Financial flows evolution in the context of capital markets regionalization

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Abstract

This paper resolves to highlight the importance, role, and evolution of capital flows in the context of ever growing interdependencies among world states. Over the past 20 years, the capital circulation has met with extraordinary developments, the transaction costs diminished, while the attraction of capital flows has currently become the object of increasingly fierce international competition. The measures taken to liberalize financial markets have become indispensable in order to attract foreign capital, to ensure the integration into international economy, and promote the development of a competitive financial sector. In close connection with the financial globalization phenomenon, in recent decades a gradual process has emerged, a process of defining a regional identity for the capital flow behavior.

Key words: capital flows, foreign investors, liberalization of financial markets.

1 Introduction

In a modern and flexible economy, capable of meeting the increasingly higher demands of multi-sector integration, the role of the capital market is unanimously acknowledged and accepted. The capital flows, the more and more complex financial instruments and operational systems, the quality of intermediation, of the financial supervision and the actors of this sophisticated game, are all enacted with a view to upholding the development of the real economy, to the benefit of all the participants on the market.

Furthermore, in the past few decades capital markets have become the referees and judges of both national economies and of the world economy. In fact, nothing evades the attention of these markets: domestic macroeconomic performance recoils on the currency market; government policies are evaluated on the state equity market, while the performance of private companies and of the sectors they belong to are often assessed on the stock exchange markets through transactions of stock and bonds.

Developing economies or economies in transition have consistently appealed to capital markets in order to finance their balance of payments or to accelerate the development of their capacities of production. This has involved and still involves a

reformative process of the financial system, of adaptation to the investors' exigencies, of adoption of standards in keeping with both domestic capabilities and with the demands of integration into a broader regional or international context.

Over the past two decades, financial markets have become interdependent to an increasingly larger extent. Financial globalization has brought significant benefits to national economies and investors, but, in the same time, altered the markets' structure, engendering new risks and challenges for the market participants and for the supervision and regulation institutions.

The globalization wave was counterpoised by an increase in the volume of capital flows between developed states, and especially between developed and developing countries. While some of these countries benefited from the increase in the volume of financial activities, recording relatively high rates of economic growth, other countries underwent periods of crisis, including financial crisis, which entailed significant macroeconomic and social costs.

Thus, globalization has become one of the chief topics for international debate and economic analysis, generating a multitude of directions for the research of the causes, volume, and movement direction of the capital flows, of the groups of states involved or affected, of the benefits, systemic risks and market volatility.

2 Body of paper

Although currently an increasingly larger number of countries from Latin America, South-East Asia or Eastern Europe have become emblematic for the development of the regions they belong to, and despite the possibility to identify clusters of countries with comparable financial behaviors, the capitalization and transactioning differences between regions and especially between developed and developing countries are still difficult to surmount.

Beside the difference of status in what concerns the real economy, statistical data shows that the underdevelopment of the emergent financial markets is deeper than that of the manufacturing sector. Thus, even though developing countries contribute 23% to the gross world product (GWP), their cumulated financial assets don't exceed 9% of the world overall, while their stock exchange capitalization is 7% of the world's total.[1]

The figures also indicate the fact that stock exchange markets have a comparatively smaller importance in the financial economy of the emergent countries with relation to the developed country, in what concerns their banking systems. Furthermore, stock exchange capitalization is not distributed uniformly by region: nearly 70% of the stock weight is held by the most financially influential countries from South-East Asia, while Latin America has a share of 20% and Eastern European countries have not yet reached 5% of the emergent regions' total, nor 1% of world overall.[2]

Beside the poor statistic weight of different regions, a more complex picture of the role played by emergent countries in the globalised financial economy can be offered by the analysis and evaluation of the capital flows, which directed themselves toward the developing countries during the past two decades, by the analysis of their causes and dynamic, as well as of the impact exerted upon their economic growth by the new resources and financial integration.

The experiences caused by the economic crises of the 1980's and 1990's have shown that massive capital infusions may bring considerable economic benefits to developing countries, but if the funds are inappropriately managed may as well generate the overwarming of the economy, the increase of exchange rate volatility, and even the loss or withdrawal of major capital sources.

