Impact of International Capital flow on Host Countries-Differentiating the Impact of FDI with Portfolio Investment

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Abstract
One of the major aspects of movement towards economic globalisation or integration through the world economy is international capital flows. The extraordinary surge in global capital flows in the recent few years and the resulting fluctuations in the ‘globalised markets’ have encouraged scholars’ interest to inspect both hypothetically and empirically the impelling factors and implications of international capital structure. FDI and portfolio investment have long been reflected as sovereign forms of foreign capital flow. This paper has analysed the impacts of FDI on portfolio investments and benefits FDI can have on host countries. This paper has further discussed the major features of FDI and portfolio investment in terms of its profitability and volatility.

Keywords: FDI, portfolio investment, host country, host countries, capital flow

1.0 Introduction
One of the major aspects of movement towards economic globalisation or integration through the world economy is international capital flows (Milesi-Ferretti & Tille, 2011). The financial theory offers two basic methodologies for learning the impact of FDI on host countries. One of the theories is embedded in the standard philosophy of internationalisation and it dates back to MacDougall (MacDougall, 1958). It is a partial stability comparative-static technique which is focused on examining by what method minimal growths in international investment are distributed. The key prediction of the model is that international capital inflow, whether FDI or portfolio capital will upturn the minimal product of workforce and decrease the minimal product of investment in the host country. The other method ensues from the philosophy of industrial organisations and was founded by Hymer in 1960 (Hymer, 1976). The extraordinary surge in global capital flows in the past few years and the resulting fluctuations in the ‘globalised markets’ have encouraged scholars’ interest to inspect both hypothetically and empirically the impelling factors and implications of international capital structure. FDI and portfolio investment have long been reflected as sovereign forms of international capital flow (Choong, et al., 2010). This paper will analyse the impacts of FDI on portfolio investments and benefits FDI can have on host countries. This paper will discuss the major features of FDI and portfolio investment in terms of its profitability and volatility.

Due to the openness of foreign capital flows, capital inflow simplifies the growth through complementing domestic resources and bringing in innovative technological awareness (Ali, et al., 2016). On the contrary, a rise in capital inflows and sudden stops and reversal can cause financial crises which have plagued different emerging economies since 1990 (Lu, et al., 2014). Emerging countries, developing economies and nations in a shift, due to benefits linked to FDI have loosened their FDI regime and followed the best strategies to draw investment (Wilson, 2015). It has been documented that exploiting benefits of FDI for the host country can be important, comprising technology spillovers, human capital growth provision, development of the competitive trade landscape, the impact to international trade integration and progress of enterprise growth (Pillai & Rao, 2013).

During the past 20 years, the economic incorporation of the developing markets with global marketplaces has received momentum (Kearney, 2012). Economic globalisation has assumed global capital flows a vital part in the working of the worldwide economy (Mendoza & Quadrini, 2010) and has consequently led to substantial economic study during the last 30 years. According to OECD, the increasing financial openness and integration around the globe have brought annual gross cross-border capital flows from 5% of the world’s GDP in the mid-1990s to around 20% in 2007 (OECD, 2018). This is now a growing agreement that international capital flows have the capability to bring good and bad (Borio & Disyatat, 2010). International
capital flows reinforce long-term development via a better international allocation of saving and investment (Gourinchas & Jeanne, 2013). While assuming the form of FDI, they can encourage improvements and management and technology and when assuming the form of portfolio investment, they can improve corporate governance and transparency through exposing recipients of international investors. Capital inflow can also amplify domestic distortion particular when poor corporate governance and financial rules allow banks and other corporates to take excessive risks and develop through international leverage (Lane, 2015). According to Trading Economics (2018), the overseas investors sold around $33.1 billion of US assets comprising short-dated instrument during December 2018. Meanwhile, foreigners soled $48.3 billion of long-term US securities including corporate and government, after buying a downwardly revised $32.0 billion in December 2018. Foreign investors traded $77.4 billion of US Treasuries, after trading an upwardly reviewed $13.2 billion in November 2018. The capital flows in the United States be around $22593.34 million from 1978 until 2018, reaching an all-time high of $272938 Million in October of 2008 and a record low of -193364 USD Million in September of 2015 (Figure 1).

