trading volume, trade openness, and bank financing come from the World Development Indicators.

RESEARCH MODELS

Following the balanced portfolio framework approach, this study uses the extended form of the research models by Singhania and Saini (2018). The models are reinforced to test the effect of country governance and economic freedom on FPI. Moreover, Arellano and Bond (1991) proposed using a generalized method of moment dynamic panel model to address any possible endogeneity and simultaneity issues in FPI. FPI is also affected by its lag values; therefore we include the lag of the dependent variable in each model, as suggested by García-Herrero, Gavilá and Santabárbara (2009) and Athanasoglou, Brissimis and Delis (2008).

$$FEPIi,t = \alpha + \beta FEPIi,(t_{-1}) + \beta CGCompi,t + \beta EFi,t + \beta MKCAPi,t + \beta BDIi,t + \beta TrVoli,t + \beta POPi,t + \beta GDPi,t + \beta RINTi,t + \beta INFi,t + \beta EXCH_{Volti},t + \beta FDIndexi,t + \beta TRADi,t + SlegRIi,t + \beta Yearsi + \beta Country + \mu i,t \ldots\ldots\ldots (1)$$

$$TDFPIi,t = \alpha + \beta TDFPIi,(t_{-1}) + \beta CGCompi,t + \beta EFi,t + \beta MKCAPi,t + \beta BDIi,t + \beta Debt\_Ratingsi,t + \beta POPi,t + \beta GDPGi,t + \beta RINT,t + \beta INFi,t + \beta EXE\_Volti,t + \beta INF\_Ratei,t + SlegRIi,t + \beta TRADi,t + BankFini,t + DCREDT\_PRIVi,t + \beta Yearsi + \beta Country + \mu i,t \ldots\ldots\ldots (2)$$

FEPI stands for foreign equity portfolio investment, calculated as total foreign equity portfolio inflows in a year divided by *GDP* in year *t* for country *i*. $FEPL_{t-1}$ is the first lag of foreign equity portfolio investment. *TDFPI* stands for total debt in FPI, calculated as total foreign portfolio debt divided by *GDP*. To ensure the robustness of the results, we also used components of total debt in foreign portfolios, i.e., long-term debt in FPI, calculated as the ratio of long-term foreign portfolio debt to GDP, and short-term FPI, calculated as total short-term FPI divided by GDP (Holtbrügge & Kreppel, 2012; Singhania & Saini, 2018). *CGComp* stands for the different measures in the country governance index of the World Bank such as control of corruption (*CCR*), political stability (*PSR*), regulatory quality (*RQR*), rule of law (*RLR*), voice of accountability (*VAR*), and government effectiveness (*GER*). *EF* stands for the Index of Economic Freedom calculated by the Heritage Foundation. We include the economic freedom index and also consider sub-indexes to confirm the robustness of the results. The sub-indexes include business freedom, monetary freedom, labor freedom, financial freedom, trade freedom, and investment freedom (Azman-Saini, Baharumshah & Law, 2010). These variables include market capitalization (*MKCAP*), calculated as the ratio of market capitalization to *GDP,* to account for the soundness of the stock market. The Business Development Index (*BDI*) is used to measure the level of business development in a country. *TrVol* stands for the trading volume of different countries' stock markets, calculated as the trading volume divided by *GDP*. This is used to measure overall stock market liquidity. *POP* is the population growth rate, used as a proxy for the country size. *GDP* is the growth in gross domestic product, used as a proxy for the level of economic development in a country (Singhania & Saini, 2018; Wu, Li, & Selover, 2012). *RINT* is the real interest rate, *INF* is the inflation rate, and *EXCH_Volt* is exchange rate volatility in a year (Singhania & Saini, 2018). *FDindex* is the financial development index used to proxy for the level of financial development. *TRD* is trade openness, calculated as total trade divided by GDP. *SLegRI* is the strength of the legal and regulatory framework in a country (Srinivasan & Kalaivani, 2015). In Equation 2, *DCREDIT_PRIV* is domestic credit to the private sector, *Dratings* is the average debt rating of a country financial instruments, *Bankfin* is financing extended by the banking sector to the corporate sector, calculated as a log of bank finance.

RESULTS AND DISCUSSIONS

This section includes results and discussion on the results of descriptive statistics, Pearson correlation matrix and regression models. All tables in this paper were created using as doc, a Stata program written by Shah (2018).

