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EMERGING MARKET ECONOMIES ON EFFECTS OF CAPITAL FLOW LIBERALIZATION FROM RECENT EXPERIENCES

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Abstract

Capital flows to emerging market economies (EMEs) have been characterized by high volatility. In recent years although gross as well as net capital flows to the EMEs have increased, they could not be absorbed domestically. Overall, savings have migrated from emerging markets to developed economies, casting doubt on the commonly held belief that capital flows to emerging markets always benefit from the expansion of their resources, which in turn leads to higher levels of investment there. EMEs' growth potential could be harmed by complete financial liberalization, which could lead to unwelcome volatility. Financial inclusion and stock market development have also seen a positive shock, which we believe is linked to wider cross-border capital flows. We investigate, in particular, whether banking regulation reduces the negative effects on economic growth of capital flow volatility. By reducing the negative impact of erratic capital flows, we have found that banking supervision enhances economic growth across countries and over four decades. The conclusions are valid for both aggregate capital flows and their numerous components, as well as for net and gross counterparts, and they are also valid for various regulatory policy indicators. It turns out that bank regulatory policies aimed at maintaining financial stability are also advantageous for long-term economic growth.

1.0 Introduction

Two of the three generalized facts that describe the dynamic composition of gross private capital inflows to emerging market economies are: Starting with the fact that investment and total inflows are very closely linked. Second, depending on where the economy is in the business cycle, the various financial account components respond differently. Third, correlations between flow types show that some of these flows can be substituted for one another. For policymakers in emerging market and developing countries, the necessity of carefully analysing the composition of reported capital inflows and the variables that drive them is emphasized by capital flow-type specific estimation results. Any comprehensive assessment of financial vulnerabilities related to external finance must take into account the degree to which domestic economic policies or international circumstances outside the control of national economic policymaking affect capital flow drivers. This understanding is critical. According to our research findings, examples of factors beyond the control of domestic economic policies include the ease with which global financial markets provide funding (with credit being a significant indication in large industrialised economies) and global policy uncertainty. There is a risk that the significance of structural forces for capital flows to emerging market and developing economies may be understated in periods like the present one, when interest rates are ultra-low worldwide, global liquidity ("credit ease") has decreased, and policy uncertainty is high. This is due to the fact that cyclical and structural forces have traditionally been studied individually rather than as part of an integrated empirical framework in earlier studies. So an empirical approach that takes structural push variables and external pull factors like policy uncertainty and global liquidity into account, as developed in this study, is critical for politicians.

Scope of the work:

The study's objectives are to look into the impact of financial inclusion on the stock market. The inflow of capital and the growth in India with the influx of capital, India's growth dynamics have begun to pick up speed. Evidence of significant complementarity with domestic investment implies that capital flows brighten the overall investment climate and stimulate domestic investment even when a part of the capital flows is actually absorbed in the form of accretion to reserves. The growth-enhancing effect of foreign capital, on the other hand, appears to have been restricted by India's low levels of actual and planned absorption of foreign capital.

Objectives of study

The study broadly examines the impact of international capital flows on economic growth in view of changing India's financial markets. Specifically, the objectives are:

- To examine trends and composition of capital flows
- To examine the impact of capital flows on economic growth.
- To suggest policy implication thereof.

