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WHAT TRIGGERS THE FLIGHT CAPITAL? AN AUTOPSY OF THE EXISTING LITERATURE

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Abstract

The word capital stimulated the interest of economists because the phenomenon of capital accumulation is the base of development. Capital accumulation transforms the mode of production giving rise to new system of production. Many studies have been made by various economists to understand the nature of capital accumulation, capital flows and its importance. The study aims to bring to light the various factors that influence the capital flows.

Keywords: Capital flow flight capital, foreign reserves, real effective exchange rate, domestic factors, and international factors

STUDIES ON INTERNATIONAL CAPITAL FLOWS, CAPITAL MARKETS AND CRISES

Collier et. al (2001)[1] sets flight capital in the context of portfolio choice, focusing on the proportion of private wealth held abroad. They explain cross-country differences in portfolio choice using variables that proxy differences in the risk adjusted rate of return on capital. Estimates of the stock of private flight capital and the stock of total private real wealth for 50 countries in the Sub Saharan Africa, Latin America, south Asia, East Asia and Middle East are made using residual regressions. The study reveals that there are large regional differences in the proportion of portfolio held abroad, ranging from 5 percent in South Asia to 40 percent in Africa. East Asia had only 6 percent of its wealth abroad. However the independent country wise regressions are absent in their study and this may lead to errors as internal factors influencing capital flows differ from country to country.

Agenor and Hoffmaister (2001)[2] have studied the relationship between capital inflows and real exchange rate. They have provided an analytical framework and econometric evidence. The Granger causality between capital inflows and real exchange rates showed that the real exchange rate Granger caused the capital inflows. The neoclassical model of capital movements is modified by using the country specific factors like country creditworthiness and rate of interest (domestic and international). The application of the model too suggests the fact that there is a causal relationship between real exchange rate and capital inflows.

Green (2001)[3] makes a cross-country study on the capital account liberalization. Capital account liberalization (CAL) remains one of the most controversial policies today. One reason is that different theoretical perspectives have very different implication for the desirability of liberalizing capital flows. Another is that empirical analysis has failed to yield extensive results. He analyses the impact of CAL on capital mobility across countries. It is a theoretical discussion based on past studies and experiences. He generalizes his study and points out that microeconomic foundation have to be searched thoroughly for answering the big question of capital account convertibility. However the article uses abstract methodology which is a combination of methodologies of previous studies.

Levine and Zervos (1996)[4], Rodrick (1998) [5], and Kraay (1998) [6],have conducted studies on the capital account liberalization and growth. Levine and Zervos in their article examine whether there is a strong empirical association between stock market development and long run economic growth. Cross country growth regression suggest that the pre determined component of stock market development is positively and robustly associated with long run economic growth. Rodrick and Kraay in their independent studies using IMF Index, Quinn Index, Gross Inflows and Outflows as alternative measures of financial openness finds no impact on GDI as a share of GDP as a result of capital account liberalization while Levine and Zervos finds that for 16 developing countries the stock markets became larger and more liquid after the opening of the capital account.

Calvo, Leiderman and Reinhart (1993)[7] have argued in a series of papers that while domestic factors were undoubtedly attracting inflows, such factors cannot explain why inflows occurred in countries that had not undertaken reforms or why the inflows did not materialize till 1990. Hence they have emphasized on the role of the external factors .Through principal component analysis they established a significant degree of co-movement among foreign

reserves and real exchange rates for 10 Latin American countries during 1990-91 than in 1988-89. Co movement with the rate of inflation diminished in the more recent period. Large bivariate correlation was also found between capital flows and US financial variables. For individual countries Granger causality showed that reserves were causing real exchange rates than the reverse. Structural VAR's, variance decomposition and impulse response functions indicated that foreign factors played a large role in accounting for reserve and real exchange rate movement

Chuhan, Claessens and Mamingi (1993)[8] attempted to disentangle the roles of domestic and external factors in motivating portfolio capital inflows. Using monthly bond and equity flows to nine Latin American and nine Asian countries from January 1988 to July 1992, they estimated separate panel regressions. These regressions explained bond and equity flows as functions of country specific variables (country credit rating, price of debt on secondary market, price earnings ratio in the domestic stock market and the black market premium. They found that bond flows (not equity flows) responded strongly to the country credit rating while P/E ratio was important in both cases. To assess the relative importance of domestic and foreign variables they computed the sum of standardized coefficients and found that in Asia domestic variables had an upper hand while in Latin America both were equally significant in attracting bond and equity flows.