According to Borio and Disyatat (2010), the international flow of capital performs a different function in the world economy. For instance, they allow the levels of domestic investment in a country for exceeding the country’s saving levels. During the last 15 years, this has been the case in the U.S (Javorcik, et al., 2011). For fast-growing economies such as the U.S., FDI inflows offer faster growth with less sacrifice on consumption (Globerman & Shapiro, 2009). Several authors argued that FDI carries the seeds which can lead towards stable economic growth whereas portfolio investment is highly volatile and it cannot ensure sustained economic growth (Agosin & Huaita, 2010; Amanor, 2012; Calderón & Kubota, 2019). The previous literature recognises that the perils associated with portfolio investment are due to the difficulties in apprehending FDI (Kudrle, 1991; Globerman & Shapiro, 2009; Fagan, 2010; Milesi-Ferretti & Tille, 2011). A foreign investor chooses to invest in a host country face increased entry costs for participating directly in the industry (Alfaro, et al., 2010). Because of this initial setup cost and ambiguity and essentials, and high exit costs due to difficult in reselling. All of these costs increase the observed volatility related to portfolio investment.

According to Kose, et al. (2009), both FDI and portfolio investment are plausible investment decisions with opposing features (in terms of risk-return) and with conflicting effects in the host country’s potential for economic development and growth. Several equilibriums can arise since there is no trade-off based on information among FDI and portfolio investment (Faeth, 2009). The informational asymmetries due to the varying nature of FDI and investment portfolio projects and to the degree of transparency can steer the decision of investors towards one form of investment versus the other.

2.0 Literature Review

Popescu (2014) has defined the role of FDI as a collection of awareness, knowledge, and capital stock in growth-enhancing aspects in Central and Eastern Europe countries (CEE). It supports insufficient domestic funds for financing ownership change and capital arrangement. According to Popescu (2014), FDI might help introduce managerial know-how, technology and skills needs for restructuring businesses. Exports and lagged FDI have a pertinent positive impact on the country’ financial growth. Inward FDI into the CEE countries was encouraged by an over-all increased economic environment (Popescu, 2014). FDI function
has the potential to shift with the event of international financial crises in the host countries (Bilgili, et al., 2012). According to Pillai & Rao (2013), FDI inflows outcomes in a positive and statistically appropriate manner to economic progress. FDI can improve technical advancement in the host country through efficiency “spillovers”.

According to the IMF balance of payment methodology (2014), foreign capital flows are categorised into three different commonly exclusive types which are FDI, portfolio investment, and other foreign investment which includes deposits, bank loans, and trade loans. According to Humanicki, et al., (2017), FDI and portfolio investment commonly comprised of debt and equity related flows. In regard to equity flows global standards defined by IMF (2014) explain FDI and international investment that accounts for above 10 percent shares or rights to vote otherwise the investment is categorised as portfolio investment. According to Humanicki, et al., (2017), debt transactions between the parent and associate firms are categorised as FDI whereas issuance of bonds to pay back credit from the parent company has been documented as portfolio investment. FDI is primarily composed of equity related flows that do not produce debt (Neumann, et al., 2009). Therefore, the conventional fact that FDI and portfolio investment are alternatives does not hold and required to be empirically studied. According to Humanicki, et al., (2017) both forms of investment can be unutilised by the investors to establish a portfolio that creates an equilibrium between FDI and portfolio investment. The major difference between and FDI and portfolio investment roots from a transaction between productivity and liquidity (Humanicki, et al., 2017). FDI empowers investors to take decisions for the business because they are not just the owner but also the managers (Globerman & Shapiro, 2009). Therefore, in the relation of portfolio investors, FDI investors have greater control over the organisation and have more information regarding its essentials which empowers them to do business in more efficient and profitable manner but this privileged position of FDI investors comes at a cost (Humanicki, et al., 2017).

