PRIVATE SHORT-TERM CAPITAL FLOWS pdf

1: UNU-WIDER : Book : Short-Term Capital Flows and Economic Crises

Short-Term Capital FlowsÂ¤ Dani Rodrik Harvard University and NBER AndrÃ©s Velasco New York University and NBER May Abstract We provide a conceptual and empirical framework for evaluating the ef-.

Short Term Capital Flows, the Domestic Money Supply, and Bubbles November 24, Many writers on the Asian financial crisis write about how short-term foreign capital inflated the domestic money supply causing a bubble economy. Later, when the foreigners withdrew the capital, they caused the domestic bubble to burst. Therefore, they reason, foreign short-term capital movements are responsible for the Asian financial crisis. In this essay, I want to show that this tale is much to simple. It fails to account for the role of the domestic banking system. The American has saved many dollars. However, before he can purchase a share of Malaysian stock, he must convert his dollars into Malaysian ringgits. Let us see how this affects the Malaysian money supply. The Malaysian money supply, in its most basic form, consists of the face value of the paper and metal ringgits in circulation plus the deposits at banks that are available to depositors to be withdrawn or used to purchase goods on demand. When the American buys ringgits from a Malaysian, he does not increase the amount of ringgits in circulation. And when he buys the stock from a Malaysian, he causes his ringgit to be transferred to the seller. This in no way causes the amount of ringgits in circulation to rise. Thus, his transaction does not directly effect the Malaysian money supply. The Role of Banks There may, however, be an indirect effect. The seller of the ringgit may feel richer because he now owns dollars. As a result, he may mortgage some of his property in order to increase his speculation. In other words, he may transfer ownership of his property from himself to a bank. If the bank merely transfers ringgits that would have been owned by someone else to the mortgager, there is still no change in the money supply. However, if the bank thinks itself richer and decides that it can afford to make loans of new demand deposits, the result is an increase in the Malaysian money supply. In a similar scenario, a bank may create money for an apparently different reason. Let us suppose that the Malaysian decides to use his dollars to invest in the U. So he puts his dollars in an investment fund or mutual fund , based in Malaysia. The investment fund manager promises to buy a portfolio of U. As the fund grows, the manager turns to a Malaysian bank in order to help finance advertising. Believing that the fund has a strong foundation in U. Finally, a government central bank may perceive that the growth in domestically held foreign assets denominated in foreign currency warrants an increase in its own money supply. So it follows various well-known measures to allow banks to expand their credit and, in so doing, to expand the money supply. The Central Fact In each of these cases, we find one central fact. The Malaysian money supply cannot be increased unless Malaysian bankers increase their credit. Moreover, if the bankers were tightly controlled by the Malaysian central bank, there could be no increase in the basic money supply unless the central bank permitted this to occur. So far, we have been concerned only with the basic money supply. The picture is complicated when we recognize that the presence of near monies like credit cards and time deposits. But the fundamental phenomenon is the same. There could have been no bubble if Malaysian bankers had not expanded the money supply. It may be true that the bankers were inexperienced and made a mistake in granting the new credit based on what they believed was a larger increase in Asian ownership of assets than in fact occurred. It is evident, however, that flows of short-term capital as between countries cannot, by themselves, cause a financial crisis. The proposition that they can is simplistic and incomplete. It ignores the complexities of international finance in a world where different countries use different currencies.

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2: Hot money - Wikipedia

Capital flows refer to the movement of money for the purpose of investment, trade or business production, including the flow of capital within corporations in the form of investment capital.

