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The movement of capital from the emerging markets to the United States: An analytical view

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Abstract

The world has indeed become smaller in the terms of finance. Today, the investors are able to invest in other economies (due to open economies and liberalized policies) to receive a “Risk adjusted return” for their investment. The financial crisis of 2008 (and of before), have taught a lesson to the investors across the globe to look for safe and liquid assets. This has not only resulted in an increased capital flow in the global arena but also presented an intellectually stimulating scenario to the world.

We characterize the patterns of capital flows between rich and poor countries. Neoclassical economic models predict that capital should flow from capital-rich to capital-poor economies. However, Robert Lucas in 1990s wrote a Research paper on the inverse capital flow stating that capital flows from poor to rich countries. We find that, in recent years, capital has been flowing in the opposite direction, although foreign direct investment flows do behave more in line with theory. My objective in this paper is to find out the reason (by an analytical approach) behind the Paradox.

Keywords: Movement of capital, emerging markets, United States

Introduction

Capital, an input of the production function, is the fulcrum of production. Production of goods and services is the Nexus of growth. In other words, enhancement of capital or the productive efficiency of capital leads to economic growth, and further economic development, thus stating the importance of capital in an economy and more importantly in a developing economy.

The neoclassical economists predicted that capital should flow from rich to poor countries; under the standard assumption that - countries produce the same goods with the same constant returns to scale production function and with the same factors of production – capital (K) and labor (L). Thus if capital were to be freely allowed to flow, the returns to investment in any location should be the same.

However, Robert Lucas, Nobel laureate, wrote a paper (in American economic review) in 1990s regarding the movement of capital from poor to rich countries. Lucas compared the U.S and India in 1988 and found that if Neoclassicals were true, the marginal product of capital in India should be about 58 times that of the United States. The scenario (in 1998) was not as per the theory, thus motivated Lucas to question the validity of assumptions such as – quality of labor and political risks – that gave rise to the difference in marginal productivity of capital.

Ever since Lucas wrote his paper, the world has moved rapidly towards a financially globalized economy. The emerging markets have become much more integrated into the international financial markets for various reasons. However, with the escalation of financial integration the paradox has also strengthened. The Private investments have flown generally in line with the theory i.e. flowing from rich to poor countries. But the pattern of the overall flows is what is relevant in terms of financing the investment in the economy.

Various research papers have drawn respective findings over time. Gourinchas and Jeanne (2006) ^[3] argued that within a group, capital should flow in greater amount to countries that have grown the fastest i.e. countries that have the best investment opportunities. However, Rajan, Prasad and Subramaniam (2006) ^[7] show that over the period of 1970 – 2004 as well as over sub periods, the net amount of foreign capital flowing to relatively high growth development countries has been smaller than that flowing to the medium and low growth countries.

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They further argue that countries that heavily relied on foreign capital grew slower than the other countries.

Therefore, the major questions that arise here is why does capital move from Emerging markets to advanced countries? And does it affect their Economic growth?

The rest of the paper is structured as follows. In section II we discuss the financial integration and its various aspects. In section III we try to examine the reasons behind the Paradox. In section IV we conclude.

The financial integration deepened in the 1980s and 1990s as the investors across the world looked for higher risk adjusted returns. Also during that time, many countries opened their economies to encourage inflows of capital by dismantling restrictions and controls on capital outflows, deregulating domestic financial market and liberalizing restrictions on Foreign Direct Investment and moved towards market oriented reforms.