According to Humanicki, et al., (2017), FDI is less liquid as compared to FPI which is why investors may not be able to easily sell their venture too early if encounter unexpected liquidity and even if FDI investors are able to find a potential buyer, they may have to sell their shares at a value less than their actual worth. According to Humanicki, et al., (2017), a significant conjecture is that market contributor is aware of the fact that FDI investors have insider know-how of the enterprise they own. Therefore, when FDI investors determine to leave the investment venture, potential buyers undertake that the investment is either risky or produce a limited amount of profits. Potential buyers may show more willingness to pay according to the actual value of the shares when they are aware of the fact that the sale is because of investor’s liquidity requirements (Humanicki, et al., 2017). According to Azman-Saini, et al. (2010), investors with a safe liquidity status usually favour FDI. Commonly, FDI is the field for multinational organisations whereas portfolio investment is the preference of enterprises that are subject to unexpected liquidity such as global investment funds (Humanicki, et al., 2017). When the transaction and entry cost is low, production cost across the border is low, and when investors have safe liquidity status, they favour FDI against portfolio investment (Humanicki, et al., 2017). This assists with the explanation of the reason behind the dominance of FDI in developing markets where production and transaction costs are considerably less as compared to the developed markets.

Many studies have asserted that FDI has mainly contributed to financial progress (Azman-Saini, et al., 2010; Almfraji & Almsafir, 2014; Tang, 2015). Specifically, FDI is capable of encouraging technology transfer and catch-up. It can facilitate to accomplish improved GDP growth as compared to local investment (Tang, 2015). The studies also highlighted that FDI influxes can significantly support progress in the host countries with a specific level of absorptive capability. The greatest productive growth impact on FDI can only happen in such countries that have proper institutional and macroeconomic structures such as academic accomplishment and economic progress (Tang, 2015). Along with FDI, portfolio investment could have a considerable impact on development (Tang, 2015). Portfolio investment influxes do not have a substantial positive impact on development other than access to global savings (Iamsiraroj & Ulubaşoğlu, 2015). Unlike FDI, portfolio investment does not encourage development via global technology transfer and knowledge (Tang, 2015). Considering that FDI is more valuable as compared to portfolio investment for development, Tang (2015) suggested that there is a requirement for selective and targeted policies to distinguish among various forms of capital influxes. In contrast, Kanu (2015) determined that directness of portfolio investment influxes would be favourable to development. The deeper financial incorporation has supported the FPI influxes towards domestic equity investments that would boost development (Tang, 2015). Therefore, the
instability of portfolio investment may not negatively affect development. Conversely, the acceleration of development right after the liberalisation of capital flow is primarily determined by the successful investments (Tang, 2015). According to Kanu (2015), portfolio investment can only contribute to development in the short-term. In contrast, the FDI paired with improved quality local institutions after capital flow liberalisation would facilitate progress in the long run (Tang, 2015). The portfolio investment influxes would improve the progress of host countries with adequate absorptive capabilities such as institutional and financial progress. The deeper and more liquid stock market would efficiently absorb portfolio investment to enhance private investment.

A great number of recent studies indicated that economic progress has crucially contributed to improving progress (Agosin & Huaita, 2010; Almfraji & Almsafir, 2014; Albulescu, 2015). Choong, et al., (2010) argued that the higher level of economic progress such as financial sector and the stock market is positively associated with better financial progress rates, physical capital accumulation, and financial productivity improvements after adjusting for country and policy features. In terms of the impact of inward FDI on host countries, the impact of FDI on the financial performance has been examined in terms of global trade, macroeconomic balance, and productivity and profitability (Tang, 2015). According to Alfaro, et al. (2010), FDI has an impact over host economies via various channels while effecting the structure of the market and also have competition and employment effects. Likewise, Tang (2015) highlights the possible advantaged of the FDI including improved performance because of diversification, competition, and human capital growth. According to Tang (2015), different aspects including the progressive externalities, capital funding prospects and the transfer of technology indicated that inward FDI has a positive impact on the financial progress. Tang (2015) also examined the contribution of outward FDI on financial progress while signifying a crucial point of argument in terms of developed markets. Outward FDI has been identified to have both negative and positive impact on the local income based on the contribution of FDI in the local market (Albulescu, 2015). According to Albulescu (2015), when outward FDI is a substitute to the local production it negatively impacts the financial progress whereas if outward FDI is complementary to the local investment it motivates the financial progress. Albulescu (2015) identified that less consideration has been made towards portfolio investment when the contribution of FDI in influencing the financial progress is intensively studied. According to Albulescu (2015), the potential advantages of portfolio investment towards financial activity in the host country include a surge in the liquidity of local capital markets, bringing discipline and knowledge within the local capital markets and assists with the utilisation of innovative products and instruments for mitigation of risk factors.