Fernandez Arias (1994)[9] studied capital flows using data that measured capital flows directly rather than on proxies in the form of reserve and real exchange rate changes. He decomposed post 1989 portfolio bond and equity inflows for 13 developing countries into country credit worthiness adjustment factor, expected return on projects and creditor country financial conditions using the fixed effect panel estimates. He found that for the developing countries changes in international interest rates proved to be the dominant force in explaining surges in capital inflows (accounts for 60 percent of the deviations in such flows since 1989). 25 percent changes were accounted for by changes in creditworthiness and 12 percent to be explained by improvements in the domestic investment climate.86 percent of the surge in inflows were accounted by movements in external interest rates when secondary market debt price was used as the creditworthiness indicator.

Dooley, Fernandez Arias and Kletzer (1994)[10] They follow the same decomposition of creditworthiness into domestic and foreign components but instead of explaining capital flows directly they attempt to account for the behavior of secondary market prices on debt since 1989, which has increased markedly. Their major finding says that all increases in prices can be accounted for by reductions in the face value of debt and international interest rates .However the effect of improvements in domestic environment amounts to almost nil.

S. Schadler, Carkovic, Bennet and Khan (1993)[11] in a theoretical appraisal points out that push factors cannot always predominate because of the following reasons (i) External shocks /changes did not coincide with the timing of the inflows (ii) Timing persistence and intensity of inflows has varied considerably across countries that have received inflows ,suggesting that investors have responded to changes in country specific factors overtime (iii)External creditors exercise cross country discrimination in the allocation of funds.

Hernandez and Rudolph (1994)[12] examined the extend to which standard credit worthiness indicators could explain long term capital inflows for a sample of 22 developing countries over the period 1986 to 1993.They splitted the sample of countries into groups of high capital inflow recipients (HCIR) and low capital inflow recipients based on domestic savings, investment as percentage of GDP, level of fiscal deficits, inflation rates and debt stock. Arranging data into a panel of annual observations capital flow equations were estimated for a broad category of long term flows as a function of lagged domestic consumption and investment rates, external interest rates and the ratio of net external debt to GNP, the variability of real exchange rate and the presence of a Brady bond deal . They found that domestic creditworthiness played a statistically significant role in attracting the flows. However no role was found for the external rate of interest which is questionable because in reality it is a major factor influencing the capital flows to developing countries.

World bank (1997)[13] adopted the Calvo, Leiderman and Reinhart methodology and suggested that the factors driving inflows have been changing overtime .Domestic factors have played a more prominent role during 1994-95. Quarterly flows from the US to 12 emerging markets in East Asia and Latin America were characterized by a substantial amount of co- movement during 1993-95(measured by the proportion of the variation captured by the first principal component). First principal component of these series was highly negatively correlated with the first principal component of a set of representative US asset returns. During 1993-95 these movements became much weaker (dropped from 75 percent to 45 percent) and correlation with US asset returns reversed signs.

Luis F de la Calle (1991)[14] tests the arbitrage pricing theory in the context of the unstable macroeconomic years in Mexico (1977-87) using information on returns on assets available to domestic investors –primarily stocks traded at the local stock exchange. An attempt is made to ascertain the extend to which these assets have offered premia for a set of proposed sources of risk. A residual market factor is obtained using Mc Elroy and Burmeister model. The

Asset Pricing Theory is applied to the relative prices of securities held by Mexicans. They found that (i) Mexican economy had paid excess premia because of unstable macroeconomic conditions (ii) Mexican capital market is not well integrated with international capital markets (iii) Mexican economy is not well diversified with respect to oil shocks.