During the 1990's, the net capital flows to developing countries increased significantly. In 2000, the net private capital amounted to 190 billion USD, nearly four times more than in 1990. Between 2000 and 2005, the infusions of net annual private capital were also intense and far more concentrated. Five countries reported more than 50% and 12 countries 75% of the overall capital amount. A number of 26 countries gathered more than 95% of the total amount of available resources. As such, 140 from 166 developing nations benefited from less than 5% of the inflow total, taken together.[3]

The structure and sectorial destination of capital flows during the latest infusion were different from the flows from the period prior to the 1982 debt crisis. During the '70's, the banking loan represented the most important component of the capital flows, while the public sector was their largest recipient. In contrast, during the '90's, the infusion was primarily made up by bonds, direct foreign investment and portfolio investments, while the private sector contracted most of the foreign loans. [4]

The growing interest of foreign investors for several developing countries ha sled to their increasing integration into the global financial system, which engendered benefits for these countries and for global economy as well. However, massive capital infusions are not always a blessing and may as well lead to massive losses caused by sudden changes of direction for the resources, by the investors' withdrawal, and the effects of contagion. It is significant that most of the countries that benefited from the largest inflows were also affected, during determined periods, by massive withdrawals, which amounted to a significant percentage of their gross domestic product.

In order to manage these elements with high financial risk, developing countries may employ a combination of countercyclical and structural policies, as well as a series of other measures drawn up especially to curtail massive net capital infusions, when needed, or to alter their structure and maturation with a view to reducing volatility.

The degree of interest on the part of private capital in the opportunities posed by the emergent markets started to improve in the '90's, due to both domestic and foreign factors, some of which, related to the liberalization of financial markets, were presented previously. At an internal level, the predicted risk-profitability ratio improved by means of three essential channels:

- the crediting policies improved, as a result of foreign debt restructuring in a large number of developing countries;
- productivity increased as a result of structural reform and trust building in macroeconomic management in the case of several developing countries that implemented stabilization programs successfully;
- the countries that maintained fixed exchange rates became interesting for investors, due to the transfer of the exchange rate volatility risk - at least for a short period of time - from the investors to the government.

Furthermore, due to cyclical and structural forces, foreign influences played an important role in the capital infusion of the '90's. Cyclical forces provided the dominant explanation for this period, when the worldwide decline of the real interest rates literally "pushed" investors toward emergent markets. However, the persistence of private capital flows after the worldwide increase of the interest rates in 1994 and after the Mexican crisis from 1994-1995 shows that foreign structural forces also had a significant contribution to this persistence beside the cyclical forces.[5]

Foreign structural forces began to function simultaneously with the apparition of two development paths in the financial structures of the capital-exporting countries, which led to an increase in the availability of private capital of crossing national borders in search of investment opportunities:

- the diminution of communication costs, fierce competition, and higher production

costs in the domestic market, determined companies from industrialized countries to manufacture overseas in order to increase output and profits;
- institutional investors became increasingly receptive to the possibility of investing on emergent markets, due to the increase in the predicted long-term outputs, the better possibilities for risk diversification, and greater investment feasibility as a result of the capital account liberalization.

However, the investments in emergent markets continue to represent only 2% of the assets of U.S. equity funds, 3-4% in the case of British institutions, and amounted to insignificant values for the rest of the equity funds in Europe and Japan.[6]

However, the importance of structural forces enhances the optimism linked to the amount of capital flows that developing countries are capable of attraction on short term. Once the private capital flows increased in importance, the resource volatility risk increased as well in these economies.

Major overturns of capital flows occurred in a number of countries between 2000 and 2002. A common reason for this flow reversal was the distrust of the domestic macroeconomic policies, which led to speculative attacks directed at the exchange rate and to crises of the balance of payments. Such crises also resulted from financial vulnerabilities or other factors that undermined the macroeconomic policies' credibility (for example, if a banking sector is poorly organized, it is possible that its managers will use currency depreciation as an adjustment instrument rather than the increase of interest rates).

In addition to this - as was the particular case of Mexico - the maturation and currency composition of the public sector debts are particularly relevant. In fact, even if a country's public sector is solvable, it can be subjected to liquidity crises when the creditors show distrust for the government's short-term debt refinancing.

As developing countries gradually become integrated into the international financial circuit, without a symmetric distribution of inter-market information, the possibility of contagion/transmission for the effects of the capital crises increases correspondingly.

The contagion effects associated with the movements of private capitals may appear via five important channels:
- the commercial exchanges and the currency pressures generated by them;
- the worsening of investors' perceptions as to the fundamental economic indicators together with the depreciation of the national currency (regarded as the "wake-up call" of susceptibility in what regards investment opportunities);
- the implementation by international financial institutions of similar investment policies for several developing countries that basically display heterogeneous fundamental indicators;
- the financial connections between countries – for example, financial holdings can transmit shocks to other countries, in the form of various reactions, regardless of the financial policy elements, be they domestic, fundamental or specific;
- the practices of liquidity management in the case of open equity funds may cause contagious effects, due to information asymmetry and to the possibility that investors sell the assets they possess with prices lower than the real market price.