Another noteworthy financial trend in the s was a substantial increase in the share of private sector borrowingâ€"especially by banksâ€"in total borrowing. An examination of syndicated loan transactions reveals that, in recent years, more than 42 percent of short-term syndicated loans to emerging markets has gone to financial institutions. Almost one-third of short-term syndicated debt has been contracted by commercial banks. Compared with a decade earlier, the shares of short-term debt contracted by oil and gas enterprises and government agencies decreased significantly, while that of financial institutions increased. Short-term lending by international banks increased rapidly despite a decline in the share of bank lending in total private debt flows to developing countries and the flat or declining indebtedness of developing countries relative to their export earnings and GDP. Shortening maturities The growth of short-term debt in the s seems to have accompanied higher incomes, stronger GDP growth, and greater openness to trade in borrowing countries. But these factors were only partly responsible for the surge in short-term borrowing. During this period, for example, Asian banks and financial institutions were borrowing heavilyâ€"and rapidly building up considerable short-term debtâ€"while fueling a speculative asset boom in Asia and elsewhere. Short-term borrowing from abroad was also encouraged by government attempts to support pegged exchange rates by sterilizing capital inflows, thereby keeping domestic borrowing costs high. In addition, short-term lending was driven by external, or "push," factors. Interest ratesâ€"especially short-term ratesâ€"dropped in the industrial countries in the s, causing an expansion in global liquidity; some of this encouraged short-term lending to developing countries. Rescues of banks during banking crises for example, in Sweden and Mexico, where short-term loans were rescued first may have created moral hazard, encouraging international banks to extend short-term loans, especially to banks in developing countries. Debt maturities may also have been influenced by Bank for International Settlements BIS regulations on minimum capital-adequacy ratios for international banks lending to countries that were not members of the Organization for Economic Cooperation and Development OECD â€"only 20 percent for short-term lending, compared with percent for loans with maturities longer than one year Table 2. Economic shocks One potential advantage of global financial integration may be the enlarged access it gives countries to international capital markets, which allows them to borrow to smooth consumption in the face of adverse economic shocks. Favorable shocks may attract large capital inflows and encourage consumption and investment at levels that are unsustainable in the longer term, and countries may be forced to overadjust to adverse shocks when capital flees. What is short-term debt? Short-term international debt is defined as cross-border debt with a maturity of one year or less. There are currently two conventions for defining short-term debt. The Bank for International Settlement BIS uses the "remaining maturity" conceptâ€"that is, all cross-border debt falling due within one year is counted as short-term debt, regardless of its original maturity. Short-term capital flows appear to be procyclical in developing countries, increasing when economic growth is cyclically faster and declining when growth rates falter. Based on data for 33 developing countries during , the elasticity of short-term debt with respect to GDP is about 0. In other words, the rate of decline of short-term debt during an adverse shock is twice as high as its rate of increase during a positive shock. In contrast, the analysis suggests that medium- and long-term debt may be weakly countercyclical to GDP shocks. Table 2 Why maturities of bank loans to developing countries were shorter in the s Policy-induced distortions and cyclical influences versus structural factors.

3: Volatile international capital flows in emerging economies / Employment / Blogs - The Broker

Opening up to capital flows, usually from a starting point where long-term investment flows are tolerated more than short-term flows, is referred to as "capital account liberalisation". After a period from to in which developed countries imposed tight restrictions on capital flows, a policy of liberalisation was pursued from the s.

