

## CAUSES AND CONSEQUENCES OF MASSIVE CAPITAL FLOWS

**Coroiu Sorina Ioana**

*University of Oradea, Faculty of Economics*

**Sabău Popa Claudia Diana**

*University of Oradea, Faculty of Economics*

*At this stage of global economic crisis that traverse, it was observed that massive capital flows have major impacts on economies. Therefore, it is important to analyze the factors behind the attraction of these massive capital flows, and the main consequences that followed.*

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In the current economic crisis, massive capital flows' analysis is very important because some authors in the literature, Reinhart and Reinhart (2008) - believe that there may be links between capital inflows and sovereign debt crises, exchange rates, inflation and the banking system. Between 1975-1982, there were concomitant capital inflows, followed by the debt crisis. Capital inflows reappeared during 1990-1993, followed by an emerging markets debt restructuring. Since 2002, many countries faced with capital inflows. End this cycle coincided with the financial crisis started in the second part of the year 2007. Massive capital inflows recorded by the current global crisis occurrence, were due to several factors, including: financial globalization, the existence of an abundant liquidity in developed economies, economic development perspective of that country, following the accession to an economic union.

*Globalization phenomenon* is one of the main reason that caused financial globalization and capital movement. Falling communication costs, strong competition, and rising costs in domestic markets, led firms in industrial countries to produce abroad to increase their efficiency and profits. This not only triggered FDI, but also changed its nature in comparison to the 1970s and early 1980s. In those years, FDI was mainly driven by resource extraction and import substitution, whereas the progressive globalization of production has led to a high proportion of current FDI being characterized as efficiency-seeking investments.

The second development in the financial structure of industrial countries that increased capital flows to emerging markets was the growing importance of institutional investors. These investors found themselves more willing and able to invest abroad because of higher long-term expected rates of return in developing countries and to wider opportunities of risk diversification.

Until the first signs of the current crisis, there was abundant liquidity in developed economies. The liquidity has to keep interest rates at low levels and volatility in financial markets lower. However, economic growth in developed countries has slowed in recent year, investors in these markets have seen lower profits, so they began to seek new opportunities for profits. Increasingly, investors began to look favorably emerging economies and capital inflows continued. Reinhart and Reinhart (2008) analyzed 181 countries, from 1980 to 2008, and noted that the maximum duration of the cycle of capital inflows was 3 years for more than 50 countries, for 4 years for more than 30 countries and almost 5 years to 20 countries.

Capital inflows have occurred both in low-income countries and middle-income or large income countries, members of the OECD. For example, capital inflows have been relatively high in the U.S. in the period 2002-2007, the United Kingdom and France between 2005 and 2007, in Spain between 2004 and 2007.

In Romania, these inflows were higher in the period 2004-2008. Romania was an attractive location for foreign investors due to cheap labor, facilities given by authorities, and so on.

Another factor behind the increase in capital inflows in a given country was that country's economic development perspective, the accession to an economic union: the European Union, NAFTA. The premise was that an economic union membership has more security, limited exchange rate fluctuations, reduce capital costs by reducing risk spreads, stock prices are maintained at satisfactory levels.

The World Bank (1997) noticed that Capital Flows suggesting Several trends have been driven by more than external factors. Fundamentals Affect the Long-term rates of return to investors. Fundamentals countries with the strongest (high investment-to-GDP ratio, low inflation, real exchange rates and low variability) have received the largest flows as percentage of GDP. Whereas countries with very poor fundamentals have attracted private flows. FDI is one of the largest component of private flows, but, although sensitive to macroeconomic fundamentals, it is not explained by global interest rates. Portfolio flows is more sensitive to interest rates. Still, they have shown year upward trend since 1992-93 despite the increase in global interest rates. Nevertheless, the role of foreign factors cannot be ignored.

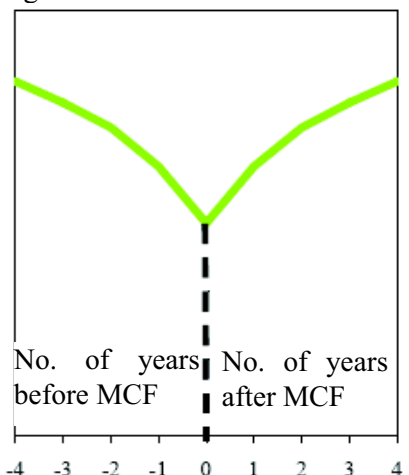
A breakdown of sources of capital inflows in the countries of Central and Eastern Europe (CEE) is provided by Lane and Milesi-Ferretti (Isarescu, 2009). In total foreign direct investment in Central and Eastern Europe, the euro zone countries had a share of 73% -95%. In 2004, in most CEE countries, over 50% of total portfolio investment in the stock market came from the euro area, which was the main source for foreign assets of the banking systems of CEE and long-term investments that create debt.