Stephany Griffith Jones *et al* (ed)(2003)[15] analyses the financial crisis of late 1990's and draws attention to the types of lenders and investors that triggered and deepened the crisis. They concentrates on institutional investors and banks and provides detailed analysis of the countries most affected by the 1997-98 Asian financial crises as well as that in Czech Republic and Brazil. It also suggests necessary international financial reforms to make crisis less likely. It scrutinizes the type of lender and investors that triggered and deepened the crisis, focusing on institutional investors and banks, allocation of theirs assets; the criteria used in the process and the impact of the nature of the investor on the volatility of different types of capital flows. They conclude by examining the asymmetries in the financial architecture discussions and implementation and by offering policy proposals.

Carlos M. Corea & Nagesh Kumar (2003)[16] concentrates on the FDI flows and WTO regime. They analyze the trend and pattern of FDI flows to the developing countries in the context of the WTO agreements. The TRIPS, TRIMS and many other much debated issues are examined to find out how they affect the inflows of capital. They conclude that the WTO regime has made FDI movement much easier among the economies where there are less trade barriers. Their study however does no justice to the analysis of the FDI flows as they have failed to account for the role of domestic infrastructure and environment in attracting FDI flows.

Sebastian Edwards (2000)[17] points out that the 1990's witnessed several acute currency crises among developing nations that invariably spread to other countries. These episodes (Mexico, Thailand, South Korea, Russia and Brazil) were in every case exacerbated by speculative foreign Investments and high volume movements of capital in and out of these countries. Insufficient domestic controls and a sluggish international response further undermined these economics, as well as the credibility of external oversight agencies like the IMF. They examine the correlation between volatile capital mobility, currency instability and the threat of regional contagion focusing particular attention on the emergent economies of Latin America, South East Asia and Eastern Europe. These studies offer an important new understanding of the empirical relationship between capital flows, international trade and economic performance. It also affords key insights into realms of major policy concern, including the fundamental usefulness of capital controls and trade restrictions.

In his work on Capital flows and crises, Green (2003)[18] analyses the implications of capital mobility for growth and stability. He discusses, historical, theoretical and empirical and policy aspects of the effects, both positive and negative of capital flow. He focuses on the connections between capital flows and crises as well as on those between capital flows and growth. He argues that international financial liberalization like other forms of economic liberalization, can positively affect the efficiency of resource mobilization and the rate of economic growth. But analysis of both recent and historical experience also shows an undeniable association between capital mobility and crises, especially when domestic institutions are weak and the harmonization of capital account liberalization and other policy reforms is inadequate. In his conclusion Eichengreen makes suggestion for policy design to maximize the benefits of international financial liberalization while minimizing the risk of financial instability.

David Woodward (2001)[19] says that FDI and to a lesser extend portfolio equity investment have been widely heralded as the key benefit that globalization now offers the south and the principal mechanism to kick start economies into rapid growth. He argues that the 1990's have seen a dramatic increase in foreign capital invested in some developing countries. David Wood ward analyses various impacts of capital flows and the benefits of such flows. He assesses the scale of the flows involved, their systematic undervaluation in official statistics, their geographically skewed distribution, the very high rates of return, the risks of substantial out flows of resources and the massive shift towards foreign ownership required to avoid them, the potentially depressive effects of over investment on the prices of many third world exports, the adverse implications for national sovereignty social welfare and the democratic right of third world people to use the governments they elect to act in ways they want them to do. He points out that FDI may have actually contributed to the Asian financial crises and could in future lead to a new wave of similar financial crises throughout the developing world.

Stephany Griffith Jones et al (2001)[20] Says that the currency crisis that engulfed East Asian Economies in 1997 and Mexico in 1994 and their high development costs raise a serious concern about the net benefits for developing countries of large flows of potentially reversible short term international capital. The studies are based on comparative case studies of key emerging economies of the East Asian, Latin American, African and Europe. The financial and real effects of financial flows and between private and public responsibilities in managing financial Markets in these economies are analyzed in detail. The selected essays analytically identify the weaknesses in both domestic and international capital market regions.

The recommendations derived from this analysis apply to the development of financial markets in developing countries, the monitoring and regulation of mutual funds in source countries and the future development of international capital markets. It makes an important contribution both to the discussion of national policies and of a new international financial architecture.

