View metadata, citation and similar papers at core.ac.uk

brought to you by CORE

provided by Research Papers in Economics

Emerging Markets Forum

The International Capital Flows´ New Directions

Marcílio Marques Moreira

Discussion Draft

Part of the EMF Series of papers on International Capital Flows, Domestic Capital Markets and Growth and Development in Emerging Markets Countries

2006 Global Meeting

The International Capital Flows´ New Directions

Marcílio Marques Moreira

Among the main differences between the current breathtaking wave of global economic integration and past episodes of a process which has been going on for thousands of years, Ben Bernanke stressed that “the traditional distinction between core and the periphery is becoming less relevant, as the mature industrial economies and the emerging market economies become more integrated and interdependent”.[1] And according to him, “an even more striking aspects of the breakdown of the core-periphery paradigm is the direction of capital flows: in the nineteenth century, the country at the center of the world´s economy, Great Britain, ran current account surpluses and exported financial capital to the periphery. Today the world´s largest economy, that of the United States, runs a current account deficit, financed to a substantial extent by capital exports from emerging market economies”.[2]

Having this new reality in mind, the present paper does not intend to discuss the ongoing debate on the sustainability of the U.S. economy´s huge current account deficits, which may be approaching the staggering annual figure of one trillion dollars - more than 7% of GDP - but rather focus on the new role of emerging markets as providers of capital to both developed economies and fellow emerging markets.

[1] Ben S. Bernanke, “Global Economic Integration: What´s New and What´s Not”, remarks at the Federal Reserve of Kansas City´s Thirtieth Annual Economic Symposium, Jackson Hole, Wyoming, August 25, 2006. See also BIS Quarterly Review June 2006: International banking and financial market developments (www.bis.org)

[2] Ibid

The new phenomenon is a natural result of the substantial current account surpluses generated by emerging countries. In some cases, of which China is paradigmatic, it is backed by the huge savings generated by those countries, in other cases as those of commodity exporting economies – of which Russia is paramount – it is connected to the recent rises in oil prices and of other commodities – of which Brazil is an example.

This redirection of capital flows and the resulting global imbalances led to a harsh debate, between those who blamed the excess consumption in the U.S. for the imbalances and those, among whom in the past Bernanke was prominent, who blamed a savings glut at the "peripheral" countries. The latter group argues that the savings glut would have led to an even sharper imbalance, where it not for the role of the U.S. as absorber of excess manufacturing capacity and surplus financial capital from the world´s periphery.

Although the above described macro-economic conditions provide the background of the redirection of capital flows from core → periphery to periphery → core, or periphery → periphery, it also responds to other considerations, some of them at the micro-economic or enterprise level.

This is particularly true for the flows of foreign direct investments, that according to the testimony of Bernanke at the occasion, are today "much larger relative to output than they were fifty or a hundred years ago".[3]

In the words of a most authorative expert on the subject, Karl Sauvant, “foreign direct investment (FDI) has become more important than trade for delivering goods and services to foreign markets.”[4] Actually, in the last year for which statistics are available, the sales of foreign affiliates (US$19 trillion) were twice as large as global exports (US$11 trillion).”

This movement is consistent with the growing trend of FDI, both in value and as percentages of gross stocks of foreign assets and liabilities. If all countries are taken into account, FDI stocks have grown from 15.6% of total foreign assets and liabilities, i.e. from 1,111 billion U.S. dollars in the period 1980-1984, to 21,8% of the total, i.e., to 16,600 billion in the period 2000-2004.

If you only look at emerging markets as recipients of capital, the total and particularly the relative growth are even more impressive. It has expanded from 12.0% of the total assets i.e. from 103 billion U.S. dollars to 26.6% of the total, or 1,306 billion, in the same period of time.[5]

In 2005, this upward trend found solid continuity, with the flow of total foreign direct investment surging to an estimated US$897 billion – up 29% from the preceding year. Of this, US$573 represented inflows into developed countries – up 38%, after a

---

[3] Ibid

[4] Karl P. Sauvant, “New Sources of FDI: The BRICS: Outward FDI from Brazil, Russia, India and China” in The Journal of World Investment & Trade, vol 6, n 5, October 2005, p.639. The latest figures were provided in the World Investment Prospects to 2010:Boom or Backlash? Released on September 5, 2006 by the University of Columbia and the Economist Intelligence Unit. www.cpii.columbia.edu/pubs/

[5] M. Ayhan Kose, Esnard Presad, Kenneth Rogoff and Shang-Jin Wei, Financial Globalization: A Reappraisal (Washington: IMF Working Paper WP/06/180, August 2006) pp 54 and 55

four year slump. US$274 billion – up 13% - were the inflows into developing countries.[6] If we focus only South-South FDI, it has become an important source of capital for the developing economies: FDI flows from developing to other developing countries have increased from US$14 billion in 1995 to 45 billion in 2003.[7]