2.0 Literature review

In this review to Investigates the capital flows and its impact on the capital formation and economic growth taking into the variable as net private capital flows, net direct investment, net official flows, net portfolio investment and other net investments in 22 countries during 1992 to 2000. **Duttaray, Mousami et al [1]** There would have to be an adjustment in both the real and financial markets if capital inflows were turbulent or short-lived. Direct foreign investment inflows are viewed as more long-term because of this. External forces can only increase capital flows, and these tend to be less long-term than those produced by factors domestic in composition **Khanna, Sushil [2].** Economies have to deal with big and unexpected capital inflows and outflows because of these effects. It is possible for a real exchange rate to increase when capital inflows are substantial. A capital account opening is not a one-time affair, according to this scholar. Capital inflows cause real exchange rate appreciation, stock market and real estate boom, real accumulation and monetary expansion, as well as effects on output and consumption **Mckibbin, W.J [3].** She investigates the impact on capital flows upon the domestic financial sector in India. Inflows of foreign capital have a significant impact on domestic money supply and stock market growth, liquidity and volatility **Singh, Ajit [4].** The domestic financial system, which includes the banking sector and the capital market, will be impacted if there is a large influx of foreign cash into India. The relationship between the Indian financial market and the international financial market emphasises India's vulnerability to financial shocks. There is some evidence that portfolio flows have an impact on the stock market price in India. In India, the gap between net capital inflows and the current account deficit has so far been favourable. **Arregui, N., Benes [5]** The Cointegration test confirms the presence of long-run equilibrium relationships between a few pairs of variables. But the dependence of each variable on private capital flows invalidates such cointegration except in two cases: cointegration exists between foreign currency assets and money supply and between nominal effective exchange rate and exports, even after controlling for private capital flows **Alfaro, L., Kalemli [6**]. Private capital flows have a one-way causal relationship with nominal effective exchange rates, according to the

Granger Causality Test, which raises queries concerning the RBI's approach in the foreign exchange market. Another significant contributor to currency asset price volatility is the volatility of private capital flows, which has a lag effect.

3.0 Research methodology

The dependent variable of our analysis, the growth rate of output, is measured as the growth of real per capita GDP in constant local currency. As controls in the set X, we include a number of variables drawn from the extant growth literature. The set includes the logarithm of beginning-of-period real GDP per capita to control for conditional convergence effects, initial secondary school enrolment rates to proxy for education, the growth rate of the population, the ratio of private investment to GDP, the ratio of trade to GDP as a measure of country openness, government consumption expenditure to GDP, inflation as a proxy of macroeconomic stability, the institutional quality of the government, and a measure of financial depth: private credit provided by deposit money banks and other financial institutions as a share of GDP

Evolution of capital flows to emerging markets and developing economies

The modern history of capital flows to emerging markets is characterized by an uneven process of successive waves of investment, each of which was followed by financial or political crisis The upswings and downswings witnessed in the data closely matches events like the Latin American debt crisis, the Asian financial crisis and, more recently, the global financial crisis. suggest that flows to EMDEs have slowed down from around the second quarter of the year. The capital flow environment witnessed significant changes since the 1980s, both in terms of the type of flows (gross inflows versus gross outflows) and in the categories of flows. Net capital flows to EMDEs, as a share of GDP, have been historically higher than for advanced market economies since net flows in advanced market economies (AMs) are influenced by both gross inflows and gross outflows, while those facing EMDEs are influenced by gross inflows predominantly capital flows in EMDEs were driven by gross inflows with gross outflows almost flat.

Capital flows and growth in India:

Capital flows into India have been predominantly influenced by the policy environment. Recognizing the availability constraint and reflecting the emphasis on self-reliance, planned levels of dependence on foreign capital in successive Plans were deliberately held at modest levels. Economy in the recourse to foreign capital was achieved through import substitution industrialization in the initial years of planned development. The possibility of exports replacing foreign capital was generally not explored until the 1980s. It is only in the 1990s that elements of an export-led growth strategy became clearly evident alongside compositional shifts in the capital flows in favour of commercial debt capital in the 1980s and in favour of non-debt flows. The approach to liberalization of restrictions on specific capital account transactions, however, has all along been against any "big-bang". India considers liberalization of capital account as a process and not as a single event. While relaxing capital controls, India makes a clear distinction between inflows and outflows with asymmetrical treatment between inflows (less restricted), outflows associated with inflows (free) and other outflows (more restricted). A combination of direct and market-based instruments of control is used, meeting the requirements of a prudent approach to

management of the capital account. The control regime also aims at ensuring a well-diversified capital account including portfolio investments and at changing the composition of capital flows in favour of non-debt liabilities and a higher share of long-term debt in total debt liabilities

Trends and Composition of Capital Flows into India

The nature of capital flow into India. From a mere absence of any private capital inflows till today such inflows represent a dominant proportion of total flows. The objective of this study is to investigate the link between financial volatility and economic growth and whether the applied regulatory rules influence this link. We broadly define financial volatility as the volatility of capital flows due to the presence of a well-established relationship between bank regulatory policies and capital inflows, for both the flows' first and second moments.