The impact of the capital flows upon development depends on the way in which domestic policies improve with time, on the period of time necessary for the relaxation of the capital control, and on the proportion to which capital flows change direction as a result of international circumstances. Although it is difficult to state that private capital flows inevitably lead to development, this can be achieved under favorable circumstances - furthermore, domestic development, in its turn, influences the capital flows. Practice has shown that private capital flows can revive the development process.

Thus, together with the steady progress of global integration over the latest years, the

distribution of returns from international capital flows has lead to an increase in some countries' incomes and deepened income differences among developing countries.

Integration intervenes via direct or indirect channels in the acceleration of economic growth, even though the effects of this relationship are not always conspicuous, unidirectional or easy to prove. Influence channels are interconnected to a large extent – instead, their delimitation is useful if we determine to empirically highlight the quantitative importance of any of the factors.

- *Direct channels*

The growth of domestic savings [internal economies]: the capital flows between developed and developing countries (also called North-South flows) are, in principle, beneficent for both groups of countries. They allow for investment growth in countries poor in capital and offer a higher capital output than in developed countries.

The diminution of capital costs by better global risk allocation: the models of setting the price of international assets prove that the liberalization of stock exchange markets improves risk allocation. This can also lead to risk diversification, which encourages companies to invest more and thus project higher business growths. In addition to this, as capital flows increase, stock exchange markets become more liquid, diminishing the risk margin for stock and lowering the costs of capital provision.

Technology transfer and management know-how: the financially integrated economies seem to attract a higher rate of direct investments, which have the potential to generate technological development transfers and lead to more sophisticated and efficient management practices. These transmissions can increase aggregate productivity and jumpstart economic growth.

The stimulation of the domestic financial sector: international portfolio flows may increase the liquidity of domestic stock exchange markets. The increase of foreign ownership in the domestic banking sector may also generate a wide range of benefits:

- the participation of foreign banks facilitates access to international capital markets;
- the supervision of the banking industry can be improved;
- foreign banks can often introduce a variety of new financial instruments and techniques and can stimulate the technological progress of the domestic capital markets;
- the entrance of foreign banks may increase competition, which results in a qualitative improvement of banking services and efficiency of allocation.

- *Indirect channels*

Promotion of specialization: the ration between production specialization, productivity, and economic growth can be intuitively determined with great ease. However, in the absence of a risk management mechanism, an extremely specialized production structure may generate a very volatile output, thus influencing consumption volatility (see annex). High production and consumption volatility may generate in its turn lower rates of savings and investments. In principle, financial globalization might play an instrumental role in the international dispersion of risks, and thus in the reduction of consumption volatility. Risk sharing can indirectly encourage specialization, which, in its turn, and according to circumstances, may exert positive influences upon economic growth.

The commitment to perfect financial policies: international financial integration may have an impact upon the governments' ability to credibly commit to the adoption of balanced financial policies. The disciplinary role of financial integration can thus alter the dynamic of domestic investments in an economy, leading to the allocation of capitals toward more productive activities, in response to macroeconomic policies. National governments are sometimes tempted to levy high taxes on physical capital, which discourages investments

and reduces economic growth. Integration can still self-sustain as an international process and can coerce governments to commit to such policies before financially opening themselves to foreign flows, since the negative consequences of these actions can be more severe in the context of financial integration.

Signaling: a country's wish to commit to financial integration may stand for a signal of adoption of more accessible policies targeting foreign investments in the near future. Thus, lifting restrictions upon capital repatriation may in itself lead to enhanced capital inflows, as was the case of a large number of countries: Colombia, Egypt, Mexico, Uruguay, as well as Italy, New Zealand, Spain, Great Britain.

Massive capital infusions may still generate an excessive expansion of the aggregate demand and macroeconomic overwarming, with negative effects upon the financial sector. Furthermore, microeconomic distortions may amplify the capital flows and their impact upon the economy.

Overwarming may manifest in the shape of inflationary pressures, the appreciation of the exchange rate or the growth of the current account deficits. Recent studies by the World Bank - carried out on a group of 20 developing countries that received massive capital flows - shows that during the '90's these countries managed to avoid the symptoms macroeconomic overwarming.[7]

Even when a certain economic variable moves in a direction similar to the one anticipated in the wake of the growing pressure upon aggregate demand, such behavior is not necessarily due to capital inflows.