Karel Jansen and Rob Vos Ed (1997)[21] opine that external finance has been essential to the development of many developing countries. They analyze how different types of capital flow have generated different types of adjustment problems in developing countries of Asia and Latin America and examines the key features of their economic structures and economic policy responses that have determined their success or failure in employing external finance as a catalyst of development. They conclude that adjustment policy failures have been strongly linked to inadequate recognition of the importance of institutionally determined market imperfections and rigidities, both at home and abroad. However the volatility in the flows of finance to the developing countries has also posed major policy problems, particularly in recent decades. This aspect is not paid much attention by the authors.

Mary Ann Haley (2001)[22] tackles and conclusively refutes a crucial tenet of the contemporary international liberalizers. Their claim is that laissez faire international capital flows promote freedom in developing countries. Her careful study demonstrates that capital account liberalization, demanded from abroad, severely constrains the economic policy options of elected leaders in emerging market countries. She explores how the private capital sourcing in particular, portfolio capital, effects democratization in developing countries. A probe into investor's co-ordination, asset concentration, political preferences and investor activation provides a frame work for understanding the international financial constraints on developing countries.

Stefano Manzocchi (1999)[23] evaluates the pattern and function of the foreign capital in developing countries using a long run perspective. The main conceptual instruments employed are the theory of economic growth and the techniques associated with recent advances in growth econometrics. The experience of the whole 1960-88 foreign capital shows that foreign capital moved according to the growth potential of developing countries over 1960-82, but its actual contribution to growth was manifest only up to 1972 .This is disappointing as after 1972 a substantial surge in capital flows towards developing countries is observed. The enhanced availability of foreign resources was associated with excessive consumption or (alternatively) external borrowing led to an over financing of high risk, low return investment projects, with perverse effects on the sustainability of foreign debts. The empirical work points out that there is no mechanical trade off between the short term dangers and the long run gains from capital markets integration, but the growth benefits of foreign capital in transforming economies are conditional as an effective destination of the resources. Over borrowing and exclusive consumption are the main pitfalls in both the short and long term.

Reuber et al (1973)[24] describes and evaluates some of the main characteristics and economic effects of Private Direct Investment in manufacturing industries in the developing countries so that these central features may be seen in perspective. Considerable attention is also given to the supply characteristics of FDI, to alternative sources of capital and to the auxiliary factory and market access associated with investment. They say that FDI have shown a mixed impact in some developing countries while in some others it has shown a negative impact with the concentration around unproductive activities and import of obsolete technology.

Walther P. Michael (1971)[25]constructs integrated accounts of international capital flows, including grant between individual countries by type of capital. He demonstrates that it is feasible to reconstruct international capital transactions in matrix form showing the flows by sources and destinations. Descriptive statistics is used to account for the trend and pattern of the flows from north to south. He says that during the 80's Latin America was the major destination of US equity and debt flows while in the 90's south Asia became the favorite destination. He fails to account for the major factors which lead to these changes and what was the impact of these flows on their domestic economy.

Brendan Brown (1987)[26] covers contemporary history of international money moments from the collapse of the old order in summer 1931 to the present day. By relating the behavior of currencies to the investor's perception of economic and political turning points, it provides a fascinating critique of market performance. The author traces six main periods in the history of the international capital flows. The Franc – Dollar axis 1931-36 - The waves of capital flight to the U.S.A in the lead up to World War II - The period up to the late 1950's when only the dollar and the Swiss Franc survived as hard monies - The emergence of the mark-dollar axis up to the floating of the mark in May 1971- The huge flows of the hot money out of the dollar in years 1971-73 and Finally the experience of floating exchange rates since spring 1973.From the historical experiences described, Dr. Brown is able both to establish patterns in currency behavior and draw lessons for the modern investor.

Donald R. Lessard and John Williamson (1986)[27] outline the proceedings of a conference held in October 1986 to assess the problem of capital flight

and its role in perpetuating the third world debt crises and discusses policy measures that might help to stem and reverse the exodus of capital from capital short countries. They point out that a better understanding of the push and pull factors facilitates the cause of these outflows. Political instability and huge inflationary pressure coupled with the burst of the stock market bubble lead to the outflows from the south East Asian countries.