DESCRIPTIVE STATISTICS

Panel-A and B of Table 1 shows that the proportion of foreign equity portfolio investment to GDP is 56.2% and 15.9% in the developed and developing countries respectively. Similarly, the proportion of total foreign debt portfolio investment to GDP is 64.5% and 19% respectively. The average short and long-term foreign debt to GDP in developed (developing) countries is 51.3% (17%) and 13% (1.9%), respectively. As expected, the governance variables, such as control of corruption, political stability, regulatory quality, rule of law, government effectiveness, and voice of accountability are indicative of better governance in the developed countries than in the developing countries. These figures suggest that due to better economic conditions, political maturity, good governance, quality of laws, rules and regulations and other similar characteristics investors are relatively more inclined to invest in developed countries. Capital markets of developed countries are assumed to be relatively more developed. Consistent with this view it is found that average long and short-term foreign debts to GDP in developed countries are 51.3% and 13%; in the case of the developing countries, the average values of long and short-term foreign debts to GDP are 17% and 1.9% respectively. The average values of governance variables such as control of corruption, political stability, regulatory quality, rule of law, government effectiveness, and voice of accountability are indicative of more good governance in developed countries relative to those of developing countries. Interestingly, the gap in the state of economic freedom between developed and developing countries is narrow, i.e., 48.47 vs 43.02 respectively. This small difference in economic freedom relative to the difference in the governance suggests that governance structure is mainly responsible for the difference in foreign investments in the two groups of countries.

Table 1: Descriptive Statistics

Variable	Obs	Mean	Std.Dev.	Min	Max
Panel – A: Developed Countries					
FEPI	5400	.562	2.391	0	13.023
TDFPI	5400	.645	2.765	0	15.937
LDFPI	5400	.513	2.211	0	12.703
STFPI	5400	.13	.571	0	3.732
CCR	3648	-.312	.61	-1.826	1.84
PSR	3648	-.245	.588	-2.089	1.267
RQR	3648	-.082	.818	-2.181	1.454
RLR	3648	-.244	.695	-2.274	1.241
VAR	3648	-.278	.683	-2.255	1.41
EF	5400	48.47	22.49	0	77
GDP	5398	3.956	0.8412	-6.2076	14.9973
INF	5398	.701	.648	-1.773	3.614
POP	5398	1.084	1.244	-3.631	9.109
TRD	5398	2.349	3.151	0	10
RINT	5398	3.6311	3.3976	0	16.6504
BDI	5398	15.148	4.0105	0	35.2292

SLegRI	5400	0.5215	10.581	0.704	0.9242
FDindex	5400	6.451	2.0984	0	35.542
MKCAP	5398	10.406	3.2609	0	48.0287
TrVol	5398	1.709	.611	-1.678	2.726
DCREDIT_PRIV	5398	2.144	0.8681	0	7.58
Dratings	5400	.907	2.351	0	12
Bankfin	5400	.214	.153	0	.728
Panel – B: Developing Countries					
FEPI	4375	.159	.461	0	2.672
TDFPI	4375	.19	.674	0	5.106
LDFPI	4375	.171	.608	0	4.645
STFPI	4375	.019	.072	0	.472
CCR	3325	-.871	.463	-1.869	.807
PSR	3325	-1.039	.529	-2.478	.261
RQR	3325	-.912	.898	-2.315	1.049
RLR	3325	-.958	.614	-2.145	.246
VAR	3325	-.964	.56	-2.106	.129
EF	4375	43.016	20.94	0	67.6
GDP	4375	3.561	7.651	-5.2428	10.628
INF	4375	.68	.604	-1.121	4.428
POP	4381	2.614	1.252	-6.185	7.918
TRD	4375	2.41	2.88	0	8
RINT	4375	1.1006	1.0927	0	10.3632
BDI	4381	.235	2.609	0	4.2476
SLegRI	4375	6.872	3.0278	-7.0439	57.2936
FDindex	4375	.019	.221	0	3.668
MKCAP	4375	.075	.844	0	16.217
TrVol	4375	1.522	.627	0	2.493
DCREDIT_PRIV	4375	.939	0.4283	0	5.51
Dratings	4375	.895	2.182	0	11
Bankfin	4375	.08	.049	0	.212

The variables used in the above regressions are defined below Table 2 and in Section 3.2 of the methodology.

Thus, most of the factors are different in the developed and developing economies which provide ground to analyze each group of countries separately in order to better understand the association between the dependent and the explanatory variables.

PEARSON CORRELATION MATRIX

Table 2 shows the Pearson correlation statistics between the variables. The correlation between the foreign equity portfolio investments and control of corruption, government effectiveness, political stability, regulatory quality, rule of law, and the

voice of accountability have positive association with foreign equity portfolio investments and also foreign long-term and short-term debts. These relations are in line with the descriptive statistics such that developed countries are found to attract relatively more foreign investments due to better governance, laws, etc. The different measures of FPI exhibit high linear correlations among themselves. Whereas, foreign portfolio equity and debt investments have a positive association with business development index, domestic credit to the private sector, trade openness, debts rating, the strength of legal and regulatory index, financial development index, and population growth. However, the foreign portfolio equity and debt investments have a negative association with the inflation rate, market capitalization to GDP, real interest rate, trading volume to GDP, stock turnover and bank finance. In fact, higher inflation rates and interest rates are said to hinder economic growth or depreciate value of currency and therefore, foreign investors hesitate to choose such economies for their investments. Similarly, probably foreign investors with longer investment horizons perceive higher market capitalization as full with lesser or no capacity for profitable investment. This phenomenon is supported by the fact that market capitalization and trading volume are highly correlated (0.81). The measures of governance and law also exhibit high correlation ranging from 0.72 to 0.87. Due to these high correlations, we avoid including all these variables in the same regression simultaneously.