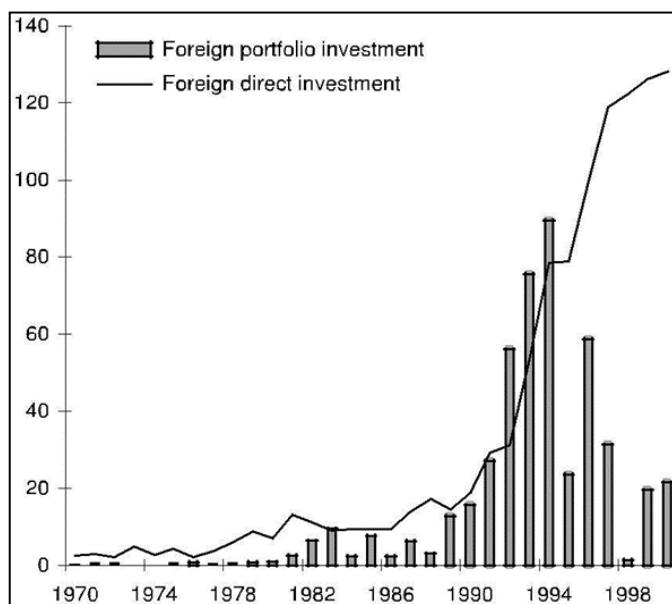


Fig 1: Net Flows of Investment to Developing Countries, 1970 –2000 (in billions of US dollars) Data source: The International Monetary Fund

As shown in Figure 1, foreign direct investment to developing countries started growing in the 1980s and expanded at an accelerated rate after 1990, whereas portfolio flows (which consist of equities, bonds and certificates of deposit) increased until the mid-1990s – reflecting, in effect, the increased incidence of financial volatility and currency crises in the last few years. At the same time, bank-intermediated flows fell significantly in proportion of total flows. Short-term, cross-border capital flows have also become more responsive to changes in relative rates of return, as a result of technological advances and increased linkages among capital markets.

Despite Financial crisis, the emerging markets have continued to remove restrictions on capital flows across

their borders and are experiencing rising flows both into and out of their economy. This reflects the confidence emerging markets policy makers that their economies are less vulnerable to the crisis sparked by external factors.

But even benign capital flows can heighten Domestic risks, inflation, Asset booms and social instability. To prevent all the above, Emerging markets reach out for ‘SAFETY’.

The Wall-Foreign Exchange Reserves

The Demand side

The emerging markets in order to safeguard their fragile economies build massive Foreign Exchange Reserves. These foreign exchange reserves are stock of hard currency (such as dollars). It has been noticed that after the financial crisis, the emerging markets have spent billions of dollars to build (massive) reserves. They help these economies to curtail any appreciation in their currency (which would hamper their export), give a layer of insurance against any forthcoming crisis or bad days, help to fulfill an economies debt obligation and help to pay for imports, if financial investors were to withdraw. Reserves managers have to contend with a variety of risks (credit, liquidity, market and currency) to their investment. Being able to liquidate a large volume of assets at short notice is crucial for reserves to be credible as a defensive mechanism to scare off currency speculators. Typically, only government debt of the major advanced economies has these characteristics of liquidity and safety.

The Supply side

Financial crisis of 2008 has not only affected the demand side but also the supply side of safe assets. In 1983, 32 non financial companies in the US had a credit rating that rated AAA. Today just 4 non-financial corporations retain the coveted status – Microsoft, Johnson & Johnson, Exxon Mobil and Automatic Data Processing. During the 1990s most advanced economies had AAA rated government debt. The worsening of public deficit and debt situation of many of these economies had AAA rated government debt at the end of 2007. By early 2012, this function had dropped to about half, cutting into the supply of safe sovereign debt.

Result

After the crisis, the price of safety has gone up in tandem with the higher demand and lower supply of ‘safe assets’. Government debt of a small set of major advanced economies especially – US treasuries, German bunds, and Japanese government bonds – now accounts for the safe assets.

Therefore, the emerging markets build reserves in hard currencies and purchase US government bonds, as these are highly liquid and safe, thus contributing to the movement in capital from poor to rich countries (which amount to 5.6 trillion dollars).

