ASPECTS REGARDING HISTORICAL EVOLUTION OF INTERNATIONAL FINANCIAL FLOWS

Lecturer PhD. Carmen BOGHEAN
camibog@yahoo.com
Lecturer PhD. Florin BOGHEAN
bogflorin@yahoo.com
The Faculty of Economic Sciences and Public Administration,
Ştefan cel Mare University of Suceava, Romania

Abstract:
The capital, under all its forms, is probably the economic resource with the highest degree of mobility in the economic context of the new millennium. The capital flows are nowadays common presences on international circuits and also on national, intersectorial or intrasectorial direction. Not just the volume of the capital flows and their motion speed are in a permanent ascendancy, but also the easiness with which they transform (direct investments, portfolio investments, bank and non bank credits, bonds) according to the characteristics of the host environment and the interest towards the holder's profile.

Key words: financial globalisation, international financial flows, financial crises.

JEL Classification: D53

INTRODUCTION

If in the first half of the past century and in biggest part of the second half, the first coordinate – the one of the national economy through inter and intrasectorial transfers- was the dominated one, and the „stars" of international changes and flows were the merchandises and services, in the last decades the international circulation of capitals represents the type of cross border transaction that registers the most rapid growth.

At the same time, if in the past the capital flow was understood only as a financing form of the current account, nowadays, the international distribution of capitals determines more and more the exchange course and the international rates of the interest that, on its turn, influences the evolution and the structure of the international trade.

During the last 20 years, the capitals flow met an extraordinary development, the transaction costs diminished, and the allurement of capitals makes nowadays the object of a more and more intense international competition. Ever since, the liberalization measures became indispensable in engaging foreign capital, in order to ensure the integration in the international economy and promote the development of a competitive financial sector.

1. HISTORICAL EVOLUTION OF FINANCIAL FLOWS

From the historic point of view, we can talk about for the first time about systematic and significant international flows of capital from the second half of the XIX - th century, when more governments and rail road companies emitted bonds with fixed interest mainly on the capital market of Great Britain, and also on the capital markets in France and Germany.

Subsequently, at the end of the XIX-th century, the direct foreign investments, especially those coming from the USA, began to compete from the value point of view with the portfolio investments. In the same period, the international flows of capital exceeded as importance the commercial ones, fact that coincided with the moment in which capitalism became a worldwide economic system.

After the end of the First World War that produced a discontinuity in the evolution of the financial flows, in the years 1920, the combination of direct foreign investments and portfolio investments progressed positively, being aimed especially towards the USA and Europe. The great depression of the years 1930 made that such international investments to diminish in a significant way, their place being taken by speculative capital movements that meant to carry out the evolutions of the currency courses.

At almost one decade from the end of the Second World War, in the years 1950, the international capital flows reappear under the form of direct foreign investments and later, of the international financial markets. This time, the main form of the international capital flows was that of loans with variable interests, in comparison with the previous periods when predominate the bonds with fixed interest.

The system of Bretton-Woods induces, for a long period of time, the so called Triffin paradox, according to which the international liquidities can only grow in conformity with the deficit of the American external balance of payments and the weakening of the dollar. But for a short period of time, the American capital exports evolved in a way converse towards the evolution of the internal cycle characteristic to the USA, and that attenuated the negative repercussions at an international level. After turning to the system of flexible exchange rates, this adjuster mechanism is more and more weak, because of the „blow up" of the short term capital movements, but also because of the influence the speculative operations had on the exchange courses. (Brakman, S., Garretsen, H., 2006)

The development of the operations specific to the international capital flows is carried out through certain specific institutions, according to the nature of the carried out operations (investments or loans). In the case of short or long term portfolio of investments the used institutions are banks or stock exchanges. In the case of the international operations with short term capital connected to the valorisation of the differences of currency, the used markets are the currency ones. The international currency market is the biggest market in the world, its volume being able to exceed 1,5 trillion dollars per day and the main present feature of this market is the strong movement towards Internet that is supported by all the important banks in the world. (Stolnik, B., 2000) In the case of the direct foreign investments we can not talk about certain specific markets, but only about specific operations developed by investors in another country than the resident one. As some promoting agencies of the foreign investments are made of significant facilitators of the foreign capital flows towards the receiver country, they can be considered the „equivalent" of some markets.

The internationalization (globalization) of the financial markets does not mean only the coverage of the entire globe with a services network, but also the integration of these markets at a global scale. In this context, capitals gain an unseen before mobility, their transfer being carried out through pressing some computer buttons. The development of the financial markets determined and a meaningful growth of the transactions volume that exceeded the international trade of goods and services. If in the past the majority of the financial transactions were correlated and determined by commercial exchanges, in the present, between the two types of flows appeared a detachment.

