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Discuss the implications short-term capital flows into emerging countries have on the financial stability and the economic development of those countries.

The impact and desirability of international capital flows on emerging markets' financial and economic development is a subject of extensive debate. The macroeconomic policies and the globalization of financial markets in developing countries have changed the dynamics of these flows. Prior to the 1990s, portfolio capital flows went relatively unnoticed because most foreign capital inflow to emerging markets took the form of direct investment. (Campion M K, 2001) However, with higher levels of portfolio capital mobility, the recipient countries' economies were affected. The overall impact of this new situation for recipient economies is however, rather ambiguous. On the one hand, capital flows provide countries with financial resources that help them bridge the gaps between domestic saving and investment, and between foreign exchange available and foreign exchange required; and they may also lead to more disciplined and coherent economic policies. On the other hand, the high volatility of short-term capital flows implies complications for macroeconomic management and permits greater vulnerability to changes in international investors' perception of country incentives and risks. Almost all of the countries affected by financial turmoil in the last few years had one thing in common – large ratios of short-term capital inflows, whether public or private. In each case, large short-term liabilities combined with relatively scarce internationally liquid assets resulted in extreme vulnerability to a confidence crisis and a reversal of capital flows. (Rodrik D & Velasco A, 1999)

This essay attempts to evaluate the impact of short-term capital flows into emerging markets, for which, it will highlight the concerned areas of financial market behavior. Some advantages and drawbacks of such capital inflows will also be discussed with reference to empirical evidence. Moreover, it will endeavor to determine whether unregulated capital flows are a feasible option for the stability and development of emerging economies. If not, an attempt will be made to come to a pertinent solution to this problem. However, before exploring the aforementioned aspects, it is necessary that the key terms of the essay is dealt with, namely "emerging markets" and "capital flows."

Broadly defined, an emerging market is a country making an effort to change and improve its economy with the goal of raising its performance to that of the world's more advanced nations. The 1980s and 1990s have witnessed the rapid rise in the significance of financial markets in most of the so-called newly industrialized countries. Stimulated by the rapid rates of economic growths in countries of South East Asia and Latin America, international investors favor emerging-market stocks and bonds because of the potential for high return in a relatively short period of time. However there is a great deal of risk involved in these investments because emerging markets are by definition in a state of transition and subject to unexpected political and economic disorders. The values of their stocks, bonds, and currency can change radically and without notice. (Pilbeam K, 1998)

At an early stage of development, domestic savings of these countries were often not sufficient to finance the investment needed to achieve capital accumulation and faster economic growth. Machinery and technology which contributes to productivity growth needed to be imported from abroad. The rise of private capital flows has however changed the conventional notion of foreign finance filling a given resource gap. A large part of these recent inflows has been motivated by the genuine, professed, or the probable relative macroeconomic conditions of countries, namely, differences in interest rates and expectations pertaining to future inflation and movements of exchange rates across different countries. Such flows are thus not specifically in response to the developing countries' needs (South Centre, 1999). Before discerning the development impact of foreign private flows, it is necessary to consider the different components of such flows.

These can be commonly classified as foreign direct investment (FDI), long term bank lending, short-term bank lending, and portfolio investment, all of which have an impact on the recipient economies in different ways. This essay is concerned with short-term capital flows, and will thus deal with the latter two, which are related to critical financial instability and represent more difficulties for macroeconomic management. (Rodriguez Y, 2000)

While the 1980's had commercial bank loans constituting the majority of the capital flows, the 1990's witnessed the rise in portfolio investments to both industrialized and developing nations. Griffith-Jones (1998) cited three main reasons for this transition. Firstly, financial deregulation and the rapid reduction of cross-border capital control. Secondly, the rise of mutual and pension funds stimulated an important growth of the international investing community. Financial intermediation enabled 'unskilled' individual savings to be managed more 'professionally.' Thirdly, technological advances in communication systems allowed electronic transfers of capital to be realized immediately. As cited in Griffith-Jones 1998, global capital flows grew from $910 billion to $1,175 billion between 1987 and 1993; but the outstanding element was in the composition of these flows. Portfolio investments increased far more rapidly rising from $134 billion in 1987 to $672 in 1993, while developing countries' share of these flows rose from 0.4% in 1987 to 12.5% in 1993.