Avinash Persaud, State Street Bank. Ms Tran-Nguyen argued that with globalisation, the international financial system has become private sector-driven. The nature of private capital flows has changed in the s, with foreign direct investment FDI and foreign private investment FPI playing a more important role than syndicated bank lending. Widespread removal of barriers to foreign investment, falling transportation and communication costs have allowed trans-national corporations TNCs to globalise their production across countries. Together, TNCs and institutional investors control increasingly large amounts of assets that they can move around globally in search of high profits. The predominant role of the private investors in the allocation of financial and productive assets is now a permanent feature of the world economy. According to Ms Tran-Nguyen, the result of these developments have been: While a small number of emerging market economies have access to private sources of finance, the majority of developing countries have to rely mainly on dwindling aid money. Massive inflows of private capital into emerging markets are frequently followed by sudden reversals. Mexican , Asian , Russian Recent crises have tended to be shorter compared to the debt crisis in the s, due to the higher share of FDI and portfolio equity flows, which are more stable than bank lending, and equity tends to flow back into the crisis-countries while asset prices are low. However, there is also a systemic threat in portfolio investment if investors, such as hedge funds, are highly leveraged and rely on bank loans to finance their investments. Ms Tran-Nguyen stated that this situation has brought a number of challenges for developing countries, namely: The Report of the Secretary-General on Financing for Development contains a number of recommendations, which Ms Tran-Nguyen believes address these challenges: Ms Tran-Nguyen concluded with some policy recommendations for addressing the volatility of private flows: However, developing countries may find it difficult to comply with these requirements and may need a special and different treatment. Moreover, source countries should share responsibility in ensuring financial stability e. Governments should retain the right to apply disincentives or controls on capital flows, particularly short-term flows, in times of capital surges or during severe crises. Concerns have been raised about the pro-cyclicality and contagion sensitivity of sovereign ratings by credit rating agencies. The Secretary-General Report encourages credit rating agencies to rate sovereign risk according to criteria that are as objective and transparent as possible. Borrowing developing and transition economies are also encouraged to give priority to the development of reliable local systems of credit information. Mr Persaud concluded that the recurrent suggestion that emerging markets should eschew portfolio flows and focus mainly on FDI flows because of the lower degree of volatility of the latter is not supported by his study. He argued that equity flows should be encouraged together with FDI flows. Bond flows, in contrast, represent the most volatile form of portfolio flows, behaving like bank-lending flows. This occurs because of the common interest of those investors in the conservation of their capital, which makes them pull out if, for example, they fear currency devaluations. Therefore, the benefit for developing countries of following the G7-IMF suggestion of deepening bond markets is highly questionable. On the other hand, equity investors are interested in the long-term evaluation of the enterprise they have invested in. Particularly in cases where investors own a slice of a real asset, especially if the asset is placed in the external sector of a foreign country e. Rather than introducing convoluted changes to bond contracts, a more effective way of ensuring private sector participation and burden sharing would be to encourage the deepening of equity markets in emerging markets. Globalisation during the last 10 years has been much stronger in terms of cross-border portfolio flows than in trade flows. In terms of GDP, the former is now six times higher than the latter. Since the mid-nineties, the equity-bond ratio has risen considerably. Until less than a decade ago, the importance of equity and bond markets generally lay in the domestic and international respectively. Today, equity flows are higher than bond flows for the first time ever. The composition of international capital flows has changed. In terms of unhedged flows, bond-holders tend to hedge their position while equity holders do not. Today equity flows are twice the size of bond flows. This has led to a change in the evaluation of markets from an emphasis on indicators and aggregates related to currencies in the emerging market world and their current accounts the real yield etc. The policy debate is about what flow is best for countries. As a result, deepening of bond markets in developing countries is advocated. However, for at least three reasons, the current policy debate is framed incorrectly: Therefore, the policy issue is about the optimal utilisation and management of the flows available. Nevertheless, other types of capital, such as equity portfolio flows, should not be discouraged. Moreover, the issue about the degree of volatility of cross-border capital flows is rather complex and often difficult to gauge. Retained earnings from FDI investment are usually a strongly volatile component of international capital flows as they are moved according to exchange rate expectations e. South Africa, April Mr Persaud presented the results of his analysis on capital flows from Europe into the US over the period January to October Mr Persaud argued that in order to assess the inherent nature of different forms of capital flows, it is necessary to analyse cross border flows among developed countries with large, broad and deep financial markets. Indeed, whereas some middle-income countries have very deep markets, other economies, particularly in Sub-Saharan Africa, either possess only extraordinarily thin markets or lack them altogether. Therefore, according to Mr Persaud, the correct methodology is to extract sound information from the study of capital flows between developed markets, enabling the provision of valid advice to developing countries on how to make optimal use of capital flows with distinct features. A comparison of portfolio equity flows from Europe into the US with portfolio debt flows over the period monthly data , showed that bond investors reacted more nervously to shocks originated in equity markets e. Moreover, portfolio flows, both bonds and equity, were more volatile during compared to Capacity building in poor and small economies for creating broader and deeper local stock markets. Genuine capacity building is necessary and important. Although countries have been building up their stock markets during the s, there is unfortunately a complete lack of liquidity in these markets. Usually, investors display trend-chasing behaviour, leaving when prices start falling and entering while they are rising, but in overseas investors bailed out from smaller and illiquid emerging markets even when they were doing well preference for liquidity. In the case of Chile, for example, one third of shares are quoted on the NYSE, while the domestic stock market is highly illiquid and unattractive to investors. A global stock market might emerge in ten years time. How to capture equity flows? One must ensure that larger local companies can compete in international markets because they are using international accounting standards, prudential controls and governance. Smaller companies cannot do that, so venture capital has to be encouraged, by involving banks in venture capital, with local companies being quoted in foreign markets rather than in the domestic market. Why not an international institution as a credit rating agency? A credit rating is the transmission of information about a borrower at a certain point in time. As a commercial rating is a private rating on private borrowers it would not be credible if performed by an international financial institution. Nonetheless, the IMF, for example, issues ratings on sovereign borrowers. Although the IMF criticises private agencies because their ratings tend to be procyclical, there is a tendency for convergence of this information. It would not be proper for the UN to intervene in rating-activities because they are private and have to be left to private markets. However, there is problem of oligopoly in the credit-rating market, with agencies giving similar ratings. Emerging markets should establish their own credit rating information, which is credible enough to compete with the international rating agencies that provide additional information. Rather, it would be a case of natural monopoly, where investors want to use a rating agency which everyone else uses, reflecting the consistent view on that corporate credit or country credit. However, international institutions should get involved in credit ratings, since the markets always get ratings wrong. The core of the problem is not a lack of information which does exist but that financial markets are ineffective at predicting crises. The question should be why the market chooses to misinterpret or simply not consider certain information. It is here that a non-market institution could help in offering an objective view of credit rating. Bond market volatility and exchange rate policy. In South Africa, bond-markets were particularly volatile and represented the main conduit for international contagion, as opposed to equity flows. Probably a structural change took place in South Africa around mid, when the country was hit by a crisis through contagion from