As part of the global financial markets, the capital flows have as source private and state companies, and also international organizations. These organizations can come from the system of the Organization of United Nations (The International Monetary Fund) or can be cooperation organisms or interstate economic integration such as the European Union or the North- American Free Trade Agreement. (Divecha, A., et al. 1999)

Of course, if in the case of the international organizations the generated capital flows have a smaller share and are generated on the basis of certain well defined and relatively slow mechanisms, the flows generated by the private companies have a much bigger share, and also a bigger mobility.

If to the commercial international flows (of goods and services) participate all the countries of the world, we can not the say the same thing about the measure of applying them to the international flows of capital. The participation to the worldwide economy through investments or external loans of capital is characteristic only to those states that reached a high level of development.

In the present, the transactions on the most important financial markets exceed the value of the international trade with goods and services. Thus, many economists believe that we witness a new phenomenon: the two sides of the worldwide economy- the real one (goods and services) and the financial one (symbolic or nominal) tend to be less interdependent. (Levich, R.M., 2000)

The international financial flows are the result of the capitalism development on a superior scale. There is at least one critical dimension in which the international capital flow before 1914 differs a lot from what we see nowadays, with important implications for, periphery (countries in a process of development). In order to see this comparison we must make the difference between the net and gross international financial assets flows.

A gaze over data reflects the fact that the difference between net and gross was very important in the last years, but absolutely with no importance in the globalization era before 1914. The reason is simple. In the last part of the XIX-th century, the main financial flows were the investments of long term capital, unidirectional. There was one exception to take into consideration: The United States of America, where the capital inflows and outgoes were high. But in most cases, the key creditor inflows, especially in Great Britain, but also in France and Germany, engaged to finance other countries in order to gain more capital. Thus, they developed a one way position in their portfolio.

In 1914, the share of the Argentinean assets in the portfolio of Great Britain was very high, but through comparison, the Argentinean holding of British assets were minor. Thus, the XIX-th century was under the sign of international assets diversity through the main creditor, nations such as Great Britain. At a first approximation, the total amount of assets and the position of bond were very close to net in that far away period.

The years 1980 and 1990 are obviously, very different. For example, The United States of America became in this period the biggest net debtor in the world. But while being responsible for the biggest national stocks of gross foreign bonds, The United States held also the biggest stocks of gross foreign assets. In the period after the war and until recently, the net capital flows among countries became smaller than before 1914, but there was bigger volume of assets in the purpose of diversifying / sharing risk. (Obsfeld, M. Alan, M. Taylor, 2005)

In which concerns the orientation of the international financial flows, the most important flow remains the North- North one but in the last years there must be mentioned the apparition and intensification of the South- South flows, as a consequence of the cooperation among the Arabian countries, exporters of oil and the developing countries, flow that, in the last period of time surpasses as dynamics the North-North one.

The world economy can be seen as an amount of the connections between the economic activities developed at a large scale. In the present, the way in which people from a country on the globe obtain and spend their incomes, the way in which they make savings and transform them in wealth are related to the people's incomes, expenses and savings from other countries. Sporadically, such international connections existed even in the preceding centuries but, in the contemporary worldwide economy these connections extended their coverage area, they intensified and changed their nature at scale with no precedent.

On the other side, the economic conditions of each country are strongly influenced by the development of the world wide economy. This correlation is felt through the international trade, through the world wide production and the international financial relations. Other important connections that connect the economies of different countries in a global entity- worldwide economy- are represented by the mobility of the labour force and the diffusion and the international transfer of technology. Even if these connections connect each country to the world wide economy, it must be underlined the fact that they do not produce uniform results, in consequence the economic growth is not uniform, in each period some countries developing more than others. The direct foreign investments became in the last years the most important source of external financing for the developing countries and even an important financing source for the developed countries.

Many companies do not limit themselves only to the import and export of goods and services but, they find it appropriate the forming of permanent enterprises in foreign countries. There could be a few reasons for such an action: for ensuring the safety of deliveries, it could be more profitable for the company to produce by itself the products than to by them from the local producers or it could be "empire- building" (gaining the control over certain projects and initiatives on order to hold the control) from the part of the company management. (Institute of International Finance, 2009)

There are certain advantages of producing in other countries: cheaper production factors (especially labour) that could facilitate the manufacturing of the product for the needs of the present market. In the second phase, the local production replaces the exports, but there is, usually a third phase in which the goods manufactured in a foreign factory are exported in other countries from the region or even back in the origin country of the company.

