Academic Script

INTERNATIONAL CAPITAL FLOWS

INTRODUCTION

International capital flows (or movements) refer to the outflow and inflow of capital from one country to the other. Capital flows refer to the movement of money for the purpose of investment, trade or business production, including the flow of capital within corporations in the form of investment capital, capital spending on operations and research and development (R&D). They do not relate to the movements of goods or payments for exports and imports between countries. International trade and movements of productive factors like capital, labor and technology, have very different economic effects on the nations involved. They take place through government, private and international organizations or agencies.

TYPES OF INTERNATIONAL CAPITAL FLOWS

International capital flows are classified in the following ways:

1.Direct and Portfolio.

Direct investments, on the other hand, are real investments in factories, capital goods, land and inventories where both capital and management are involved and the investor retains control over use of the invested capital. The flow of direct capital means that the concerns of the investing countries try exercising control over the assets created in the capital importing country by means of that investment. Direct capital investment may take many forms. The formation in the capital importing country of a subsidiary of a company of the investing country has a majority holding; the formation in the capital importing country of a company financed exclusively by the present concerns situated in the investing country; setting up a corporation in the investing country for the specific purpose of assembling parent product, its distribution, sales and exports or the creation of fixed assets by investing in infrastructure like power,refineries,railways etc. in the capital importing country. Such companies or concerns are known as Transnational Corporations (TNCs) or multinational corporations (MNCs).

Portfolio investments are purely financial assets, such as bonds, denominated in a national currency. The movement of indirect capital, known as portfolio or rentier' investment consists mainly of the holdings of transferable securities (issued or guaranteed by the government of the capital importing country), shares or debentures by the nationals of some country. Such holdings do not amount to a right to control the company. The shareholders are entitled to the dividend only. IN recent years, multilateral indirect capital investments have been evolved. The nationals of a country purchase the bonds of the world bank floated for financing a particular project in some LDC.

2. Private and Government capital

Private capital flows refer to lending and borrowing from abroad by private individuals and institutions. Private capital is generally guaranteed by the govt or the central bank of the borrowing country. Profit motive is the driving force of private capital movements. On the other hand, government capital movements imply lending and borrowing between governments. Such capital movements are under the direct control of governments. In fact, governments are important international lenders. They make stability loans, loans to finance exports and imports, and particular projects.

3. Home and Foreign Capital.

Home capital is concerned with investments made abroad by residents of the country. On the other hand, foreign capital implies investments made by foreigners in the country. Thus home capital refers to the outflow of capital, while foreign capital is concerned with the inflow of capital. The balance of payments account of a country shows the distinction between the two.

4. Foreign Aid.

It refers to public foreign capital on hard and soft terms, in cash or kind, and inter-governmental grants. Foreign aid is tied and untied aid. Aid may be tied by source, projects and commodities. Untied aid is a 'general purpose aid' and is also known as programme aid or non-project aid.

5. Short-Term and Long-Term Capital.

Short-Term capital flows are for a period of less than one-year maturity while long-term capital movements are of more than one-year maturity.

SHORT-TERM CAPITAL FLOWS

Short-term capital flows (or movements) relate to credit instruments of less than one year. These movements take place through changes in claims of residents of one country on the residents of other country or through changes in the liabilities of the residents of a country to foreign residents. The residents of a country refer to the government, the central bank, commercial banks, other types of banks and financial institutions, financial intermediaries, speculators, industrial and commercial firms, etc. Short-term capital flows take place through currency, demand deposits, bills of exchange, commercial papers, etc. They are undertaken by the central bank and commercial banks of countries.

Under the gold standard, short-term capital movements were transfers of gold between countries. For example, the transfer of gold could be to maintain equilibrium in balance of payments in current account or the outflow of gold could be for automatic short-term capital flows or due to speculation or income transfers. Under the gold standard, short-term capital outflow was in the form of inflow of gold because capital sent abroad in the form of credit instruments came back in the form of gold. As a result, there was multiple expansion in the supply of the money. On the contrary, there was the outflow of gold from the inflow of short-term capital which led to multiple contraction in money supply. However, at present, when the gold standard does not exist, short-term capital movements affect the supply of money in the following ways:

The supply of money is related to the current account of balance of payments because short-term capital movements affect the supply of money through it. When there are changes in the assets and liabilities of the central bank due to short-term capital movements, these bring changes in the money supply of the country. Changes in money supply on account of short-term capital movements can be classified in three parts:

1) Primary
2) Secondary
3) Tertiary

Primary expansion or contraction in money supply is directly due to surplus or deficit current account of balance of payments. When exports exceed imports of the country, the quantity of money, increases with the exporters. On the contrary, when imports exceed exports the quantity of money decreases with the importers because they are required to pay to the exporters more than what they receive. As a result, the net supply of money declines.