Indonesia and Russia. The government spent a considerable amount of foreign reserves in trying to defend the domestic currency but lack of success led to an abandonment of the policy of attempting to maintain a stable exchange rate. A stable exchange rate policy attracts bond flows, while equity investors prefer floating exchange rates, which stimulate competitiveness of enterprises in the host countries. Moreover, bonds are usually domestic currency-denominated assets, while equities of successful exporting businesses even if not a commodity business are a hard currency asset and thus more protected. The implication of this line of argument is the avoidance of a pegged or fixed exchange rate regime in the case of countries with large bond markets. Suggestions were made on the suitability of intermediate exchange rate regimes in some countries. Volatility seems to be over-rated as a problem. This is especially true if the issue is seen in light of maximising quantities and if one can get the right sort of capital. If quantity rather than volatility is considered, one gets a different answer. The suggestion made was to work at a joint measure, using volatility and quantity. Doubts about interpreting data for Europe into the USA for general conclusions. Considering the period of the study presented by Mr Persaud, one would probably get different results by considering a longer period e. Therefore, even if it were true that equities are better than bonds, the choice would actually be between bond and FDI, and such a comparison might give a different answer. The weights on bond, equity and FDI flows would thus be very different in the case of emerging markets. Analysis of composition of capital flows according to their functions. In the discussion on composition of capital flows, it was felt that more emphasis is needed on the function of different capital flows in borrowing economies e.

4: Private capital flows and foreign direct investment | Overseas Development Institute (ODI)

The nature of private capital flows has changed in the s, with foreign direct investment (FDI) and foreign private investment (FPI) playing a more important role than syndicated bank lending. Widespread removal of barriers to foreign investment, falling transportation and communication costs have allowed trans-national corporations (TNCs) to globalise their production across countries.