Most developing countries have taken advantage of favourable external conditions to implement domestic policies designed to reduce their vulnerability to financial turmoil and reversals in capital flows. In particular, countries have reduced their external debt burdens and lengthened the maturity structure of their debt. Several have bought back large amounts of outstanding debt, using abundant foreign exchange reserves, and refinanced existing debt on more favourable terms. The market for sovereign debt has evolved significantly, as governments debt turned from borrowing externally to borrowing domestically, usually in local currency. Creditors` assessment of creditworthiness of developing country borrowers remains positive, as reflected in spread on emerging market bonds and bank loans, which have hovered near record lows. By these measures, most developing countries have clearly improved their ability to deal with moderate shocks that may accompany changes in the international credit environment.

2. FINANCIAL FLOWS IN EMERGING MARKETS

The as we see already the 1970s marked the beginning of a new era of financial globalisation, the likes of which have not been seen since the period running up to the First World War. By the mid-1990s, increased global liquidity, the liberalisation of trade and capital accounts, and the search for high-yield investment opportunities caused private sector capital flows to the developing world to vastly surpass levels of official sector development aid.

We need however to define what we understand by an emerging market. Strictly speaking the concept as we understand it in the article is related to the countries included in JP Morgan's Emerging Markets Bond Index (EMBI), produced since the mid 1990s. However if we take an historical point of view, some of the most well known emerging markets of today were quite developed and sophisticated economies in early 1900s: Argentina for example ranked by that time as one of the most developed countries and the United States looked by the early years of the 20th Century as the pure prototype of an emerging economy. Even today some of the most established OECD countries are hard to classified: Turkey, South Korea and Mexico are all emerging economies and also OECD countries while some have been arguing that European or OECD countries like Greece could be classified as emerging economies.

But even the notion that emerging markets are also economies that have specific propensities to suffer economies crises is also questionable This diagnosis is in some ways less straightforward than sometimes is assumed because it is not a priori clear whether recent crises are more frequent or deeper than in the past, or just triggered more readily. Like in the past, serial defaulters continue to be alive, the massive historic default of Argentina in 2001, for example, being the fifth of a long series of defaults. Historically, they are not only occurring in emerging markets, although during the 20th Century they became less frequent in the more advanced economies. Sudden stops of capital flows and financial crashes abound, even if during the past decade they remained below the historical average. Political cycles and financial crises continue to go hand-in-hand in emerging markets and asymmetries of information continue to play an important role. (Nieto and Santiso, 2007). The main reason is that, despite all the structural changes since the earlier period of high capital mobility, the potential sources of cyclical variability in capital flows remain the same: divergent macro-economic conditions in capital-exporting and capital-importing countries, and crises in individual capital-importing countries

Curiously, emerging markets (EM) countries – the subset of developing countries most integrated in the system of global finance – are now receiving more private capital than they can effectively employ, making them net capital exporters to the United States. One might well expect such abundant access to foreign capital to bode well for EM economic growth and financial stability. However, the long-term growth effects of financial openness for emerging markets remain a matter of academic debate. Whatever the answer, it is clear that EM countries have often paid a high short-term price for relying on foreign capital, as a long list of EM financial crises attests. We can 'think of capital flows as a medicine with occasionally horrible side effects. (Rodrik, D. 2002)

The role played by private capital markets and financial institutions in generating the occasionally horrible side effects' of global capital flows warrant greater attention. The prevailing literature and policy discourse place too much blame either on the EM countries or on policy failings of the official and multilateral sectors. Suggested reforms to the global financial system to date have focused largely either on institutional and policy changes required of EM countries or on international crisis-resolution procedures which would only come into play once a crisis is already well under way (Roubini and Setser, 2004).

The modern era of financial globalisation has at least two notable features: first, the high volatility of financial flows for EM countries and frequency of financial crises; and second, the fact that it has largely bypassed low-income developing countries. Regarding the second point, we can describe the curious pattern of today's global capital flows as primarily a 'rich–rich' affair and contrast it to the pre-1914 era when capital flowed mainly from rich to poor countries, and in far greater amounts relative to saving and investment.

FDI comprises the largest share of total private flows to EM since the mid-1990s, the rest comprising portfolio equity and debt, commercial bank lending, and other instruments such as trade credit and derivatives. Not surprisingly, FDI has been significantly more stable than non-FDI private capital flows: based on the Institute of International Finance's data, the standard deviation of annual changes in FDI inflows to EM countries from 1978 to 2005 is 0.25 versus nearly 9.0 for non-FDI flows. (Institute of International Finance, 2006)

FDI to be significantly less volatile than bank lending or portfolio flows. Correspondingly, FDI is widely viewed as having positive long-term productivity and growth effects for developing countries, even among scholars who argue against the benefits of other types of capital flows.