FOREIGN EQUITY PORTFOLIO INVESTMENT RESULTS

Panel – A&B of Table 3 shows the results of dynamic panel regression models (1 to 6) that test the effect of country governance and economic freedom on foreign equity portfolio investment in the developed and developing countries, respectively.[2] The governance variables—control of corruption, political stability, regulatory quality, rule of law, government effectiveness, and voice of accountability—in the host country have a positive and significant effect on foreign equity portfolio investment in both the developed and developing countries, however, the effect of rule of law is insignificant in developing countries. Therefore, improvements in the control of corruption, political stability in a country, increase in the regulatory quality, enforcement rule of law and increase in the voice of accountability would attract the foreign portfolio equity inflows (Kim, 2000). These results suggest that improvement in the country's overall governance would increase the confidence of foreign investors towards host countries' stock markets due to the belief and perceived surety that both their investments and returns are safe. Similarly, the economic freedom has a positive and significant relationship with the foreign equity portfolio investment in both the developing and the developed economies. Thus, an increase in the economic freedom of a country increases foreign equity inflows to that country. The significance level of economic freedom is persistently higher in the developed countries, which suggests

[2]To save space, results of only the key variables are reported. We do it for all results of all regressions.

that investors are more concerned about economic freedom in the developing countries. Again, these results about economic freedom support the view that investors are primarily more conscious about the safety and security of their investment. Consistent with this view trade openness and the business development index have a direct relationship with foreign equity portfolio inflow.

Table 2: Pearson Correlation Matrix

Variables	(1)	(2)	(3)	(4)	(5)	(6)	(7)	(8)	(9)	(10)	(11)	(12)	(13)	(14)	(15)	(16)	(17)	(18)	(19)	(20)	(21)	(22)	(23)
(1) FEPI	1.000																						
(2) TDFPI	0.962	1.000																					
(3) LDFPI	0.957	0.997	1.000																				
(4) STFPI	0.930	0.956	0.932	1.000																			
(5) CCE	0.124	0.092	0.088	0.102	1.000																		
(6) EE	0.056	0.042	0.035	0.065	0.767	1.000																	
(7) PSR	0.114	0.097	0.093	0.109	0.716	0.659	1.000																
(8) RQR	0.048	0.015	0.008	0.045	0.669	0.665	0.607	1.000															
(9) RLR	0.056	0.047	0.041	0.069	0.847	0.811	0.801	0.720	1.000														
(10) VAR	0.224	0.181	0.172	0.210	0.668	0.622	0.682	0.653	0.767	1.000													
(11) GDP	0.028	0.040	0.043	0.027	-0.064	0.020	0.024	0.021	0.033	0.019	1.000												
(12) INF	-	-	-	-	-	-	-	-	-	-	0.0	1.0											

	0.164	0.159	0.163	0.132	0.173	0.178	0.240	0.235	0.244	0.289	32	00									
(13) POP	0.112	0.083	0.081	0.091	-0.270	-0.364	-0.199	-0.408	-0.334	-0.258	0.176	0.072	1.000								
(14) BDI	0.007	0.006	0.000	0.029	-0.068	-0.007	-0.098	0.089	-0.130	-0.094	-0.068	-0.087	-0.082	1.000							
(15) DCREDIT_PRIV	0.264	0.252	0.246	0.260	0.301	0.414	0.195	0.458	0.212	0.297	-0.095	-0.077	-0.255	0.312	1.000						
(16) MKCAP	-0.039	-0.039	-0.040	-0.034	0.149	0.237	0.060	0.212	0.141	0.198	-0.056	0.051	-0.083	0.122	0.660	1.000					
(17) RINT	-0.067	0.063	0.058	0.079	0.003	0.076	0.021	0.197	0.018	0.104	-0.041	-0.214	0.054	-0.019	0.157	0.111	1.000				
(18) TrVol	0.047	0.047	0.048	0.040	0.105	0.224	0.030	0.203	0.103	0.164	-0.033	0.099	-0.140	0.117	0.470	0.813	0.134	1.000			
(19) TRD	0.110	0.077	0.071	0.097	-0.052	-0.025	-0.075	0.083	-0.224	-0.102	0.055	0.031	0.066	0.190	0.045	0.012	0.079	0.002	1.000		
(20) Dratings	0.100	0.044	0.044	0.033	-0.314	-0.336	-0.249	-0.201	-0.292	-0.248	0.148	0.056	0.098	0.118	-0.145	-0.142	0.061	-0.169	0.103	1.000	
(21) Bankfin	-0.077	0.000	0.000	0.000	0.077	0.107	0.060	0.148	0.052	0.056	0.000	0.000	0.200	0.114	0.141	0.027	0.057	0.133	0.085	0.079	1.000