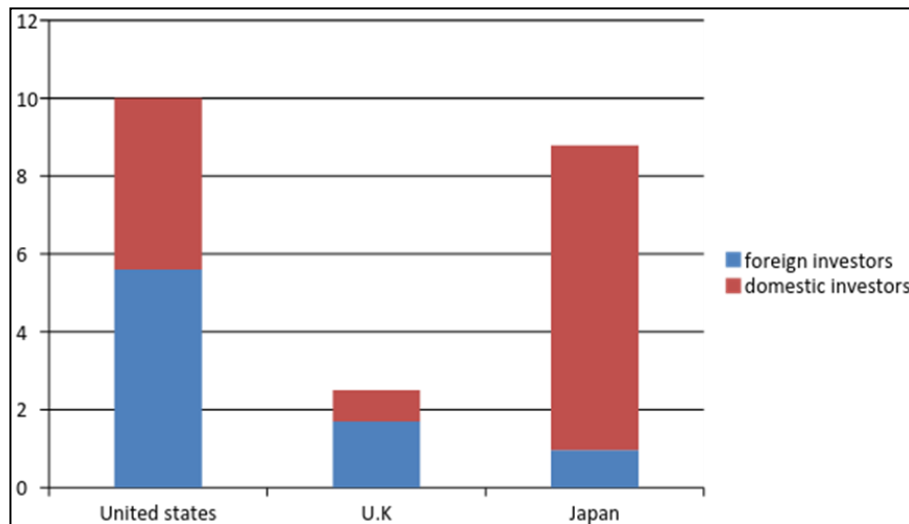


Fig 2: Data sources: - U.S Treasury Department; Bank of Japan; U.K office of Debt Management

Notes: - Data shown are for December 2012. For the U.S., the net debt concept used here is “privately held Debt,” which excludes intra government debt holdings as well as the Fed’s holdings of Treasury securities.

Why are American bonds Safe?

The foreign investors take a calculated risk on their investments in the U.S. bonds. The political economy implications of the ownership are interesting. More than half of net privately held debt is owned by foreigners certainly makes it a lot less painful for the U.S. to inflate away the value of its debt. But it does not do so, because the remaining portion that is held by domestic investors is a sizable amount of over \$4 trillion.

match retirement age. These funds change the balance of investments over time from more risky ones like equities to less risky ones like government bonds and high grade corporate debt issued by corporations that are perceived to be highly unlikely to default. Such funds usually have 40-50% of their investments in these highly rated fixed income investments by the target date.

These numbers suggest the domestic holders of Treasury debt are potent voting and lobbying blocs. Older voters tend to have a high propensity to vote. Thus, Insurance companies as well as state and local government would clearly be unhappy about an erosion of the value of their holdings of Treasury securities.

The situation creates an interesting balance of interests from a political economy perspective. Foreign investors know that they would be on the hook for a major share of the losses in the real value of treasury debt if the us decided to inflate away some of its real debt obligations. The degree of pain that would be suffered by the domestic holders of the debt, who have considerable political influence, makes it less likely that inflation would be seen as a viable way to reduce political debt.

In short, the profile of domestic holders of US treasury debt renders it politically difficult to use inflation to pay down the debt. High inflation would not be politically acceptable in the U.S. and it could be difficult to put the inflation back in the safe once it is unleashed.

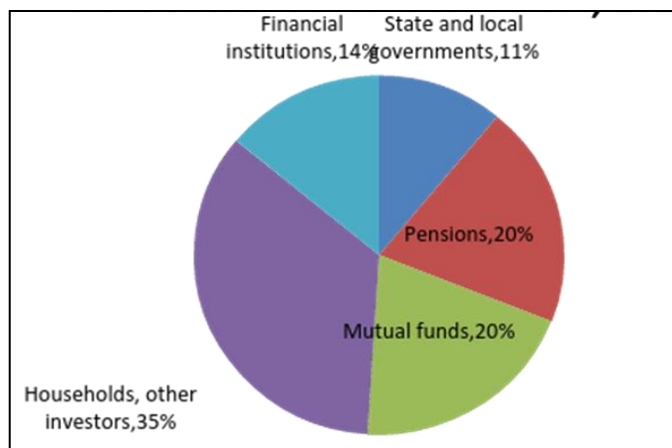


Fig 3: shows the breakdown of the domestic holdings of net privately held debt in the US.

Data source: Table OFS-2(Ownership of Federal Securities), US Treasury Bulletin, June 2013.

Treasury securities constitute an important part of individual investment portfolios, either directly or through mutual funds and pension funds. Retirees and those approaching retirement tend to be more conservative in their investment choices, preferring safety and a low return rather than risky investments. These funds automatically adjust investors’ portfolio over time until a target date that is usually set to

Conclusion

My findings suggest that the emerging markets across the globe accumulate massive reserves to safeguard themselves from the financial crisis. Since, a multibillion dollar reserve is bound to various risks, the central banks invest in advanced economy’s government bonds (especially the United stated) to keep their money “safe and highly liquid”, which in turn results in capital movement to advanced economies

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