

# Emerging Markets and the Volatility of International Capital

## *A Historical Perspective*

### 2.1 Introduction

We are seeing a reconstruction of the truly global economy, similar in many ways to that which existed in the period before World War I. As in that period, we expect that this global system will give rise to convergence among the economies that are open to it. There are two key mechanisms of such convergence: technology transfer and capital flows (interconnected in an important way).

Unlike the period before World War I, these movements are taking place among sovereign states, rather than between an imperial core and periphery. Such capital flows and transfers of technology create difficult questions, both for the sovereignty of the states which receive them, and for the international institutional structure in which the states are embedded.

### 2.2 The Closing and the Re-opening of the Global System

This re-opening is a relatively new historical phenomenon. From 1918 to the 1960s there was a closing associated with

- ❖ the collapse of the international trading system
- ❖ inward-looking macroeconomic policies associated with financial repression, international capital controls and currency inconvertibility
- ❖ microeconomic policies: 'state building'
- ❖ mercantilist trade policies and protectionism
- ❖ 'big push' industrial policies

Keynes (1933, p 236) summarised the intellectual beliefs which supported these policies:

*"I sympathise with those who would minimise, rather than with those who would maximise, economic entanglements between nations. Ideas, knowledge, art, hospitality, travel – these are the things which should by their nature be international. But let goods be homespun whenever it is reasonably and conveniently possible; and, above all, let finance be primarily national."*

It turned out that Keynes was mistaken: with homespun goods and national finance, ideas could not be international. These two policies institutionalised technological backwardness in present day developing countries.

Protection created an inward-looking manufacturing sector, small-scale and fragmented, with none of the benefits of scale and dynamism associated with freer trade. Paradoxically, therefore, protection priced manufactures out of world markets and so enforced precisely that dependence on exports of agricultural staples which protectionism was designed to avoid. Thus protectionist policies produced a developmental roadblock.

By contrast, trade liberalisation causes every enterprise to know that it has to compete in an open international environment. This makes the enterprise sensitive to developments elsewhere in technology, management and market trends, and it encourages rapid adjustment to change. Firms know that to survive they must adopt the world's best practices, and so take care to inform themselves on and compare themselves with the world's best practices. Capital imports both provide the new technology and information (in the case of direct investment) and also bring firms into international system, with accompanying monitoring and benchmarking of their

performance (in the case of foreign portfolio investment in domestic equities).

Even stock markets, for which Keynes used the metaphors 'casino' and 'beauty contest', turn out to be good for economic growth, and a primary factor in the healthy development of stock markets is opening up to foreign investors (see Sec. 6.1).

### 2.3 Capital Flows after Trade Liberalisation

Partly because of growing recognition of these positive effects, liberalisation of capital flows – and their explosive growth – has followed trade liberalisation. In the first half of the 1990s, capital flows have come to resemble in both quantity and composition the 'golden age' before World War I. Securitised debt and direct investment have been dominant. Private flows to developing countries averaged \$1.2 billion a year between 1961 and 1970 and \$3.8 billion a year between 1971 and 1980 (Cuddington, 1989). Following the 'lost decade' of the 1980s, lending exploded: aggregate net long-term resource flows to developing countries rose to \$46 billion in 1990, \$103 billion in 1992 and \$173 billion in 1994 (World Bank, 1995). This flow of funds had a major impact on the recipient countries: for Mexico net capital inflows averaged six per cent of GDP in the first half of the 1990s. Initially, much of the lending went to Latin America and East Asia; since 1990, however, South Asia and some countries of Sub-Saharan Africa (Kenya, Tanzania, Uganda) have also experienced substantial capital inflows.

The capital inflows to emerging markets reflected four factors. Most fundamental was economic liberalization and reform in the developing world. In addition to opening goods and capital markets, developing countries improved their macroeconomic policies, emerging from the debt crisis of the 1980s with a firmer grasp on fiscal conditions and with inflation under growing control. Privatization created new opportunities for financial capital. The

economies of East Asia moved up the technological ladder toward the production of higher value-added goods.

Second, reforms encouraging capital transfer took place in developed as well as developing countries. By the late 1980s, thoroughgoing deregulation of financial markets became widespread. Trade liberalization had made capital controls more difficult to enforce: importers and exporters could over- and under-invoice transactions and exploit 'leads and lags' to circumvent restrictions on capital flows. New information technologies and the globalization of financial markets made the restrictions needed to close off domestic financial markets more costly. The authorities could not deregulate banking systems while continuing to prohibit banks from borrowing and lending abroad. Nor could they encourage the development of a stock market, in order to capture financial business from regional rivals and offer domestic firms attractive sources of external finance, so long as foreign investors were barred from participation.

Third, rather than turning the capital markets away, the debt reduction afforded by the Brady Plan also encouraged new capital flows to the middle-income developing countries that benefited from it. Between 1990 and 1993, countries participating in the Brady Plan were able to reduce their debt loads significantly by exchanging their floating-rate bank debt for bonds that bore below-market interest rates and by discounting the original loans. The subsequent rise in the secondary-market prices of the remaining commercial bank debts indicates that the markets perceived a significant improvement in these countries' creditworthiness.

Finally, since 1989, monetary policies in the capital exporting countries have for the most part favoured capital flows to emerging markets, which are highly sensitive to the level of global interest rates. Lower rates in the financial centres stimulate investors to search for higher yields abroad, and they enhance the creditworthiness of developing-country borrowers by reducing the cost of servicing existing debts. Cohen and Portes

(1990) demonstrated a strong inverse relationship between US interest rates and the secondary market prices of developing country debt. Notice that this last relationship goes both ways. By raising interest rates in 1994, the Fed increased the yield and attractiveness of domestic securities and heightened the debt-servicing burdens of countries like Mexico with substantial short-term obligations outstanding. Indeed, Dooley *et al.* (1996) argue that a repeat of this rise in industrial country interest rates, if sufficiently pronounced, would probably stop and even reverse capital flows to developing countries.

The composition and type of lending has changed. In the 1970s lending had been directed primarily at governments, while private foreign borrowing in developing countries was still tightly controlled. Between 1990 and 1993, however, more than 80 per cent of all long-term private capital received by developing countries flowed to the private sector (Fernandez-Arias and Montiel (1996), Table 3). In practice, the line between private and public debts is not that easy to draw, in view of the implicit guarantees that governments extend to parastatals and private enterprises. But it is clear that there has been a major shift in composition. In part, this

has been a consequence of the wave of privatisation and financial liberalisation that were from the outset an integral part of the policy reform process.

In the 1970s bank loans and direct foreign investment had been the principal conduits for private capital transfer to emerging markets. Starting in 1989, securitized investment finally regained the prominence it held in the 1920s and the period up to 1913. The use of bonds and other securities as vehicles for redistributing financial capital internationally was particularly important for developing countries. The turn away from financial repression and the conscious efforts to develop securities markets paid off. The volume of foreign capital that flowed into developing countries' bond markets rose by a factor of ten between 1989 and 1993. Investment in emerging stock markets rose in parallel over the period, again by a factor of ten. Information flows improved, and managers of major institutional portfolios sought diversification: Since the stocks and bonds which they bought were relatively liquid (they could be sold as easily as they had been purchased) capital inflows could now be reversed much more easily.