As Sauvant reminds us, "in addition to integrating markets, FDI also integrates production activities internationally, through the corporate production systems established by transnational corporations (TNCs). Such "deep integration" constitutes, in many ways, the productive core of the globalizing world economy".[8]

One might add that, besides "corporate production systems", a strengthening trend of integration is taking place through the development of business networks in the sense best described by Castells.[9] As chapter 4 of the Global Development Finance 2006 stresses, "the expansion of FDI flows has been driven by developing countries' increasing openness to capital and trade, and by their increasing participation in international production networks".[10]

The above described reversal of direction in capital flows, with an increasing share flowing from periphery to core or periphery to periphery, is changing the previous assimmetry characteristic of an

---

[6] UNCTAD Press Release 2006/2002, dated 23/01/06

[7] Global Development Finance 2006: The Development Potential of Surging Capital Flows, Chapter 4: "Financial Integration among Developing Countries" (Washington: The World Bank, 2006) pp 110-111.

[8] Sauvant, ibid, p.639

[9] Manuel Castells, The Rise of the Network Society, 2nd ed. (Blackwell, 2000)

[10] "Financial Integration among…", p.111

one-lane road and is thus strengthening the financial, productive and distributional integration of the world economy in a ever closer interactive and mutually enmeshed global fabric.

Those flows from periphery to core are no novelty as such. However, in the past, they represented predominantly a search for economic security by wealthy individuals or a safe heaven for them to evade taxes and circumvent legal restrictions imposed on illict money. They flew in great part through the black market and could legitimately be called flight money.

In contrast, today, we witness increasing savings, current account surpluses of emerging countries and, within them, the emergence of large corporations.

In order to ensure their continuing growth and their competitiveness in a much harsher global competitive environment, emerging corporations are forced to globalize themselves, reaching out their presence into the world. They are, thus, led to act as genuine transnational corporations (TNCs). Consequently, they become natural generators of outward flowing foreign direct investments (OFDI).

The recent acquisition or merger – the two concepts are sometimes difficult to distinguish – of the Indian steel company MITTAL and the giant European steel corporation ARCELOR, valued at almost 40 billion dollars, is an eloquent example of this new reality and of its intensity and visibility.

Commenting on the phenomenon, Sauvant remarks: "OFDI from emerging markets – although not new – is the neglected twin of their inward FDI. On the surface, the reason for this neglect, especially from a policy perspective is clear:

> Emerging markets typically face a foreign exchange shortages and are capital constrained; hence they should import, not export capital. However this view neglects at least two considerations:
>
> - individual companies may well have the capital to expand abroad;
> - companies increasingly need a portfolio of locational assets to remain competitive."[11]

As developing countries suffered systematically from what at the time was called "dollar shortage", and as the outward flows used to involve illicit operations or were intended to avoid paying taxes or to protect assets from exchanges risks, deriving from domestic inflation or exchange crises, the respective authorities and public opinion used to regard such operations with severe recrimination and distrust. Consequently, they used to be forbidden. They used

[11] Sauvant, p.640

to be even subject to severe fines and their perpetrators to criminal indictment, which in extreme cases could lead to imprisonment.

As the urge for the acquisition of locational assets became stronger, led by efficiency and competitiveness considerations, often made possible by the country´s improvement in its exchange position, as was the case in many although not all emerging economies, restrictions against outward capital movements were gradually dismantled, especially of OFDI, despite a lingering distrust and a still strong resistance to the complete liberalization of capital controls.

As remarked by Sauvant:

> By liberalizing OFDI, governments can allow their firms to exploit their ownership advantages abroad, thereby helping them to remain competitive and, in the process, improve access to markets, technology and foster economic restructuring.[12]

Three factors combined - legal and regulatory liberalization; improved macro-economy, especially the current account; and the competitiveness demand on the enterprise level - pushed OFDI flows from emerging countries to rise from negligible amounts in the 1980s to US$46 billion in 2003, while their accumulated stocks reached US$853 billion.[13]

---

[12] Sauvant, p.641
[13] Ibid, p. 642

Many studies have examined the different more relevant factors which induce corporations, even medium sized ones, to transnationalize and to ensure a portfolio of locational or strategic assets abroad.