The secondary changes in the money supply as a result of short-term capital movements are due to the impact of reserves of banks. When exports exceed the imports of the country, payments are made by foreign monetary institutions in the central bank of the country which increase the deposits of national banks. On this basis, these banks lend more which leads to secondary expansion in money supply or credit. On the contrary, when imports exceed exports, the reserves of national banks decline due to more payments to foreign banks. Consequently, the lending capacity of these banks declines.

When reserves of the central bank increase and if it discounts exchange instruments of banks or purchases securities through open market operations, the expansion of money that takes place is called the tertiary effect of short-term capital flows. On the contrary, when reserves of the central bank decline due to the increase in its foreign liabilities and it sells securities in the open market, the supply of money falls that is also the tertiary effect of short-term capital movements. Under the gold standard, short-term capital movements were influenced by changes in the bank interest rate-through which the balance of payments was balanced. For this, speculative capital was transferred in the money market. But under flexible exchange rates, the exchange risks are undertaken sensibly. If the exchange risks are not undertaken, short-term capital movements are not possible. Under destabilizing speculation, if imports exceed exports, then the outflow of capital takes place which leads to excessive decline in the reserves of the central bank. On the contrary, if speculation is destabilizing and exports exceed imports, with the increase in the exchange rate and decrease in the interest rate there is inflow of capital which leads to the increase in bank reserves and expansion in money supply. Similarly, there can be short-term capital movements due to stabilizing speculation. Under convertible paper money standard through which adjustment limit of the exchange rate can be fixed or a high limit of exchange rate adjustment can be fixed for short-term capital movement through destabilizing speculation.

LONG-TERM CAPITAL FLOWS

Long-term capital flows take place through credit instruments of more than one-year maturity. These include bonds, convertible debentures, stocks, term-loans by banks, etc. They may also be in the form of new securities or bonds floated in foreign countries and inter-governmental loans. The long-term capital movements take place through both private and government banks, international financial institutions such as the World Bank, European Investment Bank, Asian Development Bank, etc. and agencies established by governments.

1. Balancing BOP.

Long-term capital movements are needed for balancing deficit or surplus in the balance of payments of a country. With the inflow of capital, the BOP deficit of the borrowing country improves, while that of the lending country may become adverse. But the lender country gains when it starts receiving interest, dividend, royalty, etc. which it can utilize to fill its current account deficit in balance of payments.

2. Improving Terms of Trade.

When with the inflow of capital, output increases in the borrowing country, its exports may increase and imports decline in the long run. As a result, its terms of trade may improve in relation to the capital lending country.

3. Meeting Developmental Requirements.

They are also needed for meeting the financial, industrial and development related requirements of the people living in the creditor and debtor countries.

4. Increasing Output, Income and Employment.

The long-term capital movements help in the process of capital formation and thereby increase output, income and employment. When a borrower country uses the foreign loan to establish an industry or start a capital project, there is increase in output, income and employment in the country.

5. Changing Factor Proportions.

The long-term capital movements also bring about changes in factor proportions of the country to which they flow. The capital-labour ratio changes with the import of more capital. This may help in addressing the problem of capital scarcity, especially in developing countries.

6. Maximizing Welfare.

There is more and better utilization of the country's resources. Modern governments which borrow long-term capital from private and international financial institutions see to it that the borrowed capital is utilized in proper works, projects and industries. Thus capital moves in those directions where it maximizes welfare.

7. Equalising Interest Rates.

There is a tendency for interest rates to equalize between countries involved in international capital movements. If there are no restrictions in international capital movements, capital moves from capital surplus country to capital scarce country because the interest rate is high in the latter. Ultimately, the interest rate increases in the capital exporting country and falls in the capital importing country.