Portfolio inflows may help finance a current account deficit, but there is no guarantee that they will contribute to substantial capital accumulation. As mentioned earlier, the highly volatile nature of these short-term investments presents grave problems for maintaining economic stability in emergent economies, creating particular problems for the balance of payments and exchange rate stability. The volatility is largely rooted in the herd-like behavior of investors, and the "contagion effect", whereby what investors do in one market often affects what investors do in another. Illustrating this effect, World Bank (1997), pointed out that when the Mexican crisis erupted, investors were not discriminating among emerging markets, and almost all of these economies experienced a sharp decline in portfolio flows. Furthermore, FitzGerald (1999), emphasizes that investors perception have a greater impact on capital flows than economic fundamentals. In his words, "shifts in international portfolio composition usually correspond to changes in perceptions of country solvency by international investors rather than to variations in

underlying asset value." Another cause for volatility of portfolio flows is "asymmetric and incomplete information." FitzGerald argues that recent progress in trading technology and financial integration has increased the amount of transactions and number of participants in greater proportion than the availability of information. Thus market participants are left with different expectations for price changes. In summation, it can be said that 'volatility or instability of short-term capital flows arises from the desire of investors to hold liquid assets in the face of uncertainty.' (FitzGerald 2000:1, cited in Rodriguez Y, 2000)

Thus, it can be said that investments are commonly undertaken based on expectations about the future behavior of other market participants and are rarely based on "genuine long-term expectation", because it implies more risk and requires more effort than just guessing the future reactions of the crowd of investors and the effect of their behavior on the prices of stock shares. (Keynes 1936, cited in Rodriguez Y, 2000) The speculative character of financial markets is derived from the way they are organized. Flexible asset prices make financial markets liquid, since assets can be liquidated at any moment if their prices are not assured. Thus investors are encouraged to undertake more risk, because they know that they can sell their assets in the short-term, before any uncertain changes take place. Clearly, this short-termism results from the purpose to be protected against uncertainty, and also to obtain quick profits under uncertain circumstances.

Concentrating on the impact posed by the short-term capital inflows into the emerging countries, as mentioned earlier, they have constructive as well as destructive outcomes. They primarily stimulate investment and growth by helping to bridge what Chenery and Strout called the 'dual gap.' (Chenery and Strout 1996, cited in Rodriguez Y, 2000) According to this analysis, foreign financing compliment domestic savings and help to bridge the gap between domestic savings and investment. Moreover, since inflows provide foreign exchange, they also contribute to reduce the difference between the foreign exchange generated by export and that required for imports. Furthermore, as pointed out by Griffith-Jones, FDI inflows have an advantage that it allows capital to stay in the country for long stable periods implying technology transfers and access to markets. Emphasizing on his prosper-thy-neighbor policy, Dr. Mahathir Bin Mohamad (1997), the Prime Minister of Malaysia said that when Japan invested in manufacturing in Malaysia, the country not only became prosperous but it also emerged as one of Japan's biggest markets. The trade balance was hugely in favor of Japan, and it reaped huge profits from its investments in Malaysia. Foreign Direct Investments had helped Malaysian per capita to increase by almost 1,000 percent over a period of 30 years. Moreover, the financial inflows tend to lower the cost of capital by pushing domestic rates downwards. Financial openness reduces "the costs of financial intermediation through enhanced competition and satisfies "demand for risk diversification." (Devlin et al, 1995 cited in Rodriguez Y, 2000)

However, capital inflows, in large volatile volumes may easily cause major changes in macroeconomic balances, which frustrate domestic policy and target for economic growth, inflation, and employment. They usually cause appreciation of the real exchange rates and increases prices of real estate and financial assets, moving them away from

what might be considered as their long-term equilibrium. (Rodrik D & Velasco A, 1999) Moreover, there is always a risk of sudden reversals, which are inclined to lead to serious financial difficulties for the country concerned building up high costs in terms of investment and output.

Evidently, it can be argued that the benefits posed by the capital inflows are subsequently over-shadowed by the problems it creates. In practice, financial liberalization, that was expected to benefit the financial global system, created conditions in which hedging operations and other speculative currency transactions gave rise to exchange rate instability and currency depreciation with disastrous economic consequences. Eatwell (1997) cited some 'expected' benefits that did not materialize. Firstly, financial liberalization aimed a better allocation of resources, moving capital from rich to poorer countries. Secondly, more opportunities for savers and lower costs for borrowers have been upset by higher real interest rates. Thirdly, the overall performance in investment and growth has not improved. Fourthly, the development of new instruments of investment (e.g. future contracts), created new systematic risks, instead of improving risk management. (Rodriguez Y, 2000)

Developing countries are still struggling to find their way in the global financial system. World Bank (2000) stated that past episodes of surges in capital flows to emerging markets have all ended in severe international financial crises. The large amount of capital inflows almost always comes as a package deal with financial instability.