One of the more traditional drivers lies in the exporting companies' desire to overcome obstacles which jeopardize the competitive access of their products to preferred markets. Those obstacles may be high tariffs, non-tariff barriers, or other forms of protection, often disguised by institutional, cultural or sanitary considerations. Additional reasons derive from the need to assure distribution networks, warehousing and transport logistics or the need to satisfy technical requirements and specific demands of the market, to diversify the firms production base or to acquire brandnames.[14]

Besides the motivation of pursuing the goal of expanding or retaining promising export markets, there is often the objective to secure reliable sources of raw materials and intermediate goods indispensable for the productive chain in which the company is inserted; to tap less expensive factors of production, be it labour, electricity or other inputs; to readily access fast evolving technologies, new product developments, and skills; or to reach new sources of funds.[15] The wish to provide a broader experience

[14] This must have been an important consideration in the purchase by LENOVO of IBM´s personal computer division. See Sauvant, ibid, p. 652

[15] Roberto Magno Iglesias and Pedro Motta Veiga, "Promoção de exportações via internacionalização das firmas de capital brasileiro", in Armando Castellar Pinheiro et al. (eds), O Desafio das Exportações, BNDES, 2002

to their personnel and to familiarize them with new methods and approaches is an additional driver.[16]

While many developing countries still keep several constraints on OFDI, there are others, on the contrary, which, after having lifted or eased such controls, provide fiscal, institutional and credit incentives for outward FDI, specially if destined to countries in the same region.

The institutional support often takes the form of Bilateral Investment Agreements (BITS), double taxation treaties (DTTs) - treaties which cover both inward and outward FDI - or of Regional Trade Agreements, which use to dedicate a chapter to enhancing the legal protection of mutual capital investments.[17]

Some countries keep an ambiguous position in relation to the issue. This is true for Brazil, despite it having reached the significant stock of US$69,2 billion in OFDI by the end of 2004.[18]

Authorities and public opinion openly express pride in the emergence of large Brazilian multinationals like Petrobrás, CVRD, Odebrecht or Gerdau, but actual official support is scant and usually restricts itself to finance projects or acquisitions in South America or in Africa.

---

[16] See also, Shu-Chin Huang, Assistant Professor of Economics, Ming Chuan University, Taiwan and John Lew Cox, Professor (Ret) Department of Management and MIS, the University of West Florida, Pensacola, FL, USA, Outward Foreign Direct Investment and Technology Transfer: Selected results from the U.S. and Taiwan in the Eletronics Industry (IAMOT 2006) esp. p 2

[17] See "Financial Integration Among…" pp 115 and 116 and Sauvant p 653

[18] Banco Central do Brasil, Capitais Brasileiros no Exterior: Data-base 2001 a 2004. www.bc.gov.br

The lukewarm official support is also reflected by the fact that the country has signed few double taxation treaties and has not ratified a single bilateral investment treaty (a few were signed, but either were not submitted for approval to Congress or have been withdrawn after submittal).

This attitude, of course, is not consistent with the growing role of Brazilian firms as large investors in other South America countries. On the other hand, the arguments against multilateral or bilateral investment treaties – Brazil is the only exception among all other South American countries – revolve significantly around those treaties' arbitration mechanisms, deemed unconstitutional. This contention is gradually loosing backing in the doctrine, jurisprudence and even in the current legislation. In many instances, for instance, foreign arbitration has been accepted by law for specific cases. Actually, the negative arguments are old fashioned and politically inspired, ignoring the new reality of the country as both host of inward FDI and generator of OFDI. [19]

If outward flowing direct investments from emerging countries have been mostly welcomed by authorities and the specialized literature, as a significant step in the globalization process, first signs appear on the horizon of a forthcoming backlash against them, driven by protectionism, prejudice, nationalism (under the national security argument) or sheer competition.

[19] See Suzana Medeiros, "Arbitragem Internacional Investidor – Estado: Um Caminho Inevitável para o Brasil", Paper presented to the Seminar by the ABCI Institute, in Rio de Janeiro, on August 21, 2006. abci@gmail.com Pedro Batista Martins "Ten Years of Brazilian Arbitration Law: Overview and Prospects" www.batistamartins.com and Selma Maria Ferreira Lemes, "O Congresso Demora Injustificadamente para aprovar Acordos Internacionais de Promoção de Investimentos" in O Estado de São Paulo, September 8, 1997.

The phenomenon is specially acute in France, where the authorities have resisted the acquisition by foreign concerns of many French firms considered “strategic”, from high-tech and pharmaceuticals to steel and energy. Lately it also appeared with vigour in the U.S., being examples the opposition to the purchase by a Chinese state-owned company of a U.S. oil company and the rejection of the takeover by a Dubai company of the management of U.S. ports.

