Chapter 10

Modern Trends in Capital Flows in Emerging Markets

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ABSTRACT

This chapter provides an evaluation of the influence of the most significant external and internal factors on international capital flows in the form of direct and portfolio investments for 24 developing countries during the period 1990–2015. The authors have adopted the partial adjustment model and the feasible generalized least squares estimator for panel data. Results show that the determinants of capital flow for foreign direct and portfolio investments differ. The impact of political risks on cross-border capital flows has been identified.

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INTRODUCTION

International capital flow plays a central role in the global economy, affects the macroeconomic policy, but also brings some benefits and risks for recipient countries. However, in contrast to labour and natural economic resources, historically, capital can move and accumulate quickly. In the last decades, in search of profitable areas of application, capital has rushed to developing countries, whose share in the international capital flows has grown significantly. Thus, these countries have become not only importers but also exporters of capital. Despite the fact that in absolute terms the biggest part of financial flows is concentrated in developed countries, this distribution also depends on the financial stability of emerging markets (EM) which are particularly vulnerable to market fluctuations caused by inflows or outflows of foreign capital. After the global financial crisis 2008-2009, countries with EM faced unprecedented volatility in capital inflows. Before the financial crisis, developing countries policymakers feared that excessive capital inflows could provoke an economic overheating. However, they have been concerned about a reduction in capital inflows or even its net outflows in recent years.

The main challenge for the entire developing world is to deal optimally with the challenges of economic growth in conditions of the volatility of capital flows. It is common knowledge that the influx of international capital into a country stimulates economic growth through investment financing, with which new technologies arrive and, due to the increased income, a higher level of household consumption is provided (Obstfeld, 1998; 2009). Moreover, capital inflows contribute to a better diversification of asset portfolios of developing countries. However, a surplus of capital may be accompanied by adverse macroeconomic effects, such as an intensive increase in the money supply, excessive strengthening of the national currency in real terms, and inflationary pressures.

Determinants of capital flows can be grouped into 2 categories: External and internal factors to the economy in which capital flows. External factors stimulating the influx of international capital in developing economies are: Capital surplus and its relative cheapness (lower interest rates on borrowed capital), lower gross domestic product (GDP) growth rates, higher taxes and labour, raw materials, energy costs, purchase or lease of land, and, as a result, the lower efficient use of capital, reflected in the stock indices of developed countries. Low interest rates in developed countries make investments in countries with EM more attractive. The impact of this effect is strengthened if the developing country is interested in external borrowing and low global interest rates ensure its greater solvency. Internal factors that affect capital flows include political risks, availability of economic resources (labour and natural resources) and their value, the capacity of the domestic market, higher GDP growth rates, lower taxes and labour, raw materials, energy costs, purchase or lease of land.