	02	06	07	05							03	69	04										
(22)	0.0	0.0	0.0	0.0	-	0.0	-	0.0	-	0.0	-	-	-	0.4	0.2	0.0	0.0	0.0	0.1	0.1	-	1.0	
SLegRI	27	06	01	23	0.0	15	0.0	94	0.0	17	0.0	0.2	0.0	38	57	96	09	45	55	37	0.0	00	
					35		54		49		96	23	42								26		
(23)	0.0	0.0	0.0	0.0	0.2	0.4	0.1	0.4	0.1	0.2	-	0.0	-	0.1	0.7	0.5	0.2	0.6	0.1	-	0.2	0.0	1.0
FDindex	59	68	65	75	67	43	33	74	88	22	0.0	41	0.3	81	43	56	59	38	63	0.2	01	68	00
											36		34							22			

FEPI stands for foreign equity portfolio investments and it is computed as total foreign equity portfolio inflow in a year divided by GDP of that year t for a country i. FEPLt-1 is the first lag of the foreign equity portfolio investments. TDFP stands for the total debts of FPI and it is computed as total foreign portfolio debts divided by GDP. LDFPI stands for the long-term debts of foreign portfolio investments and is computed long-term foreign portfolio debts to GDP. STFPI stands for the short-term FPI and is computed by total short-term FPI divided by GDP. CGComp stands for the different measures of country governance index such as control of corruption (CCR), political stability (PSR), regulatory quality (RQR), rule of law (RLR), the voice of accountability (VAR) and government effectiveness (GER). EF stands for the index of economic freedom computed by the Heritage Foundation. MKCAP stands for the market capitalization and it is computed as market capitalization to GDP, BDI stands for the business development index, TrVol stands for the trading volume of different countries stock markets and is computed as trading volume divided by GDP, POP is the population growth rate, GDP stands for the gross domestic product growth, RINT stands for the real interest rate, INF stands for inflation rate, EXCH_Volt stands for exchange rate volatility in a year. FDindex stands for the financial development index. TRAD stands for the trade openness and it is computed as a total trade divided by GDP. SLegRI stands for the strength of the legal and regulatory index. DCREDIT_PRIV stands for the domestic credit to the private sector, Debts_ratings stands for average debts rating of a country financial instruments, Bankfin stands for the financing extended by banking sector to the corporate sector and is computed as a log of banking finance. Year and Country stands for the year dummy from 2001 to 2017 and country dummy for each of the countries.

Table 3: Regression Results of Foreign Equity Portfolio Investments (FEPI)

	(Model1)	(Model2)	(Model3)	(Model4)	(Model5)	(Model6)
			Panel – A: Developed Countries			
CCR	0.004***					
	(0.001)					
PSR		0.005***				
		(0.001)				
RQR			0.004***			
			(0.001)			
RLR				0.004***		
				(0.001)		
VAR					0.002*	
					(0.001)	
GER						0.004*
						(0.001)
_cons	0.552***	0.431***	0.609***	0.504***	0.641***	0.643***
	(0.149)	(0.147)	(0.147)	(0.162)	(0.173)	(0.173)
Year	YES	YES	YES	YES	YES	YES
Obs.	3646	3646	3646	3646	3646	3646
AR(1) P-value	0.049	0.042	0.045	0.039	0.041	0.039
AR(2) P-value	0.163	0.123	0.151	0.161	0.159	0.163
Hansen Test	2.65	2.34	3.52	3.98	4.15	2.55
Prob. Value	0.912	0.954	0.653	0.481	0.599	0.922
			Panel – B: Developing Countries			
CCR	0.006***					
	(0.002)					
PSR		0.003**				
		(0.001)				
RQR			0.005**			
			(0.002)			
RLR				0.002		
				(0.002)		
VAR					0.004***	

					(0.002)	
GER						
						0.051*
						(0.030)
_cons	-0.263*	-0.166	0.042	-0.090	-0.179	-0.261*
	(0.135)	(0.132)	(0.129)	(0.134)	(0.132)	(0.135)
Year	YES	YES	YES	YES	YES	YES
Obs.	3306	3306	3306	3306	3306	3306
AR(1) P-value	0.045	0.045	0.012	0.010	0.191	0.049
AR(2) P-value	0.821	0.791	0.791	0.782	0.801	0.811
Hansen Test	3.234	4.295	3.303	4.252	3.294	3.201
Prob. Value	0.801	0.534	0.841	0.582	0.839	0.851

*The variables used in the above regressions are defined in Table 2, Standard errors are in parenthesis, and *** p<0.01, ** p<0.05, * p<0.1.*

Moreover, these results suggest that greater financial and economic strength of a country attracts more foreign direct equity investment. More specifically, control variables, such as GDP growth and the financial development index, have positive and significant effects on foreign equity portfolio inflows in both types of countries. However, the market capitalization, trading volume, and stock turnover show an inverse association with foreign direct equity investment, but they are insignificant in the developing economies. The capital markets in developing countries are reported to be volatile and sentiment-driven, and hence foreign investors are expected to act cautiously. The negative and significant effect of market capitalization shows that countries with large market capitalization are mature, and there is less scope for earning abnormal returns, which negatively affects foreign investor sentiment (Portes & Rey, 2005). In a similar manner, increases in the stock trading volume and stock turnover demonstrate that volatility in the stock market negatively affects the confidence of investors in the market (Otuke, 2006). In addition, an increase in inflation, exchange rate volatility, and real interest rates decreases foreign equity portfolio inflows. Countries with higher inflation rates, more exchange rate volatility, and higher real interest rates shatter the confidence of the foreign investors to invest in that country. However, higher interest rates attract more foreign investors to debt instruments, rather than equity, and affects foreign equity portfolio inflows (Mendoza & Terrones, 2008). In short, a growing economy with more trade openness demonstrates a country's future economic growth and potential gains. The business development index, the strength of the legal and regulatory system, and the financial development index represent a country’s institutional efficiency, business stability, and a conducive environment for growth in the corporate sector which create additional stimulus in attracting foreign investment inflows (Rivlin, 2001). The results of