An increase of the current account deficit was the general symptom of overwarming displayed by most of the countries from the study group. Responding to the open economy model, the current account deteriorated because of the growth in the percentage ratio between investments and consumption on the one hand and GDP on the other.

As for the impact of capitals upon the domestic financial sector, there is no doubt that capital flows affect the financial system that intermediates them. They have, per instance, two major effects upon the domestic banking system:

- Firstly, in a fixed exchange rate regime, the fiscal quasi-deficit - which includes financial transactions of the central bank and other financial public institutions that administer taxes and subsidies - grows as a result of a sterilizing policy through which national bonds with high profit rates are sold and foreign assets with lower interest rates are bought.
- Secondly, the financial system may become more vulnerable because of the increase of credit, thus exacerbating the decorrelation of terms - short/medium/long - between bank assets and liabilities, reducing the quality of loans. The growing appeal to bank loans represented a generalized result of capital inflows, while the vulnerability of the financial sector grew along with the credit costs until unsustainable levels were reached.

Microeconomic distortions can further exacerbate the negative impact of the capital flows upon economy, proving that a developing country may pass from a reasonable growth stage prior to an economic crisis to a stage of utmost activity decline after the crisis.

The fluctuations of the economic cycle in particular may be amplified - in the context of massive capital inflows- by the rigidity of prices and wages, the asymmetric information in the domestic or international banking sector, the faulty supervision and organization of financial institutions, unsafe capital markets, and reforms with a low level of credibility and applicability.

However, in recent years, some developing countries were capable of surpassing most of the symptoms of economic overwarming. Hence, not all the countries that experienced credit enhancement ended up by having a weak financial system; the

fluctuations of the economic cycle were also different from country to country. By means of the policies they implemented, some countries avoided the theoretical consequences of massive capital inflows.

In theory, capital flows migrate from the countries where they can be found in abundance to the countries where they are insufficient, due to the fact that the outputs offered by the new investment opportunities are greater where the capital is scarce. Such capital reallocation will lead to an investment growth in recipient countries and will generate significant social benefits.[8]

However, theory is accompanied by the specification that in certain circumstances (which do not necessarily constitute the general rule) capital outputs diminish when investments imply the construction of new infrastructure and installation of new technological equipments. Instead, new investments are more productive where skilled (or trainable) labor can be found and some infrastructure elements are already functional.

Thus, an interesting observation is that new capital flows tend to direct themselves toward countries that received massive flows of financial resources in the past, and where investors are convinced that they are welcomed by a propitious business environment. In this context, it is not surprising that capital flows to low income countries are in a steady decline.

3 Conclusions

Although economic theory and empiric investigations have a solid say with regard to the directions that the international capital is headed for, there are no definitive conclusions as to the impact of these flows. Once they enter a country, the private flows can determine either the growth of domestic consumption or investments, or the increase of the state's foreign reserves. If the flows are primarily influenced by stimuli related to tax evasion or the elusion of other legal barriers, money can leave the country as fast as they entered in the first place.

Despite this indistinctness, it is nonetheless certain that private capital flows have an impact on domestic investments, especially if they come in the form of direct foreign investments and of international bank loans. So far, research has anticipated a weaker connection between portfolio inflows and the growth of domestic investments.

When a country is poor and its domestic savings are small, a capital surplus from abroad may have a bolstering effect in carrying out the domestic investment. For example, recent research has shown that a growth of 1% for the capital flows to the countries of the African continent enhances domestic investments with more than 1%. However, the net value of the capitals directed toward Africa is low and generally limited to a number of countries that have important natural resources. Furthermore, because the investments' productivity is relatively small in many of these countries, the long-term impact of foreign capital upon development may be insignificant.

As a country becomes more and more integrated, both economically and financially, within the ranks of other countries, the percentage of the foreign capital influences investments to a lesser extent than in the past. This change can be explained in several ways.

Firstly, the capital flow structure changes with time. Direct foreign investments for "greenfield" projects are less and less called for, while mergers and acquisitions grow in importance, similarly to portfolio investments. The latter become more frequent and their presence in the overall capital flows has been steadily growing.

Secondly, in recent years, countries have used large parts from the capital flows to build foreign reserves, in response to ever larger liquidity necessities to guard against potential financial crises.

Thirdly, capital outings have increased in recent years. Although still not documented

clearly enough in international statistics, they have multiple causes: leakages of domestic capital abroad, "circular movements" performed with a view to evading domestic taxes and the diversification of investment portfolios by domestic residents.

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