A recent article in New York Times commenting on the Mittal-Arcelor deal focused on the issue:

> The fight for Arcelor was closely watched around the world, as it evolved into a clash between two major forces shaping the world economy: the ascendancy of India and China as sources of new business models and ambitious new companies, and a rising tide of protectionism in the West fueled by anxiety that new competition will erode a way of life.[20]

A similar concern was expressed by Fred Bergsten, writing on the contagious and deleterious effect of the Dubai vs U.S. ports affair and offering proposals to streamline and give more transparency to the U.S. government review process, particularly by the committee on Foreign Investment in the United States (CFIUS).[21]

---

[20] Heather Timmons and Arnaud Giridharades, “Arcelor Deal with Mittal Establishes Steel Giant” in New York Times, June 26, 2006.
[21] Fred Bersten, “Avoid Another Dubai”, Op. Ed in The Washington Post, February 28, 2006
See also Karl Sauvant “O medo do investidor estrangeiro”, VALOR, Sept. 5, 2006, p.A11

In fact, a negative chain reaction triggered by such protectionist outbursts can be very serious. In the report just released by Columbia and the Economist Intelligence Unit, Sauvant remarks that “it would be ironic if developed countries – which led the FDI liberalisation wave of the past two decades or so and, like most other countries benefited from it – now led a backlash against FDI and triggered a roll-back of liberalisation.[22]

In a debate in London, last June, on why the Middle Eastern countries are so hesitant in investing in the expansion of their oil production, I heard a senior financier from the area arguing that unless the surging clouds on foreign direct investments from Middle Eastern and other large oil producing countries (read Russia) are dissipated, those countries will not show great enthusiasm to invest in expanded oil production, accumulating petro-dollars, if the only open markets for them would be low-yielding Bank deposits, which then are recyled for purposes which totally ignore their basic needs and interests. One of their concerns, is the fact that oil, being exhaustible, would have to be succeeded by other reliable sources of income. As investments abroad are often more promising, OFDI for them becomes an important element in their global investment strategy.

Here, the close interrelationship between trade and investment shows itself again with great force and deserves an increased degree of attention.

[22] World Investment prospects to 2010: Boom or backlash. Special edition of an Economist Intelligence Unit report written with the Columbia Program on International Investment, p.77, September 5, 2006 www.cpii.columbia.edu/pubs/

A final word of caution. Although focusing primarily on flows of direct investments, I referred, at the introduction, to the macro-economic condiitons (savings glut at the periphery, excess consumption in the core), which functioned as an enabling and stimulating factor of the decision – taken primarily for micro-level considerations – by which companies from emerging markets embark on investments in other developing countries or in the developed ones.

While trying to explain the phenomenon, and even to point to some of its virtues, there is a broad consensus that the implicated global imbalances are unsustainable. Like an airborne plane, sooner or later, there must be a landing. Where opinion differs, is on the nature of the expected landing: will it be a hard one or a soft landing?

Consensus opinion still tilts toward the soft landing hypothesis, but out-of-consensus "hard-landers" have become more vocal, as can be read from Paul Krugman's op-ed articles in the New York Times or from the articles and blogs by NYU Stern Bsiness School's professor Nouriel Roubini (www.rgemonitor.com).

More recently a disturbing alternative – mainly from the point of view of developing countries – has been ventilated. Guillermo Calvo (IADB) and Ernesto Talvi (CERES, Montevideo) have examined the issue in an intriguing article "The Resolution of Global Imbalances: Soft Landing in the North, Sudden Stop in Emerging Markets?"

They argue that world savings are not likely to shrink, but "global liquidity might contract inducing a sharp rise in interest rates worldwide". In conclusion they argue that while they "expect landing in the U.S. to be soft" emerging markets "are bound to suffer a series of sudden stops".

And they conclude: "this outcome, where apparently unrelated events end up hitting EMs through their reverberations on international capital markets, would not be unprecedented, as the 1998 Russian crisis clearly illustrates".

Although direct investments, as in past episodes, may weather such crises better than debt and portfolio flows, the suggested perspective should work as a reminder to developing countries that they should not be satisfied with recent improvements in their exchange condition. On the contrary, they should strive to be better prepared, by strengthening their own economy, to face harder times after four years of high growth, no crises, and almost unlimited worldwide liquidity.

Rio de Janeiro, September 6, 2006

The Emerging Markets Forum is a not-for-profit initiative that brings together high level government and corporate leaders from around the world for dialogue on the key economic, financial and social issues facing emerging market countries – *a dialogue that concludes with consensus and commitment to actionable outcomes.*

The Forum is focused on some 50 emerging markets economies in Asia, Europe, Latin America, Middle East and Africa that share prospects of superior economic performance, already have or seek to create a conducive business environment and are of near term interest to private investors, both domestic and international.

The dialogue at the EMF Global and Regional Meetings is based on a Series of papers written by world-renowned authorities exclusively for these meetings.

For more information about the Emerging Markets Forum, please visit our website,

http://www.emergingmarketsforum.org

or email us,
info@emergingmarketsforum.org

The Watergate Office Building, 2600 Virginia Avenue, N.W., Suite 201
Washington, DC 20037, USA Tel: (1) 202 393 6663 Fax: (1) 202 393 6556

© 2006 Emerging Markets Forum, All Rights Reserved

2006 Global Meeting