AR (1) show the presence of autocorrelation, whereas AR (2) is insignificant and indicates that no autocorrelation exists at lag 2 of the dependent variables. Moreover, results of the Hansen test also generate the same results.

TOTAL FOREIGN DEBT PORTFOLIO INVESTMENT RESULTS

Table 4 reports results of the dynamic panel data regression models. These results are about the effects of country governance and economic freedom on the foreign debt portfolio investment. The results show that governance variables have a positive and significant effect on foreign debt portfolio investment in both the two types of countries. However, the rule of law and the voice of accountability are statistically insignificant in the developing countries (Li & Filer, 2007). These results demonstrate that country governance plays a vital role in building the confidence of foreign investors in the host country markets and create an attraction to invest and earn returns. Likewise, the coefficients of economic freedom in the different regression models show a positive and significant effect on foreign debt portfolio inflows in both the developed and the developing countries.

Therefore, countries with a high economic freedom index are expected to have more foreign debt investment, as is the case with foreign equity investment. These results, in general, are similar to those for foreign equity investment.

Table 4: Regression Results of Total Debt Foreign Portfolio Investments (TDFPI)

	(Model1)	(Model2)	(Model3)	(Model4)	(Model5)	(Model6)
			Panel – A: Developed Countries			
CCR	0.006***					
	(0.001)					
PSR		0.005***				
		(0.001)				
RQR			0.004***			
			(0.001)			
RLR				0.006***		
				(0.001)		
VAR					0.001	
					(0.001)	
GER						0.413***
						(0.0481)
_cons	0.744***	0.635***	0.860***	0.658***	0.927***	0.715***
	(0.157)	(0.155)	(0.157)	(0.172)	(0.186)	(0.157)
Year	YES	YES	YES	YES	YES	YES
Obs.	3646	3646	3646	3646	3646	3646

AR(1) P-value	0.015	0.018	0.015	0.016	0.029	0.010
AR(2) P-value	0.158	0.155	0.101	0.157	0.192	0.183
Hansen Test	4.12	4.11	3.99	3.19	3.19	3.15
Prob. Value	0.514	0.531	0.489	0.581	0.581	0.554
			Panel – B: Developing Countries			
CCR	0.006***					
	(0.002)					
PSR		0.005***				
		(0.001)				
RQR			0.004*			
			(0.002)			
RLR				0.002		
				(0.002)		
VAR					0.001	
					(0.002)	
GER						0.005**
						(0.002)
_cons	0.168	0.173	0.451***	0.347***	0.392***	0.714***
	(0.129)	(0.127)	(0.126)	(0.131)	(0.130)	(0.157)
Year	YES	YES	YES	YES	YES	YES
Obs.	3306	3306	3306	3306	3306	YES
AR(1) P-value	0.001	0.001	0.002	0.003	0.001	0.002
AR(2) P-value	0.210	0.199	0.199	0.207	0.206	0.364
Hansen Test	3.19	3.29	4.37	3.29	3.76	4.158
Prob. Value	0.611	0.621	0.691	0.621	0.691	0.671

The variables used in the above regressions are defined in Table 2, Standard errors are in parenthesis, and *** p<0.01, ** p<0.05, * p<0.1

The results of other control variables, such as GDP growth, real interest rate, business development index, strength of the legal and regulatory index, financial development index, and debt ratings, have a positive and significant effect on foreign debt portfolio inflows in the developed countries. However the variables, inflation rate, domestic credit to the private sector, and exchange rate volatility have a negative and significant effect on foreign debt inflows in the developed countries. Moreover, population growth rate, trade openness, and bank financing have statistically insignificant effect on foreign debt portfolio inflows. But in the developing countries, the results demonstrate that GDP growth, trade openness, domestic credit to the private sector, real interest rate, business development index, financial development index, and debt ratings have a positive and significant effect on foreign debt portfolio inflows. However, inflation rate and exchange rate volatility, which reduce the value of investment and its returns, have a negative and significant effect on foreign debt inflows. Moreover, population growth, strength of

the legal and regulatory index, and bank financing has an insignificant effect on foreign debt inflows in the developing economies.