Focusing the attention on financial crises, a series of them have occurred over the last two decades, and have seriously hampered the process of economic development. It almost seems that the developing world has just been moving from one crisis to the next. Latin America experienced its capital market crisis in December 1994, South East Asia faced its crisis in the summer of 1997, and then Russia troubled all financial markets in 1998. Losses of output, unemployment, bankruptcies, and currency devaluation have marked these crises. Mussa et al (1999) cited in Gentry S.B (1998), placed the value of cumulative output losses at 55-60 percent of GDP for Indonesia and Thailand, and 15 percent for countries less severely affected such as Mexico or the Philippines.

In each of these crises, the flow of financial capital was high and associated with extreme currency volatility. The peso, baht, and rouble crises had unique characteristics that resulted in distinctive capital flow interactions. The Tequila crisis was contained in Latin America and very few countries experienced significant withdrawals following the crisis. It was with the collapse of the Thai baht on July 2, 1997, that the contagion had spread to the neighboring countries of Malaysia, Indonesia and Philippines, and many other countries ending them up under waves of speculative attacks, that marked the famous Asian crisis of 1997. Asian economies were rocked by tumbling currencies and equity markets, resulting in International Monetary Fund-led bailouts for South Korea, Indonesia and Thailand that cost billions of dollars. Some economies, notably Indonesia, fell into recession and it was several years before the region generally recovered. However, the flight away from emerging markets peaked during the rouble's demise as

international investors shied away from Russia, Asia, and other European transition economies (Campion M K, 2001).

The crisis had brought downward pressures on the currencies of those countries that exhibit potentially unsustainable current account deficits, and especially those that have relied heavily on short-term borrowing. They witnessed sharp declines in stock market prices, with generally smaller stock market reverberations experienced in the advanced economies. Large exchange rate depreciations and falling equity prices had worsened financial sector fragilities in many countries, including most recently in Korea. Banking sector problems had also intensified in Japan, where the fragile economic recovery, was further undermined by spillovers from the crisis affecting many of Japan's Asian trading partners. (South Centre, 1999)

The crises only led to a fall in capital inflows into developing countries. The annual average of net private capital flows to these developing countries had counted for $20 billion between 1984 and 1989 (World Bank, 2000). This had risen to a maximum of $212 in 1996, but the post-Asian crisis saw a further fall by nearly 50% in aggregate terms, with 1998 and 1999 reaching the lowest levels of the decade.

Another grave impact of the short-term capital flows on emerging economies is the speculation it generates in the financial market. Liberalization schemes, particularly those promoted by the International Monetary Fund (IMF) and the U.S., are burdened with dangers and dilemmas for emerging market economies. As stated earlier, one of the most damaging consequences of liberalization is that it imposes upon emerging markets a set of unacceptable and ultimately unworkable exchange rate policies. In order to make the target country's assets attractive, the liberalization program insists on these countries to insure the investors against private financial loss. Governments are advised to permit full and free convertibility of their currencies into U.S. dollars so that investors can enjoy full dollar liquidity. This however proves to be incompatible with exchange rate stability. Once countries lift controls on short-term capital movements and allow full convertibility of their currencies, the process of exchange rate determination is privatized as well. Speculative trading comes to determine the external value of the currency - something over which emerging market governments exercise little control. (Frank E, 1999)

However, this speculative nature, leading to an inevitable currency crises, is misrepresented as internal failures of emerging market governments by the international policy officials. Governments like China, which prohibit trading in their currencies, can maintain a stable currency peg by preventing private transactions at an exchange rate other than the stated one. In contrast, countries that allow full convertibility have only weak levers by which to stabilize their exchange rates. Like Argentina, they can institute a currency board, which issues domestic currency only in proportion to foreign exchange reserves. However, the result of speculative assault on the currency, the futile and costly efforts by the government to hold the peg, is eventually an economic collapse. In the aftermath of the crisis, blame is ascribed: to the government for "overvaluing" its currency; to the IMF for delaying a bailout; to the markets themselves for excessive speculation. The fundamental incompatibility between a privatized financial system and a realistic exchange rate policy is rarely raised (Frank E, 1999). Dr. Mahathir Bin