3.0 Methodology

The research paper is based on a qualitative methodology. A qualitative method for research is reasoned with the investigative and inductive way of research (Neuman & Robson, 2014). This has been used to identify the impacts of international capital flow on host countries and to differentiate between the impacts of FDI with portfolio investment. A total of three relevant studies and further supporting literature is discussed in detail to provide a theoretical overview of the impacts of international capital flow on host countries and difference between the impacts of FDI with portfolio investment. This research paper is based on the systematic review of researched literature of theoretical studies on the Impacts of International Capital Flow on Host Countries. Interdependency, gradation, and attention to detail provided a holistic view of the subject being studies and presented a comprehensive image of its overall nature (Mallett, et al., 2012) The literature research was limited to the studies conducted in past decade and available in the English language from the period of 2009 to 2019. The results obtained from the search were further filtered on the basis of their titles. The selection was further reduced by overviewing the abstract of the studies. Further assessment of the full text was conducted. From a total of 20 studies, three articles made it to the final selection on the basis of relevance to the international capital flow, FDI and portfolio investment.

4.0 Discussion

The first study selected for this research paper by Tang (2015) studied the impact of foreign capital flow on the financial progress of the European Union (EU) during the period of 1987 to 2012. The primary focus of the study was to identify if the FDI and portfolio investment influxes have a substantial positive impact on the growth during the European Monetary Union (EMU) period. Tang (2015) discussed in the context of
developing economic market integration since the late 1990s that increasing developed economic markets were capable of allocating resources to fund foreign capital flows for profitable investment. Tang (2015) analysed if the FDI influxes supported to improve the progress in the EU countries with powerful economic markets. Another critical issue examined in the study was if the FDI influxes supported the progress within the EU countries with well-established institutional and macroeconomic frameworks. Tang (2015) suggested that open trade policy helped the directness of capital flow which further indicated that when FDI influxes are joined with greater trade flows, it spurs the progress of EU countries. Tang (2015) also identified that those EU countries which have greater academic achievements could further encourage the progress within the EU region. Tang (2015) also studied the contribution of FDI in the financial progress of EU countries via economic markets. Since the establishment of EMU the stock market within the EU region has turned extremely integrated and liquid (Spiegel, 2009). Tang (2015) suggested this as the enabler of the rise in the FDI influxes towards the stock markets. At the same time, the banks within with EU region have increasingly incorporated since the establishment of EMU (Tang, 2015). The inception of the Euro enabled the financial sector to deal with greater competition and resulted in increasing mergers and acquisitions (Tang, 2015). This made banks more resourceful for allocating resources to fund FDI for profitable investment. According to Tang (2015), the trade flows within the EU region continued to surge because of the expansion of EU membership towards Eastern and Central Europe. This openly profits the main exporting countries who were directing their exports towards these emerging markets. In the meantime, EU countries managed to progressively expand their market to reach outside the EU region (Tang, 2015). The EU countries with a greater orientation towards trade became more direct to the foreign capital influxes and the trade flows and FDI influxes supported each other. Tang (2015), also suggested that the increasing academic accomplishment within the EU region highly favoured the accomplishment of advantages of FDI. According to Tang (2015), the countries within the EU region that have a more educated workforce were in a better position of maximising the progressive externalities of FDI influxes.

The study observed the promotion of financial progress within the EU region during 1987 – 2012 because of the financial integration among the EU countries. Tang (2015) argued that since 1999, the establishment of EMU has improved the foreign capital influxes towards the EU countries because global investors consider investing in large-sized integrated markets more profitable. In addition to that, the developed stock market and integration of the financial sector further supported such influxes of capital with more resources for funding (Tang, 2015). According to Tang (2015), the influxes of portfolio investment did not have a major impact on the progress in the long run because they did not bring considerable advantages other than providing with the accessibility to foreign capitals. A short-lived success in investment generally prompts the rise of portfolio investment. Portfolio investment can only take part in short-lived growth because they are primarily allocated to non-productive investment. Tang (2015), suggested that FDI influxes lead to the progress in the long run because they implicate greater progressive externalities transfer of technology to the EU countries. This can motivate research activities and consequently speed up innovative growth. Tang (2015) identified that countries having greater FDI influxes are inclined towards a better competency in keeping up with the evolving technology trends and can accomplish better productivity and GDP progress. The study identified that FDI influxes have better stability and implicate assurance in the long run as compared to portfolio influxes because they do not demand a massive amount of capital investment whereas portfolio influxes cost higher when it comes to reversal. This indicated that the FDI influxes had a better positive impact on EU progress.