ECONOMIC FREEDOM SUB-INDICES AND FOREIGN EQUITY AND DEBT PORTFOLIO INFLOWS

The results in the previous section show a positive significant effect of the economic freedom index on foreign equity and debt portfolios. These results are different for the emerging markets and developed markets. We further investigate the effect of the sub-indices of the economic freedom index on foreign equity and debts portfolio inflows. We intend to examine if there is any variation in the results of the sample firms of the developing and developed countries due to these sub-indices. The results in Panels A&B of Table 5 show that all components of economic freedom are positively associated with foreign equity portfolio in the developed and the developing countries. However labor freedom is statistically insignificant in both types of countries whereas financial freedom is insignificant in the developing countries only. The results for foreign debt portfolio inflows (see Table 6) are not different, though monetary freedom is insignificant. Moreover, in the case of foreign debt portfolio inflows, the coefficients of trade freedom and investment freedom is significant. However, business freedom, labor freedom, monetary freedom, and financial freedom have an insignificant effect on foreign debt portfolio inflows. A comparison of the results between developing and developed economies shows that business freedom, monetary freedom, and financial freedom are found to have a different pattern of effects on both foreign equity portfolio and debt portfolio inflows. The reason for these variations in the results might be the prevalence of more business freedom, monetary freedom, and financial freedom in developed economies than in the developing economies. These results suggested that countries with higher levels of business, monetary, trade, investments and financial freedoms are expected to attract relatively more foreign investments. In general, these sub-indices have similar effect as that of the economic freedom index. Moreover, the results of other variables are consistence with the results in the previous sections.

Table 5: Regression Results of Equity Foreign Investment Portfolio and Economic Freedom Components

	(Business Freedom)	(Labor Freedom)	(Monetary Freedom)	(Trade Freedom)	(Investment Freedom)	(Financial Freedom)

Panel – A:Developed Countries						
Business Freedom	0.123***					
	(0.021)					
Labor Freedom		0.418				
		(0.321)				
Monetary Freedom			0.146***			
			(0.021)			
Trade Freedom				0.134***		
				(0.021)		
Investment Freedom					0.105***	
					(0.022)	
Financial Freedom						0.117***
						(0.023)
_cons	1.228***	1.235***	1.254***	1.234***	1.205***	1.208***
	(0.106)	(0.105)	(0.106)	(0.106)	(0.106)	(0.106)
Year	Yes	Yes	Yes	Yes	Yes	Yes
Obs.	9775	9775	9775	9775	9775	9775
AR(1) P-value	0.049	0.042	0.045	0.039	0.041	0.039
AR(2) P-value	0.163	0.123	0.151	0.161	0.159	0.163
Hansen Test	2.65	2.34	3.52	3.98	4.15	2.55
Prob. Value	0.912	0.954	0.653	0.481	0.599	0.922
Panel – B: Developing Countries						
Business Freedom	0.039***					
	(0.011)					
Labor Freedom		0.077				
		(0.073)				
Monetary Freedom			0.097***			
			(0.031)			
Trade Freedom				0.079**		
				(0.033)		
Investment Freedom					0.097***	
					(0.010)	
Financial Freedom						0.071
						(0.135)
_cons	-0.367*	-0.166	0.073	-0.090	-0.179	-0.361*
	(0.173)	(0.173)	(0.139)	(0.177)	(0.173)	(0.173)
Year	YES	YES	YES	YES	YES	YES
Obs.	7706	7706	7706	7706	7706	7706

AR(1) P-value	0.033	0.023	0.023	0.040	0.021	0.049
AR(2) P-value	0.632	0.673	0.691	0.683	0.891	0.801
Hansen Test	3.377	3.393	3.707	3.333	3.397	3.331
Prob. Value	0.921	0.901	0.771	0.933	0.891	0.937

The variables used in the above regressions are defined in Table 2, Standard errors are in parenthesis, and *** p<0.01, ** p<0.05, * p<0.1

RESULTS OF THE FOREIGN SHORT-TERM AND LONG-TERM DEBT PORTFOLIO INFLOWS

Further analysis is conducted to determine whether the effect of country governance and economic freedom varies when a foreign debt is divided into short and long-term debt portfolio inflows. These results are reported in Panels A&B of Tables 7 & 8.

All components of the governance index have positive and significant effect on long-term debts. However, the voice of accountability has an insignificant effect on long-term debts in the developing countries. Results of the dependent variable foreign short-term debts portfolio inflows and all other explanatory variables are consistent with that of the long-term portfolio investments except that the voice of accountability is insignificant in the developed countries as well. The governance variables such as control of corruption, political stability, regulatory quality, government effectiveness and rule of law exhibit positive and significant effect on short-term debts in both the developed and developing countries.