3. CONCLUSION AND PERSPECTIVE

World growth is moderating and financial markets are signalling a turn in the financing conditions facing the developing world. As these developments make themselves felt, 2008 is likely to be a year of adjustment for capital flows to developing countries. After recovering from the sharp contraction of 2001-20002, private flows weathered several episodes of global volatility and passed through a full cycle of global monetary easing and tightening to reach a record level of 647 billion dollars in 2007, up 17 percent from 2006. Total capital flows, including lending by official creditors, levelled off at 5 percent of GDP in 2005-2006, just below in 5.25 percent level reached in 1995-1997, before the East Asian crisis.

Developing countries have come to account for a large share of the growth of word output and trade, a fact that in increasingly recognized by international investors. Their economies grew more than 7 percent in 2007 – more than twice the 3 percent rate of growth in high-income countries. The expansion was particularly evident in China, where output increased 10.7 percent, and India, which grew 9.2 percent. But the strong performance was broadly based, with all developing regions growing al least 5 percent.

With almost half the year over, it is clear that net private capital flows to emerging economies in 2009 will be down substantially from 2008. Net flows are now projected to be about $141 billion for the year as a whole, less than half of the $392 billion estimated for 2008, and far below the record level of $890 billion in 2007 (The institute of International Finance, 2009). Our new estimate for 2009 is down somewhat from the last one in January, which was for $165 billion. Estimated flows for both 2008 and 2007 have also been revised down, however, so the underlying change in our forecast is not that material. In a sense, this lack of a significant further downward revision is encouraging, sine it implies a degree of stabilization in flows following a phase of sharp deterioration, especially in the months immediately following the disorderly failure of Lehman

Brothers in mid-September 2008. This stabilization is indeed evident in a whole series of high-frequency indicators, including both asset prices and available weekly and monthly data on capital flows to emerging economies. Following a phase of net outflows between October 2008 and March 2009, flows to emerging markets appear to have improved somewhat over the past two months, albeit to levels far below the early months of 2008 (and certainly well below those of 2007). This recent dynamic in capital flows mirrors what we believe is happening in the broader global economy. Following six months of alarming decline, measures of global output are now contracting more slowly. This stabilization in turn reflects a huge degree of policy stimulus - both monetary and fiscal - put in place across the global economy in recent months. In aggregate, global growth is likely to resume later in 2009 and continue, albeit at a very moderate pace through 2010.

The return to positive growth seems to be happening earliest and most decisively across a number of large emerging economies, especially in Emerging Asia and, to a lesser extent, Latin America, which is helping bolster confidence in flows - especially portfolio equity flows - to emerging markets. Net portfolio equity inflows are expected to strengthen by about $118 billion, net, in 2009. In line with these relative global business cycle trends, net private capital flows to emerging economies are projected to revive in 2010, to be about $373 billion, net. The main turnaround is expected to come from debt-related flows, attracted, in part, by the persistence of wide nominal interest rates differentials between emerging and mature economies.

REFERENCES

1. Brakman, S., Garretsen, H.,(2006) *Nations and Firms in the Global Economy, An introduction to International Economics and Business*, Cambridge University Press.
2. Divecha, A., Drach, J., Stefek, D, (1999) *Emerging markets: A Quantitative perspective*, Journal of Portfolio Management New York.
3. Levich, R. M., (2000) *The importance of emerging capital markets*, Working Paper, Stern School of Business, New York University.
4. Nieto, S. and Santiso, J. and (2007), “The Usual Suspects: Investment Banks’ Recommendations and Emerging Markets,” *OECD Development Centre Working Paper, 258*, January.
5. Obsfeld, M., Alan M. Taylor, (2005) *Globalization and Capital Markets*, Working Paper, 8846.
6. Rodrik, D. (2002), ‘Who Needs Capital Account Convertibility?’, in *Should the IMF Pursue*
7. *Capital-Account Convertibility?*, Princeton Essays in International Finance 207 (Department of Economics, Princeton University).
8. Roubini, N. and B. Setser (2004), *Bailouts or Bail-ins? Responding to Financial Crises in Emerging Economies* (Washington, DC: Peterson Institute for International Economics).
9. Stolnik, B, (2000) *International Investments*, Fourth Edition, Addition-Wesley Publishing Company, Reading-Massachusetts.
10. ***World Bank, Global Development Finance, (2007) *The Globalization of Corporate Finance in Developing Countries,* The International Bank for Reconstruction and Development, Washington.
11. ***Institute of International Finance, (2009) *Capital Flows to Emerging Market Economies*, June 11, (available at www.iif.org). Washington, DC