In the beginning of , the national average rate of one year certificate of deposit in the United States is 0. Given this situation, if an investor in the US deposits his or her money in a Chinese bank, the investor would get a higher return than that in the situation in which he or she deposits money in a US bank. This makes China a prime target for hot money inflows. This is just an example for illustration. In reality, hot money takes many different forms of investment. The following description may help further illustrate this phenomenon: In the next destination, capital inflows create a boom that is accompanied by rising indebtedness, rising asset prices and booming consumption - for a time. But all too often, these capital inflows are followed by another crisis. Short-term foreign portfolio investments , including investments in equities , bonds and financial derivatives Short-term foreign bank loans Foreign bank loans with short term investment horizon The types of capital in the above categories share common characteristics: Although the specific causes of hot money flow are somewhat different from period to period, generally, the following could be considered as the causes of hot money flow: The lower interest rates in the developed nations attract investors to the high investment yields and improving economic prospects in Asia and Latin America. Emerging market countries began to adopt sound monetary and fiscal policies as well as market-oriented reforms including trade and capital market liberalization. Such policy reforms, among others, have resulted in a credible increase in the rate of return on investments. As described above, hot money can be in different forms. Hedge funds , other portfolio investment funds and international borrowing of domestic financial institutions are generally considered as the vehicles of hot money. Capital flows can help developed countries achieve a better international diversification of their portfolios. Especially, when capital flows in volume into small and shallow local financial markets , the exchange rate tends to appreciate, asset prices rally and local commodity prices boom. These favorable asset price movements improve national fiscal indicators and encourage domestic credit expansion. These, in turn, exacerbate structural weakness in the domestic bank sector. Inflow of massive capital with short investment horizon hot money could cause asset prices to rally [5] and inflation to rise. The sudden inflow of large amounts of foreign money would increase the monetary base of the receiving country if the central bank is pegging the currency , which would help create a credit boom. This, in turn, would result in such a situation in which "too much money chases too few goods". The consequences of this would be inflation. Furthermore, hot money could lead to exchange rate appreciation or even cause exchange rate overshooting. This is especially so in countries with relatively scarce internationally liquid assets. There is growing agreement that this was the case in the East Asian Financial Crisis. In the run-up to the crises, firms and private firms in South Korea, Thailand and Indonesia accumulated large amounts of short-term foreign debt a type of hot money. The three countries shared a common characteristic of having large ratio of short term foreign debt to international reserves. When the capital started to flow out, it caused a collapse in asset prices and exchange rates. The financial panic fed on itself, causing foreign creditors to call in loans and depositors to withdraw funds from banks. All of these magnified the illiquidity of the domestic financial system and forced yet another round of costly asset liquidations and price deflation. In all of the three countries, the domestic financial institutions came to the brink of default on their external short term obligations. Different countries are using different methods to prevent massive influx of hot money. The following are the main methods of dealing with hot money. If the currency is believed to be undervalued, that would be a cause of hot money inflow. In such circumstance, economists usually suggest a significant one-off appreciation rather than a gradual move in the exchange rate , as a gradual appreciation of the exchange rate would attract even more hot money into the country. One downside of this approach is that exchange rate appreciation would reduce the competitiveness of the export sector. For example, on December 16, , the

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Turkish Central Bank surprised markets by cutting interest rates at a time of rising inflation and relatively high economic growth. Erdem Basci, deputy bank governor of Turkish Central Bank argued that gradual rate cuts were the best way to prevent excessive capital inflows fuelling asset bubbles and currency appreciation. For example, in China, the government does not allow foreign funds to invest directly in its capital market. Also, the central bank of China sets quotas for its domestic financial institutions for the use of short-term foreign debt and prevent banks from overusing their quotas. In the face of large net capital inflow, those countries would intervene in the foreign exchange market to prevent exchange rate appreciation. Then sterilize the monetary impact of intervention through open market operations and through increasing bank reserves requirements. This would put upward pressure on the value of the yuan. In order to prevent the appreciation of the Chinese currency, the central bank of China print yuan to buy US dollars. This would increase money supply in China, which would in turn cause inflation. Then, the central bank of China has to increase bank reserve requirements or issue Chinese government bonds to bring back the money that it has previously released into the market in the exchange rate intervention operation. However, like other approaches, this approach has limitations. The second, in the emerging market economies, the domestic financial market is not deep enough for open market operations to be effective. Martin and Wayne M. Reinhart and Vincent R. Caballero, Guido Lorenzoni, Persistent Appreciation and Overshooting: International Monetary Fund, March

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5: Capital flows and growth | World Finance

Abstract. The operations of the Eurodollar market have had a substantial influence on both the volume and the nature of private short-term capital flows in the U.S. international accounts on the one hand, and on the character of international dollar liquidity held by foreigners on the other.