8. Narrowing Technological Gap.

When capital moves from one country to another; technologies from the lending country are transferred along with plants, equipment, etc. to the borrowing country. This tends to upgrade technologies in the latter country and the technological gap between the two countries is narrowed down.

FACTORS AFFECTING INTERNATIONAL CAPITAL FLOWS

The following factors affect international capital movements:

1. Rate of Interest.

The most important factor which affects international capital movements is the difference among current interest rates in various countries. Capital flows from that country in which the interest rates are low to those where interest rates are high because capital yields high returns.

2. Speculation.

Speculation related to expected variations in foreign exchange rates or interest rates affects short-term capital movements. When the speculators feel that the domestic interest rates will increase in future, they will invest in short-term foreign securities to earn profit from the possibility of fall in bond prices. This will lead to the outflow of capital. On the contrary if, the possibility is of fall in domestic interest rates in future, the foreign speculators will invest securities at a low price at present. This will lead to the inflow of capital in the country. Similarly, if there is the likelihood of devaluation of the country's currency in future, the domestic speculators will try to change the currency into foreign securities. This will lead to the outflow capital. On the other hand, if the foreign exchange rate is expected to rise, there will be an· inflow of capital in the country.

3. Expectations of Project.

A foreign investor always has the profit motive in his mind at time of making capital investment in the other country. Where the possibility of earning profit is more, capital flows into that country. Similarly, a foreign entrepreneur keeps expected profit in view while investing in various projects in a country. He will invest in that project where expected profit is more as compared to a less profitable project. This leads to larger inflow of capital.

4. Bank Rate

A stable bank rate of the central bank of a country also influences capital movement because market interest rates depend on it. If the bank rate is low, there will be outflow of capital. On the contrary; if the bank rate is high, there will be inflow of capital in the country.

5. Production Costs

Capital movement depends on production costs in other countries. In countries where labor; raw materials, etc. are cheap and easily available, more private foreign capital flows into them. The main reason of huge capital investment in

Korea, Singapore, Hong and other developing countries by the multinational corporations is low production costs.

6. Economic Conditions

The economic conditions in a country, especially size of the market, availability of infrastructure facilities like the means of transport and communication, power and other resources, efficient labour, etc. encourage the inflow of capital.

7. Political Stability

Political stability, security of life and property, friendly relations with other countries, etc. encourage the inflow of capital in the country.

8. Taxation Policy

The taxation policy of a country also affects its inflow of capital. To encourage the inflow of foreign capital, the taxation policy should avoid double taxation, should not burden entrepreneurs heavily, give tax relief, etc. to new industries and foreign collaborations.

9. Foreign Capital Policy

The government policy relating to foreign capital also affects capital movements. If the government provides facilities of transferring profit, dividend, royalty, interest, etc., to foreign investors, there will be inflow of capital in the country. Similarly, soft foreign exchange contracts and fiscal, monetary and other policies which encourage foreign capital are helpful in the inflow of capital.

10. Marginal Efficiency of Capital (expected rate of profit)

The marginal efficiency of capital is positively linked with the inflow of capital. Foreign investors generally compare the marginal efficiency of capital with the interest rate in different countries and prefer to invest in that country where the rate of return is likely to be high.

Trends in capital flows in developed and developing countries

With the exception of a handful of nations in North America, Western Europe and japan most of nations of the world are classified as less developed or to put it more positively, as developing countries. There is, however no sharp dichotomy between developed and developing nations but a fairly continuous spectrum from the very rich to the very poor. In the past the economic relationship between the developed and developing nations was characterized by developing nations exporting primarily food and raw materials in exchange for manufactured goods from developed nations. This is still the case for the poorest developing nations, but not for the advanced ones. The developed countries as a whole gains from investing abroad, there is a redistribution of domestic income from labor to capital. On the other hand, while the developing countries also gains from receiving foreign investments, these investments lead to a redistribution of domestic income from capital to labor. If we allow for less than full employment, foreign investments tend to depress the level of employment in the investing country and increase it in the host country.

CONCLUSION

In emerging economies, capital flows can be particularly volatile as the economy may experience periods of rapid growth and subsequent contraction. Increased capital inflows can lead to credit booms and the inflation of asset prices, which may be offset by losses due to depreciation of the currency based on exchange rates and declines in equity pricing. International capital transfers also affect the balance of payments of the investing country and host country. They increase the national income of both developing and developed economies.