The second study selected for this research paper by Albulescu (2015), contributed to the literature that examines the impact of FDI on the financial progress of the host country. The study identified the impact of FDI and portfolio investment over the financial progress of Central and Eastern European (CEE) countries in the long run through a panel framework. The study also examined the contribution of outward FDI on financial progress and represented a central point of argument in developed economies. Albulescu (2015) identified that the outward FDI is capable of having both negative and positive impact over the domestic income based on the contribution of the outward FDI in the local market. Albulescu (2015) presented the idea that if the outward FDI is substituted to the local manufacturing, it negatively impacts the financial progress; conversely, if the outward FDI is complementary to the local investment, it motivates the financial progress. The study tested the effect of FDI as well as portfolio investment on financial progress. In addition, the author considered both outward and inward investment and marked the difference between debt.
instruments and equity investment. According to Albulescu (2015), a few economists advance the qualities of foreign equity investment in the detriment of debt investment signified by debt securities, currency, loans, deposits, and superior drawing privileges. Albulescu (2015) discussed the basic concerns between FDI and progress with the help of panel data analysis and evaluated the case of CEE countries where the reforms and transformation of local companies built such environment in which possible advantages of FDI are substantially more valuable and where the portfolio investment gained significance after the liberalisation of capital account. The study revealed that in the case of the FDI equity assets as well as liabilities have a positive impact over financial progress; conversely, there is no effect of debt instruments on the GDP per capita. The study revealed similar outcomes for portfolio investment. The outcomes of the study are strong against a number of controlled variables that have an impact of financial progress such as inflation, circulating money, interest and exchange rates, redundancy, or primary energy consumption. The study revealed that equity and fund investment instruments only have a positive effect over GDP per capita. According to Albulescu (2015), this reflection was also effective in the case of both FDI and portfolio investment for both inward and outward investments whereas the study did not document any substantial influence over debt instruments. According to Albulescu (2015), the appreciation of interest and exchange rate has a negative impact on the financial progress whereas the rate of inflation and the circulating finance have a positive impact. The rate of unemployment and the primary energy consuming have a negative effect on financial progress. Lastly, even though the level of education has a positive effect, it is rather insignificant in most circumstances. Albulescu (2015) argued that this outcome is not unexpected because the input of education towards financial progress comes with substantial lags. The study revealed that both FDI and portfolio investment should be encouraged; however, the accent must fall on equity products. According to Albulescu (2015) the growth of capital markets and the convenient accessibility to finance reassure the long-term financial actions of the CEE countries.

The final study selected for this research paper by Humanicki, et al. (2017) evaluated the common link between the FDI and portfolio investment and made an effort to address the problem that if both elements complement each other or act as a substitute for each other from the outlook of a foreign investor. The study defined the primary features of FDI and portfolio investment in terms of their instability and productivity. Humanicki, et al. (2017) evaluated the associations between FDI and portfolio investment in both long-term and short-term for Poland because it is the biggest CEE country and gets the largest share of FDI and portfolio investment within the CEE region. Humanicki, et al. (2017) initiated the empirical analysis from the first quarter of 2002. According to Humanicki, et al. (2017), while still high corporate income tax (CIT) rate slowed down the FDI influxes, advancements within the law and tax structures attracted portfolio investment and further foreign investment. After Poland become a member of the EU in 2004, the CIT rate was considerably reduced and consequently, it was observed that the FDI influx improved to a greater extent in the form of reinvested incomes. As the consequence of the international economic and financial crisis, initially FDI influxes experienced a downfall; however, during the later years, foreign capital again started to rise.