Mohamad, the Prime Minister of Malaysia, addressing the annual seminar of the World Bank in Hong Kong, 20 September 1997, said that “We have always welcomed foreign investments, including speculation. They come in to buy shares and get out whenever they wish to. But when the big funds use their massive weight in order to move the shares up and down at will, and make huge profits by their manipulations, then it is too much to expect us to welcome them, especially when their profits results in massive losses for ourselves. When we say that we have the money to carry on with our big projects, they will make sure we won't have the money by forcing the devaluation of our currency.” He went on to say, that for almost half a century, the countries of East Asia have toiled day and night, to better the lot of their people. When Malaysia became independent in 1957, the per capita income of its five million people was 350 U.S. dollars. By June 1997, after 40 long hard years, the per capita of its 20 million people was almost 5,000 U.S. dollars. However, after the Asian crisis, all their efforts of years went down in drains. The poor became poorer, and everyone, including the government lost 20 percent of the purchasing power of the money they had. (Kidd D, 1997)

Thus it can be seen that the international financial system is not only unethical but is also dangerous to economic and ecological stability. When speculators attack the currencies of emerging markets, their losses is covered by the foreign exchange reserves of the target governments and by bailout packages arranged by the IMF. The target countries are obliged to replenish these reserves and to repay these bailout funds by selling what resources and labor they can mobilize. The world cannot long endure this state of affairs. International financial policy must be reformed.

Countries need to exercise control over their exchange rates in order to pursue internal development goals, yet at the same time, must agree to be bound by the economic needs of other countries. Exchange rate policy must be dictated by the demands of development and trade, not by the demands of creditors and private financial markets. This can be accomplished through the reinstitution of capital controls or through the establishment of a transaction tax to curb currency trading, as many have proposed. Controls and curbs are only partial solutions, however. By themselves, they can serve to isolate countries from needed international trade and financing opportunities. (Frank E, 1999)

Given the situation of financial crisis, it is necessary to examine the viability and appropriateness of such capital controls as a solution. Capital controls represents the policy of introducing some flexibility regarding the degree of openness of the capital account. They enable the local authorities to set optimal levels of openness, which can differ in different stages of development of the domestic financial system. (Rodriguez Y, 2000) Capital controls can be justified in various grounds. Reduction of balance of payments instability, undue exchange rate volatility, retention of domestic savings, prevention of foreign ownership of domestic factors of production, etc are a few to mention. However, in practice, capital controls have debatable effects. Some external imbalances have roots in sources other than capital movements and, therefore, the imposition of capital restrictions cannot be expected to mend the situation. (Sweeny J.R and Reis P.C, 1997) Malaysia recovered from the Asian financial crisis swiftly after the imposition of capital controls in September 1998. The fact that Korea and Thailand recovered in parallel has been interpreted as suggesting that capital controls did not play a

significant role in facilitating Malaysia's rebound. However, the financial crisis was deepening in Malaysia in the summer of 1998, while it had significantly eased up in Korea and Thailand (Rodrik D & Kaplan E, 2001). Thus, based on past experiences capital controls can be offered as a solution to crisis, depending upon the external environment of the country. However, such controls also have their own drawbacks which have raised issues in the past.

In conclusion, short-term capital inflows can be said to have grown faster than any other type of investment. The overall impact in recipient economies has been ambiguous. However, with reference to the recently experienced crises, large unregulated short-term flows have only proved to be volatile in nature, disturbing the economic and financial stability of the emerging nations. A clear pattern is identified, where short-term inflows are eventually reversed sharply causing currency crisis, banks and enterprises bankruptcies, dramatic reductions in output and economic activity in general. The benefits obtained by recipient countries were in many cases impaired by the dramatic outflows of capital. The expected progress to be brought about with financial liberalization was certainly not attained. Tobin (1997), cited in Rodriguez Y (2000), states that "experience has not, not yet anyway, vindicated current orthodox confidence that free global financial markets are the keys to global prosperity." Capital controls are proposed as a probable solution for developing markets in order to reduce the euphoria and the erratic ebbs, flows, and volatility of capital. What is essential is that policy negotiations keep sight of fundamental principles and remember that the financial system must serve the needs of the world economy, not the other way around. (Frank E, 1999)

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