Table 6: Regression Results of Total Debts Foreign Investment Portfolio and Economic Freedom Components

	(Business Freedom)	**(Labor Freedom)**	**(Monetary Freedom)**	**(Trade Freedom)**	**(Investment Freedom)**	**(Financial Freedom)**
			Panel – A: Developed Countries			
Business Freedom	0.090**					
	(0.039)					
Labor Freedom		0.241				
		(0.961)				
Monetary Freedom			0.041			
			(0.067)			
Trade Freedom				0.072***		
				(0.020)		
Investment Freedom					0.191**	
					(0.072)	
Financial Freedom						0.168**

						(0.070)
_cons	2.617***	2.807***	2.679***	2.641***	2.589***	2.617***
	(0.467)	(0.456)	(0.466)	(0.465)	(0.468)	(0.469)
Year	Yes	Yes	Yes	Yes	Yes	Yes
Obs.	1175	1175	1175	1175	1175	1175
AR(1) P-value	0.021	0.028	0.035	0.026	0.031	0.035
AR(2) P-value	0.215	0.355	0.309	0.357	0.410	0.389
Hansen Test	4.39	4.22	3.87	3.35	3.34	3.67
Prob. Value	0.414	0.401	0.589	0.661	0.671	0.593
Panel – B: Developing Countries						
Business Freedom	0.090*					
	(0.046)					
Labor Freedom		0.0322				
		(0.096)				
Monetary Freedom			0.071			
			(0.057			
			)			
Trade Freedom						
				0.063***		
				(0.020)		
Investment Freedom					0.191**	
					(0.073)	
Financial Freedom						0.168
						(0.170
						)
_cons	0.168	0.177	0.731	0.777***	0.793***	0.717*
			***			**
	(0.139)	(0.137)	(0.136	(0.171)	(0.170)	(0.137
			)			)
Year	YES	YES	YES	YES	YES	YES
Obs.	3306	3306	3306	3306	3306	3306
AR(1) P-value	0.001	0.001	0.003	0.007	0.001	0.003
AR(2) P-value	0.310	0.199	0.199	0.307	0.306	0.767
Hansen Test	3.19	4.39	3.77	3.39	3.76	4.13
Prob. Value	0.611	0.531	0.591	0.601	0.593	0.551

*The variables used in the above regressions are defined in Table 2, Standard errors are in parenthesis, and *** p<0.01, ** p<0.05, * p<0.1*

Economic freedom exhibits a positive significant effect on the long-term debt portfolio inflows in the case of developed and developing countries. More interestingly in Table 8, the coefficients of economic freedom have an insignificant effect on short-term debt inflows in

Table 7: Regression Results of Long Term Debt Foreign Portfolio Investments

	(Model1)	(Model2)	(Model3)	(Model4)	(Model5)	(Model6)
			Panel – A: Developed Countries			
CCR	0.005***					
	(0.001)					
PSR		0.005***				
		(0.001)				
RQR			0.003***			
			(0.001)			
RLR				0.005***		
				(0.001)		
VAR					0.002*	
					(0.001)	
GER						0.007**
						(0.001)
_cons	0.720***	0.628***	0.836***	0.643***	0.893***	0.721***
	(0.156)	(0.154)	(0.156)	(0.171)	(0.185)	(0.156)
Year	YES	YES	YES	YES	YES	YES
Obs.	3646	3646	3646	3646	3646	3646
AR(1) P-value	0.010	0.015	0.019	0.012	0.015	0.011
AR(2) P-value	0.154	0.153	0.150	0.152	0.148	0.154
Hansen Test	3.13	3.19	3.31	3.99	4.76	4.13
Prob. Value	0.681	0.665	0.651	0.521	0.671	0.619
			Panel – B: Developing Countries			
CCR	0.006***					
	(0.002)					
PSR		0.005***				
		(0.001)				
RQR			0.004*			
			(0.002)			
RLR				0.003*		
				(0.002)		
VAR					0.001	
					(0.002)	
GER						0.004**

						(0.002)
_cons	0.102	0.105	0.386***	0.281**	0.305**	0.116
	(0.126)	(0.124)	(0.124)	(0.128)	(0.127)	(0.126)
Year	YES	YES	YES	YES	YES	YES
Obs.	3306	3306	3306	3306	3306	3306
AR (1) P-value	0.001	0.000	0.010	0.011	0.015	0.001
AR (2) P-value	0.110	0.101	0.106	0.109	0.109	0.110
Hansen Test	3.121	4.39	3.310	3.190	4.711	3.211
Prob. Value	0.512	0.401	0.510	0.532	0.311	0.491

The variables used in the above regressions are define in the Table 2, Standard errors are in parenthesis, and *** p<0.01, ** p<0.05, * p<0.1

both types of countries. This suggests that in short-term debt, foreign investors are more concerned about governance than the economic freedom of the host country because the safety and security of funds rely more on the state of governance and the rule of law than the assumed short-term constant economic freedom. The negative insignificant inflation rate in the developing countries and the negative significant association in the developed countries indicate that investors are less concerned about inflation rates in the developing economies but are particularly concerned in the developed countries. Unlike in the case of investors in the developed countries, investors in the developing countries expect and therefore allow volatility in inflation rates. In other words, it is though plausible to argue that the inflation rate may remain constant within a short period however these results indicate that investors have different perceptions about inflation rates when investing for short periods in the two different types of countries. Investors are less concerned about inflation rates in the developing economies but are particular in the case of the developed countries. The rest of the results are consistent with the baseline regression models, except for bank finance, which has a negative effect on short-term debt portfolio inflows in the developed countries.

