

CAPITAL FLIGHT

When the risk doing business in a country rises sharply or the expected return falls, we sometimes observe large outflows of investment funds so that the country experiences massive capital account deficits. Such outflows of funds are often descriptively referred to as capital flight. The change in the risk-return relationship that gives rise to capital flight may be the result of political or financial crisis, tightening capital controls, tax increases, or fear of a domestic currency devaluation.

One of the issues arising from the developing country debt crisis of the 1980s was an assertion by bankers that some of the borrowed money was not put to use in the debtor nations but, instead, was misappropriated by individuals and deposited back in the developed countries. In addition to allegedly misappropriated funds, wealthy individuals and business firms often shipped capital out of the debtor nations at the same time that these nations were pleading for additional funds from developed country banks.

An important aspect of the capital outflows is that fewer resources are available at home to service the debt, and more borrowing is required. In addition, capital flight may be associated with a loss of international reserves and greater pressures for devaluation of the domestic currency.

The capital flight highlights the importance of economic and political stability for encouraging domestic investment. The stable and growing developing country faces little, if any, capital flight and attracts foreign capital to aid in expanding the productive capacity of the economy.

CAPITAL INFLOW ISSUES

The early 1990s were characterized by a surge of capital inflows to developing countries. Interest in countries with emerging financial markets stimulated both direct and portfolio investment in these countries. The inflows were welcome in that they helped poor countries finance domestic infrastructure to aid in development and they provided additional opportunities for international diversification for investors. However, some countries that experienced particularly large capital inflows exhibited problems that could reduce the positive effects of the capital flows.

A large capital inflow in a short period of time can lead to an appreciation of the recipient country's currency. This appreciation may reduce the competitiveness of the nation's export industries and cause a fall in output and rise in unemployment in these industries.

The capital inflow may also be associated with a rapid increase in the country's money supply, which would create inflationary condition. As a result of potential problems associated with capital inflows, some countries have imposed policies aimed at limiting the effects of these inflows.

Fiscal restraint is a policy of cutting government expenditures or raising taxes, so that the expansionary effect of the capital flows is partially off-set by the contractionary fiscal policy. Many countries have used some sort of exchange rate policy measures. Generally, these involved an appreciation of the currency in countries where the exchange rate has maintained little flexibility. Allow money supply to be insulated from the capital flow so that inflationary monetary policy does not occur. Some countries also permitted greater exchange rate flexibility as a way to insulated the domestic money supply from the capital flows.

Some countries imposed capital controls to limit the inflow of capital. Such measures include taxes and quantity quotas on capital flows, increased reserve requirement on bank borrowing in foreign currency or limits on foreign exchange transactions.

GLOBALIZATION OF EQUITY MARKETS

Just a couple of decades ago, many countries had equity markets that were segmented. A segmented market is one in which foreign investors are not allowed to buy domestic stocks and domestic investors are not allowed to buy foreign stocks.

Part of the process of the globalization of world economies is the liberalization of stock market restrictions to open market to the world.

When a country moves from a segmented market, cut off from foreign investors and foreign markets, to a globalized market in which the domestic restrictions are lifted, the domestic stock market is now freely open to the world and domestic investors can hold stocks of both domestic and foreign firms.

Now, we can think about a risk premium that must be paid to compensate investors for taking risk. Let us denote the return on the risk-free asset as R_f . Then we can consider the risk premium on small country C's assets as being equal to the return on C's assets minus the risk-free rate of return

Or Risk Premium = $R_c - R_f$. The size of this risk premium should depend upon the variance of the return on the market portfolio and the price of risk.

In a segmented market, the variance of returns is just the variance of the domestic market return, so the risk premium before globalization is $P \text{var}(R_c)$. Where P is the price of risk. So, the risk premium required on domestic stocks in segmented financial market C will just depend upon the variance of stock prices in country C multiplied by the price of risk P . P is determined by the risk aversion of investors are the same everywhere, then P is a constant across countries.

In a world of segmented markets, a country with a variance of returns twice as high as another country would have twice the risk premium on its stocks. **This risk premium is what investors require in order to willingly hold shares of the stocks.**

In the globalized equity markets we can think of the portfolio return volatility for the residents of small country C as the variance of a portfolio comprised of the stocks of country C and the stocks of the rest of the world.

If country C is a segmented market, then the portfolio return variance would just be equal to the variance of the return on country C stocks . Now, we can think that, if the government of country C would open up or liberalize its financial markets and become globalized. The risk premium on C's stock should depend upon the contribution of C's stock to the variance of the world portfolio, which is given by the covariance of the return on stock in country C with the returns in the rest-of-the world.

Now we can find the conditions under which globalizing a financial market will reduce the risk premium on a country's stock.

So, the risk premium on country C stock will fall with globalization if the ratio of the standard deviation of the stock returns in C to the stock returns in the rest-of-the world is greater than the correlation coefficient between the two.

In general, we expect that when a government liberalize its financial markets to become globalized or integrated with the rest of the world, the risk premium on its stock falls.

This points out a major benefits of globalized financial markets; a lower risk premium on domestic financial assets allows domestic firms to lower their cost of capital.

The cost of capital is what firms have to pay investors to raise new funds. If a domestic firm sells new shares of stock, then the lower the risk premium, the smaller dividends or cash flows the firm must pay stockholders. This allows firms to raise money more cheaply and will allow greater investment spending and expansion than otherwise.