Top 5 trade deals that changed history Whether cross-border movement of capital brings about real economic benefits is a controversial topic. These views are so different they could be describing the economies of different planets. The values of major currencies and assets may remain distorted for years or subject to excess volatility under the influence of speculative capital flows, causing misallocation of resources in the real economy In the parlance of economics, movements of funds in and out of a country are recorded in the balance of payments. Funds related to trade of goods and services, and interest on debt, go in the current account. Funds related to investment go in the capital account. After a period from to in which developed countries imposed tight restrictions on capital flows, a policy of liberalisation was pursued from the s. Subsequently, the IMF and other multilateral bodies pushed for a similar policy on less-developed nations. Free capital movement The view of many mainstream economists is that freedom of capital to cross borders to invest in physical assets, stocks, bonds or other financial contracts is fundamentally good. Firms and investors can allocate long-term investment to where it will yield the greatest return, leading to a faster rate of economic growth globally. Less-developed countries benefit most because â€" provided they get basic structural conditions right â€" they are where the most unexploited opportunities lie. Short-term flows of capital in and out of different regions, meanwhile, serve to iron-out inconsistencies in the pricing of assets. This ensures that investors face a consistent picture globally and can see what things are really worth, enabling them to make the most effective choices. Other observers take a different view. One criticism is that capital flowing across borders chases is not a real, tangible economic opportunity, but rather a perceived opportunity. Thus, capital may flow into a country because of a speculative bubble underway there or an over-hyped view of economic prospects. This inflates asset prices and the domestic currency, attracting still more foreign capital in a self-perpetuating process. Some of the funds may be used for useful investment, but much may be squandered on property speculation or credit-based consumption, including consumption of foreign goods made cheap by an over-valued currency. Eventually, some investors realise what is happening and withdraw. Seeing this and the effect it has on the price of assets, others also withdraw. The result is a stampede of funds out of the country. The consequences can be devastating. The currency may collapse far below its equilibrium value, triggering import-driven inflation and making it difficult to purchase essential supplies from abroad. Banks may collapse if they had not hedged their exposure to extreme currency movements, or if depositors seek to withdraw and convert domestic currency that is plummeting in value. Domestic borrowers may default on foreign currency debts that are now insupportably expensive, particularly if they had not hedged exchange rate risk or if the crisis destroys banks that had provided the hedge. Domestic firms may find it impossible to get trade finance denominated in major currencies. Ultimately, these developments lead to losses or insolvency for domestic firms, mass unemployment, a downward spiral of aggregate demand and a deep recession. The values of major currencies and assets may remain distorted for years or subject to excess volatility under the influence of speculative capital flows, causing misallocation of resources in the real economy. Markets may withhold funds from a country pursuing publicly funded programmes to improve social and economic conditions, sending the money elsewhere because investors tend to believe that state activism is generally undesirable. Conversely, foreign firms building facilities in a country or foreign investors gaining control of a domestic company by purchasing equity in it, may not be sensitive to the needs of the local society and economy and may behave in ways that actually undermine growth. It is clear that there are potential costs and benefits associated with a policy of free cross-border capital movement. Level headed analysis is required to determine whether the costs or the benefits are greater. Letting the data speak The scientific method entails analysing data collected carefully from experiment or observation, developing theories to explain this data and testing these theories using more data. Economics, for a subject that claims to be a science, often puts too much emphasis on theory and not enough on data. It is important to redress this imbalance by using statistical evidence to try and settle economic controversies. In this regard, it is informative to compare the evidence relating to free trade in goods and non-financial services to that on free movement of capital. A study published in by the National Bureau of Economic Research NBER in the US examined twenty-four developing countries that adopted, relatively suddenly, a new policy of trade liberalisation at different times between and Taking data on GDP growth between and , the average rates of GDP growth before and after trade liberalisation were computed for each of these countries. The data showed that 12 countries obtained a clear benefit from liberalisation in terms of faster economic growth, six neither gained nor lost, and six suffered slower growth after liberalisation. Another study, by US academics, examined 10 Asian economies and found that trade liberalisation produced