Table 8: Regression Results of Short Term Debt Foreign Portfolio Investments (STFPI)

	(Model1)	**(Model2)**	**(Model3)**	**(Model4)**	**(Model5)**	**(Model6)**
			Panel – A: Developed Countries			
CCR	0.002***					
	(0.001)					
PSR		0.002***				
		(0.001)				
RQR			0.002*			
			(0.001)			

RLR				0.002***		
				(0.001)		
VAR					0.001	
					(0.001)	
GER						0.003***
						(0.001)
_cons	0.468***	0.403***	0.507***	0.433***	0.544***	0.461***
	(0.130)	(0.128)	(0.129)	(0.140)	(0.151)	(0.130)
Year	YES	YES	YES	YES	YES	YES
Obs.	3646	3646	3646	3646	3646	3646
AR(1) P-value	0.221	0.222	0.222	0.222	0.221	0.221
AR(2) P-value	0.127	0.127	0.126	0.126	0.125	0.120
Hansen Test	3.27	3.25	4.51	4.59	4.61	4.27
Prob. Value	0.543	0.591	0.381	0.315	0.310	0.380
	Panel – B: Developing Countries					
CCR	0.005***					
	(0.001)					
PSR		0.002**				
		(0.001)				
RQR			0.002*			
			(0.002)			
RLR				0.002*		
				(0.001)		
VAR					0.001	
					(0.001)	
GER						0.005***
						(0.001)
_cons	-0.095	-0.020	0.112	0.048	0.064	-0.091
	(0.093)	(0.091)	(0.089)	(0.092)	(0.090)	(0.093)
Year	YES	YES	YES	YES	YES	YES
Obs.	3306	3306	3306	3306	3306	3306
AR(1) P-value	0.212	0.212	0.141	0.142	0.142	0.142
AR(2) P-value	0.591	0.561	0.552	0.553	0.554	0.591
Hansen Test	2.37	2.73	3.91	3.64	3.55	3.15
Prob. Value	0.737	0.712	0.532	0.591	0.569	0.618

*The variables used in the above regressions are define in the Table 2, Standard errors are in parenthesis, and *** p<0.01, ** p<0.05, * p<0.1*

CONCLUSION AND FUTURE SCOPE OF THE STUDY

Country governance, economic freedom, and FPI are an integral part of globalization and stock market liberalization. In the last two and half decades of globalization and liberalization, these phenomena have taken different paths with different catalysts. However, they converged to become an important aspect of the business environment. This study investigated the relationship between country governance, economic freedom and foreign capital inflows in the form of equity, long-term debts and short-term debts in developed and developing countries. The study analyzed data of 81 developed and 58 developing countries through dynamic panel regression, system generalized method of movements (GMM). The empirical results reveal that governance components such as control of corruption, political stability, regulatory quality, rule of law, government effectiveness, and voice of accountability of host country have positive and significant effects on the foreign equity and debts portfolio investments in the developed and developing countries. Moreover, in the case of long-term and short-term foreign debts control of corruption, political stability, regulatory quality, rule of law, and government effectiveness have positive and significant effects except for the voice of accountability in the two types of countries. The index of economic freedom has also a positive and significant effect on foreign equity, long-term debts and short-term debts in both developed and developing countries. The economic freedom sub-indices results portray a different pattern in the developing and developed countries i.e., business, monetary, financial, trade and investment freedoms are found to have positive and significant effect on the FPI in the developed countries, whereas, in case of the developing countries only trade and investment freedom were found to have significant effect on the FPI.

The results of the control variables show that GDP growth, trade openness, business development index, financial development index, market capitalization, and trading volume are exhibiting a positive and significant effect on the foreign equity portfolio inflows in both developed and developing countries, except the trading volume which is insignificant in case of the developing economies. However, inflation rate, exchange rate volatility, and real interest rate are exhibiting a negative and significant effect on the foreign equity portfolio inflows. Moreover, GDP growth, real interest rate, business development index, strength of legal and regulatory index, financial development index, and debt ratings have a positive and significant effect on the foreign debt portfolio inflows in these two types of countries. Whereas, inflation rate, domestic credit to the private sector and exchange rate volatility show a negative and significant association with foreign debt inflows in the developed countries. Moreover, population growth rate, trade openness and bank financing exhibit an insignificant effect on the foreign debt portfolio inflows in the sample countries.

We observe that unlike in the case of long-term debt investments investors show some differences when investing in short-term debt investments in the two different types of countries. Investors are found to be relatively more concerned about governance than economic freedom of host countries because the safety of short-term investments relies more on the state of governance and rule of law than the assumed constant economic freedom. In addition, investors of short-term debt investments are less concerned about inflation rates in the developing economies but are relatively more particular in the case of developed countries. In general, both developing and developed countries are required to improve the same set of factors in order to be able to attract the needed foreign direct investments for their economic growth and prosperity. However, these results suggest that if short-term foreign direct investments are to be attracted then all countries must have better governance systems. Moreover, high and volatile inflation are found as potential barriers therefore developed countries are also required to have low and stable inflation.

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