In general, relatively high capital markets became relatively small and shallow. The discrepancy between financial depth and volume of emerging economies in capital inflows led to appreciation of currencies. To prevent the excessive appreciation of currencies, the reserves have strengthened. This was more intense in countries that export energy resources. Also, to prevent massive capital inflows, the authorities raised the reserve requirement, imposition of taxes on financial transactions and other administrative restrictions. However, positive developments have dimmed prices real need for structural adjustment, which were postponed. This was probably the most important implication for these economies since the long term, structural adjustment delay adversely affects external competitiveness.

All episodes of inflows or sudden stop of capital have common characteristics, even though they showed different features depending on the country or time period analyzed. These characteristics refer to the dynamic indicators such as GDP, real exchange rate, inflation and current account, both before and after an episode of capital inflows. Using the results presented in literature - Reinhart and Reinhart (2008), Isarescu (2009), one can identify certain patterns of dynamic indicators mentioned, 4 years before concluding episode of capital inflows and 4 years after this time.

The graph in Figure 1 presents the evolution of current account deficit before and after the episode of large capital inputs (denoted by zero on the horizontal axis). Note that during the episode of capital inflows, it has been a deterioration in current account adjustment, beginning to previous levels. V-shape of the current account evolution is sharper for small and medium-income countries.

Fig. 1. The evolution of current account deficit (% in GDP)

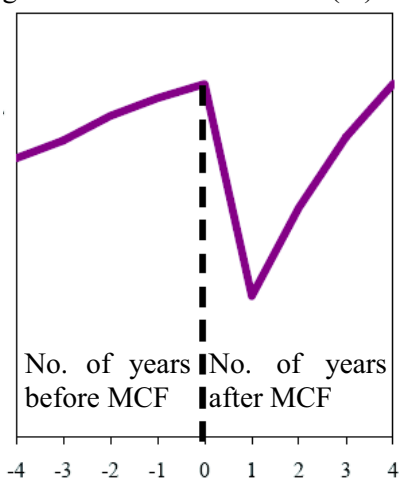


0 = Moment of massive capital flows (MCF)

Source: Isarescu, 2009

Generally, there is a directly proportional relationship between inflows and GDP. During the period of capital inflows, GDP recorded a relatively high growth, and decreases sharply in concluding episode, then again there is a noticeable trend. In other words, after completion of large capital inflows, GDP has a V-shaped trajectory (Fig. 2).

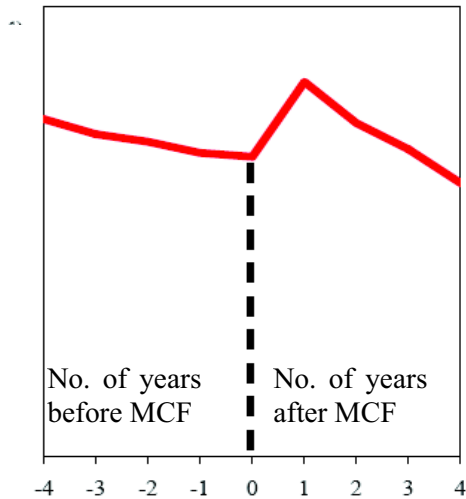
Fig.2. The evolution of GDP (%)



Source: Isarescu, 2009

It has been difficult to identify a trend of inflation, because the data presented in literature are varied, because monetary policy plays an important role. Isarescu (2009) believes that the end of the cycle of capital inflows followed by a short-term inflationary spurt, mainly due to exchange rate channel. In subsequent years, however, inflation is at levels more or less similar to those before the end of episode than capital inputs.

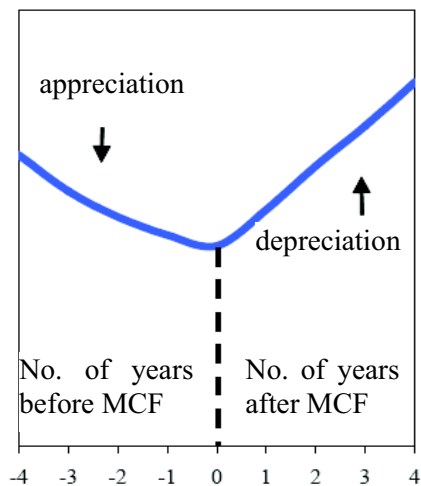
Fig. 3. Inflation rate evolution (%)



Source: Isarescu, 2009

Figure 4 presents the evolution of the exchange rate. If capital inflows last few years, real appreciation of each year tends to be significant, so the cumulative assessment is also significant, leading to downward slope of this graph. Literature shows that in most cases, real depreciation occurs through nominal depreciation of the currency. In the graphic we see that real depreciation is driven by falling prices only after the first year of the end episode.

Fig. 4. Exchange rate evolution (%)



Source: Isarescu, 2009

We have seen that massive capital flows have significant consequences, therefore, the control of the volume is necessary. The biggest challenge after the financial crisis, is to direct capital flows and avoid recurrence of imbalances, that have accelerated the decline in savings.

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