gains of between 0. A different study examined seventeen developed and developing economies and found that eliminating trade barriers produced one-off gains, realised over a few years, ranging from 3. The conclusion seems clear: By contrast, a study published by the IMF in looked at an index of capital account openness and how it changed positively or negatively for a panel of seventy-five countries over the period It then compared this to the average rate of economic growth of these countries over the same period. A simple examination of the experience of advanced industrial economies that are members of the OECD supports this conclusion. In , 80 percent of such countries had capital controls. By , only five percent still had them. The average rate of economic growth for such countries, meanwhile, was 4. The decline in growth was due to the disappearance of structural factors that had been beneficial in the s and s adoption of a backlog of technologies delayed by the war, rapid progress in science and technology, favourable demographics, post-war rebuilding, a restoration of trading networks and cheap oil. Nevertheless, it seems clear that capital account liberalisation had no great effect in reversing the slowdown. The case of financial derivatives presents a similar picture. The volumes in existence of some classes of these instruments has grown thousand-fold since the s, driven by improving computer and communications technology and a need on the part of financial institutions to manage risk in more volatile markets. Yet, if the wider economic benefits of these contracts were as great as is sometimes claimed, surely we would have noticed by now? Other studies, however, have produced different results. A paper published in by academics at Georgetown and Villanova universities in the US examined a panel of ninety-four countries from or their date of independence to They computed an index of capital openness and compared it to rates of economic growth for these countries, in the process controlling for the effects on growth of such variables as education and quality of government institutions. The result was a weak but consistent association between capital account openness and rates of economic growth. So, in contrast to free trade, which substantially boosts economic growth in most but not all cases, we must conclude that free capital movement has either no effect or a weak positive effect on rates of growth. Trends and risks These studies focused on trend rates of growth. But other considerations also matter. The most obvious is economic stability. Analysis published in by academics Kenneth Rogoff and Carmen Reinhart looked at the percentage of countries experiencing banking crises in any year, weighted by percentage of world income, between and Between and , the average proportion was about 10 percent, peaking above 40 percent during the Great Depression. Between and â€” the era of capital controls â€” there were no significant banking crises anywhere in the world. And, between and , the average was above 10 percent. Estimates of excess mortality, due to cuts in government social programmes and mass unemployment in a setting where the social safety net was weak The same structural factors noted above as benefiting growth in the s and s technology, cheap oil probably also contributed to stability: However, at other times and places, rapid growth has led within a decade or less to over-enthusiasm, speculation and instability. That this did not occur in the period seems likely to be due, in part, to capital controls and strong financial regulation more generally during these years. A good example of how volatile capital movements can contribute to economic instability is the experience of emerging market economies in the late s and early s. In Thailand, strong economic performance over many years caused an influx of foreign capital, leading to a bubble in commercial property. The bubble began to burst from early summer and capital flight from the country began. Thai authorities attempted to maintain their long-standing fixed exchange rate with the dollar but they failed and the peg broke in July This caused investors to panic about the region more generally and to withdraw capital. Indonesia, which had many of the problems common to emerging economies but which was otherwise well balanced, was hit hard. Its currency fell 60 percent against a trade-weighted basket of other currencies and its GDP fell 12 percent. Estimates of excess mortality, due to cuts in government social programmes and mass unemployment in a setting where the social safety net was weak, ranged from tens to hundreds of thousands. The capital flight subsequently spread to Argentina â€” which had a history of financial mismanagement and instability â€” and Russia. At this time, the massive New York hedge fund Long Term Capital Management LTCM had been betting a narrowing of the spread in yields between the government bonds of developed countries and those of emerging markets. When Russia defaulted on some of its sovereign debt and its bond yields jumped accordingly, LTCM was driven towards insolvency and â€” because it had borrowed heavily from US banks â€” its weakness threatened the financial system as a whole. Limited benefits The evidence is reasonably clear: Even under a system of capital controls, it is mainly short-term investment that is restricted while long-term investment is welcomed as are special kinds of short-term finance, like trade finance. However, allowing for this distinction, it is clear that capital controls may have a place in the policy mix.