Uri Dadush et al (2000)[28] points out that in the second half of 1997, Thailand, Malaysia, Korea and Indonesia experienced an outflow of foreign capital of more than 100 billion. The effects of this outflow rival the worst years of the Latin American debt crisis and the early years of the great depression. The Asian Crisis demonstrates how inter connected the global economy has became and they try to understand the Asian financial crisis by taking into account the dynamics of private capital flows. They point out that capital account liberalization, inadequate policy framework and weak governments perpetuated these crises. The timing of the reforms was also not suited to these economies.

Paul Krugman Ed (2000)[29] addresses the following fundamental issues. What drives currency crisis? How should government behavior be modeled? What are the actual consequences to the real economy? His analysis points out that apart from the capital flight there are various internal and external elements which perpetuates crises. However all the blame suddenly falls on the capital flows, which though triggers off the crises, does not alone contributes to the currency crises. The factors like the degree of capital account liberalization, real effective exchange rates, disinvestment policies etc plays a significant role in it. Weak governments face pressure from the creditors to manipulate the liberalization policies in their favor. This act as a serious constraint in the working of the government. Taking the examples of Mexico Thailand, Philippines and Indonesia he argues that the currency crises leads to the collapse of the real as well the monetary sectors of the economy.

Magnus Blom Storm (1989)[30] opines that the spill over effects of MNC's is a matter of much controversy and theorizing at present. The assumption that the host countries can be expected to enjoy spillovers- improvements in the Balance of payments, in the inflow of foreign currency and in other sectors of the economy not directly affected by the multinational has not been necessarily corroborated in practice. He comes to very different conclusions which can be drawn about spillovers, reporting on much original research on Latin America and contrasting this with findings from earlier studies. He finds that contrary to the common belief the developing world does not enjoy the spillover benefits. However he fails to give satisfactory explanations and empirical evidences for the factors which prevent the spill over.

Dilip K. Ghosh and Edgar Ortiz Ed (1994)[31] examine the emerging issues, the basic questions and analytical structures-arising from increasingly globalized financial markets of the south Asian countries from 1986-1994. They analyze foreign exchange market long run equilibrium, refinance and fluctuations vis a vis government intervention. Various issues from capital flows to balance of payments, international reserves, foreign debt, and country risk analysis and equity market quotations systems are examined in detail. They discuss integration of Municipal finances, optimum tax structures in closed and open economies, the issue of trade liberalization, off shore banking and the role model of global banking. They conclude that the policy frame work of the developing countries is inadequate and insufficient to meet the needs of the globalized financial markets.

Swoboda (1976)[32], says that Argy (1969) , Polak and Argy(1971) , and Swoboda (1972) have explored the long term equilibrium condition of capital flows by examining implications of monetary and fiscal policies on income and international reserves, given the long-run constraint that the balance of payments must be restored to equilibrium. He outlines the models by McKinnon and Oates (1966), Oates (1966), Levin (1970), and Whitman (1970) which assume perfect capital mobility by considering that asset holdings by the private sector consist of both domestic and foreign bonds, which are treated as perfect substitutes. In these models, money supply is determined exogenously, implying that the monetary authorities sterilize the effect of disequilibrium in the balance of payments. Consequently, the equilibrium in this kind of model is satisfied when a surplus or deficit on the current account is offset by a deficit or surplus in the asset market.

SUMMARY AND CONCLUSION

Review of existing literature is a precondition to any model formulation, theorizing or research analysis. It helps to identify the research problem and stimulates new thoughts and ideas on the same. Large number of studies has been made about the capital flows and their impact on economic development. Studies on international capital flows, capital market and crisis reveals that there are large regional differences in the proportion of portfolio held abroad. There exists a causal relationship between foreign reserves ,real exchange rate and capital inflows. Cross country growth regression suggest that the pre determined component of stock market development is positively and robustly associated with long run economic growth. The existing literature strongly supports the fact that both internal and external factors trigger the flow of capital from one destination to another.

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