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Figure 2: FDI and FPI inflows in Poland, Source: Humanicki, et al. (2017)
Humanicki, et al. (2017) highlighted that above 90 per cent of the portfolio investment influx to Poland comes as independent debt securities, which is why a general surge in the liabilities represents permanent imbalances within the financial sector. According to Humanicki, et al. (2017), the provisioning of government debt securities of Poland was restricted only during the period of 2006 to 2008 and robust GDP progress and increasing tax incomes were witnessed during the same period. According to Humanicki, et al. (2017), Poland witnessed a surge in the portfolio investment influxes during the recent global crisis and it substantially contributed to determining entire capital influxes. According to Humanicki, et al. (2017), this made Poland desirable for global investors because of its low risk and comparatively high yield of the government bonds as compared to both developed markets and other developing peers within the region. The study revealed that in a small open market like Poland rate of exchange is primarily affected by the global markets and is linked with the foreign investment and GDP growth. According to Humanicki, et al. (2017), the wealth effect resulting from a destabilised exchange rate of the host country in case of developed markets is weak and dominated by the profit-orientation. Humanicki, et al. (2017) argued that it appears to be reasonable that also for Poland and comparable developing markets there is no substantial contribution of wealth effect coming from a weak currency. The wealth effect is already captured within the substantial difference in capital stocks. According to Humanicki, et al. (2017), even if the host country has a strong currency, global investors are still more likely to acquire assets. This means that the rate of exchange can be anticipated to have a minimal contribution or may have absolutely no significance. Factually FDI and portfolio investment have been reflected as different and sovereign forms of foreign capital flows (Dunning & Dilyard, 1999). The study revealed that FDI and portfolio investment are instead interrelated. According to Humanicki, et al. (2017), there are consistent long-term stability connections among FDI, portfolio investment, market size, comparative actual unit labour costs, and the actual variance in the rate of interest. The outcome of the study supported a possible trade-off between FDI and portfolio investment.

5.0 Conclusion
The higher FDI and portfolio influxes prompted the EMU have not influenced the development. It is actually unexpected to witness the lacking of the effect of FDI considering the greater technology catch-up might speed up the productivity progress and GDP growth. The FDI and portfolio influxes entail a higher volume of capital investments and are expensive when it comes to reversal. The financial sector and stock market progress have highly contrary impact on the development. The financial sector credit flows in the EU region have steadily decelerated the progress. This might be associated with the deteriorating implication of financing by the financial sector after the developed integration of stock market. On the other hand, the stock market capitalisation has enhanced the development in reality. Due to the openness of cross-border capital flows, capital inflow simplifies the growth through complementing domestic resources and bringing in innovative technological awareness. On the contrary, a rise in capital inflows and sudden stops and reversal can cause financial crises which have plagued different emerging economies since 1990. The robust stock market size impact prior to the EMU establishment is further clarified by the impact of EU membership during the 90s. The inception of the Euro during the EMU era has promoted the expansion of stock market size. Consequently, this amplified the funding for local investment and eventually stimulating the development. The FDI interrelated with the financial sector progress has a delayed positive impact on the progress. However, this impact is considered weak due to the fact that the EU financial sector has not been fully incorporated regardless of the establishment of EMU.

The FDI and portfolio investment influxes do not have any impact at all whereas the FDI based economic progress interaction has a positive impact over the development. This validates the requirement for the EU countries to distinguish between FDI and portfolio investment. The FDI has huge positive externalities including technology transfer which can enhance productivity and GDP growth. Considering that FDI can contribute to the development, in the long run, EU countries must attract increasing FDI instead of portfolio investment inflows. When it comes to CEE countries, both assets and liabilities FDI and portfolio investment with the substitution for outward and inward investments tend to have a positive effect on the financial progress but this assertion would only be effective in case of equity instruments. Provided the advantages of FDI and trade for development, EU countries must reach out to the intercontinental free trade agreement with the United States. The FDI and trade requirements would result in the increasing level of FDI and trade flows from the United States towards the EU countries. Specifically,
the application would enhance the FDI because of the inclusion of the investment liberalisation provisions. Along with eradicating any residual obstacles toward capital flows, extremely comprehensive investment provisions would be highly effective in further increasing the FDI. Considering that trade and FDI flows are the primary development factors for the EU, the application of the agreement would further support their development in the long run.

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Conflict of Interest
We write to confirm that, none of the authors have any competing interest whatsoever and dully approve the manuscript for review. This manuscript has not been submitted for publication nor published anywhere else.

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