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6: Private capital flows - OECD Observer

9 Private Short- Term Capital Flows and the Eurodollar Market RAYMOND F. MIKESELL Introduction THE operations of the Eurodollar market have had a subÂ-.*

Developing and emerging countries have a long history of vulnerability to large and volatile short-term capital flows. The last decade has seen a new wave of such flows of unprecedented size and fickleness. Moreover, the nature of these capital flows has changed. Rather than foreign currency denominated assets, foreign investors, such as international banks and funds, have become increasingly exposed to short-term domestic currency assets. These include domestic currency bonds, equities and alternative asset classes such as derivatives and indeed the currency itself, as in the notorious carry trade phenomenon. In that case, investors borrow in low interest rate currencies like the Japanese Yen to invest in high interest rate currencies like the Brazilian Real, South African Rand or Turkish Lira. As a result, foreign investors have been able to profit from both domestic financial returns and exchange rate movements. According to mainstream authors and international organizations like the International Monetary Fund IMF , these changes should reduce the vulnerability of developing and emerging countries to volatile capital flows, as the countries are able to borrow in their own currencies. In a forthcoming paper with Juan Pablo Painceira we argue that this has not been the case. On the contrary, we show that these structural changes have maintained, if not exacerbated, the external vulnerability of developing and emerging countries, for several reasons. Causes First, foreign investments in domestic currency assets, funded on international financial markets, create a currency mismatch for foreign investors. This makes them very sensitive to or unexpected exchange rate changes, increasing the volatility of their investment decisions. This volatility is exacerbated by an increasing share of assets aimed at generating returns from capital gains, which can be easily wiped out when domestic or international market conditions change. Finally, as mentioned above, in the case of domestic currency assets, the exchange rate becomes a crucial element of international returns. This importance, in turn, creates the risk of destabilizing feedback and bubble dynamics, if expected or unexpected exchange rate gains are validated by large capital flows in thin financial markets. Returns from capital gains, which can be easily wiped out when market conditions change, contribute to the volatility of these capital flows. Consequences The consequences of these volatile capital flows have been sustained appreciations of domestic exchange rates, interrupted by sudden and sharp depreciations as investors reverted to international financial markets. These adverse exchange rate movements, in turn, had devastating consequences for industrial production and employment. Moreover, whereas the industrial sector suffered, the financial sector reaped substantial gains from volatile asset prices, worsening income distribution. Measures The dangers of volatile capital flows and excessive exchange rate movements have not remained unacknowledged by international organizations such as the IMF. Indeed, in an apparent U-turn, the IMF has recently endorsed some form of national capital account regulations. These measures should be temporary, levied primarily on inflows rather than also on outflows, and follow a clear, unified path across all developing and emerging countries. Recommendations Although an important step, we argue that these measures do not go far enough. Rather than temporary, national capital account regulations should be imposed as a permanent measure to shield developing and emerging countries from the vagaries of international financial markets. These measures, imposed by the governments of these countries, should also include controls on supposedly long-term capital flows, such as FDI, which can be short-term portfolio flows in disguise. Identifying these and the risks created by foreign investments require a detailed microstructural analysis of specific financial markets of these countries. In particular, our paper suggests identifying the specific locus of exchange rate determination to avoid the adverse exchange rate dynamics discussed above, and regulations that require foreign and domestic investors to fund themselves on domestic financial markets to avoid destabilizing currency mismatches in their balance sheets. These measures, we argue, should reduce the vulnerability of developing and emerging countries to volatile capital flows and help foster a domestic accumulation process which draws on domestic rather than international savings. This process has to be accompanied by targeted industrial policy to create a well-diversified and productive economy which generates decent employment for everyone. Photo credit main picture:

7: Finance & Development, December - The Role of Short-Term Debt in Recent Crises

Private capital flows to developing countries were about US$ billion in , about a third of official aid flows. By the s they were generally larger than the aid flow, and they rocketed upwards in the s, peaking around US$ billion in

8: Brazil Net Capital Flows | | Data | Chart | Calendar | Forecast

private capital flows and investment, savings, and the current account, Note: The bars in this chart are computed coefficients representing the change.

9: Short Term Capital Flows, the Domestic Money Supply, andBubbles

The model also specifies the circumstances under which short-term debt accumulation is socially excessive. The empirical analysis shows that the short-term debt to reserves ratio is a robust predictor of financial crises, and that greater short-term exposure is associated with more severe crises when capital flows reverse.

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