Table: Summary statistics

Different statistics parameters	Mean	Std Dev	Min	Max
Growth rate of GDP per capita	2.21	3.06	−10.86	13.04
Total capital flows	1.73	2.33	−1.51	20.75
Volatility of total capital flows	0.810	1.48	**0**	14.36
Initial GDP per capita (log)	0.432	1.60	4.77	20.75
Education	67.91	33.37	1.40	160.6
Population growth rate	1.45	1.16	−1.42	6.95
Investment	23.21	5.97	4.66	47.49
Trade	59.76	30.36	12.22	207.7
Government consumption	15.72	5.55	3.98	41.71

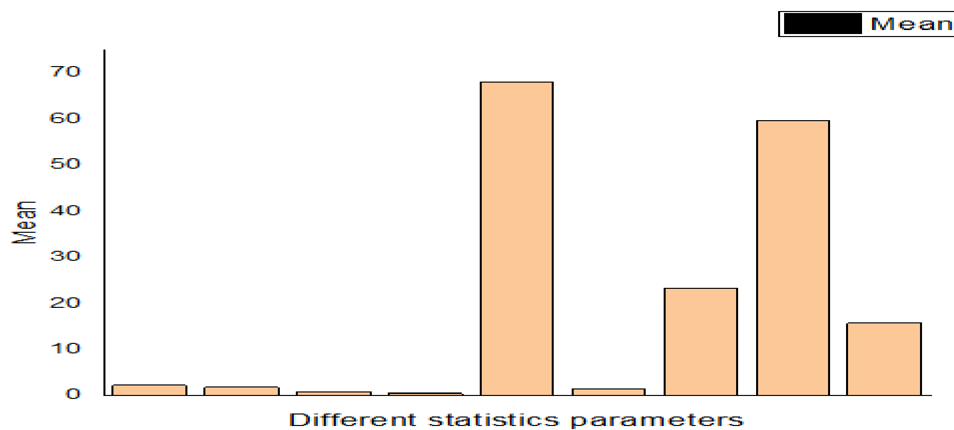

Figure: Different statistics parameters vs Mean

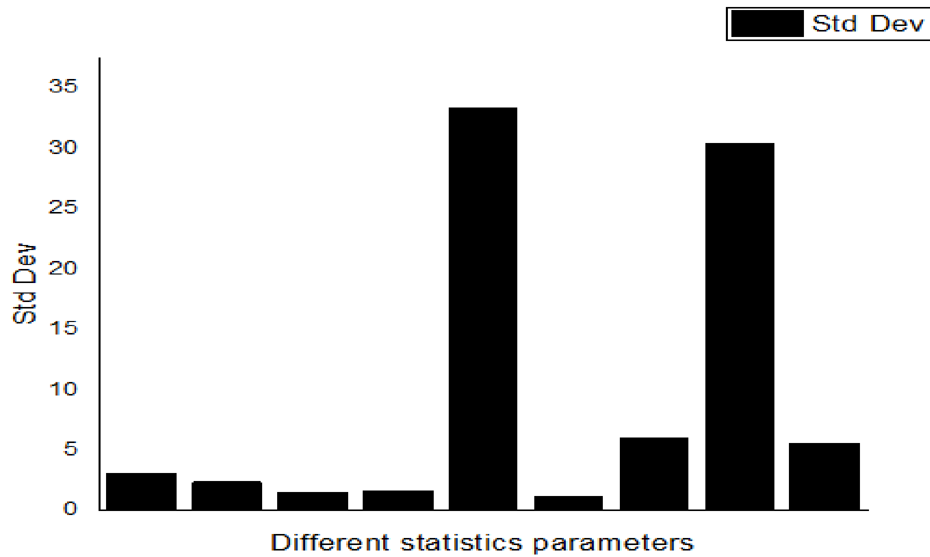

Figure: Different statistics parameters vs Std Dev

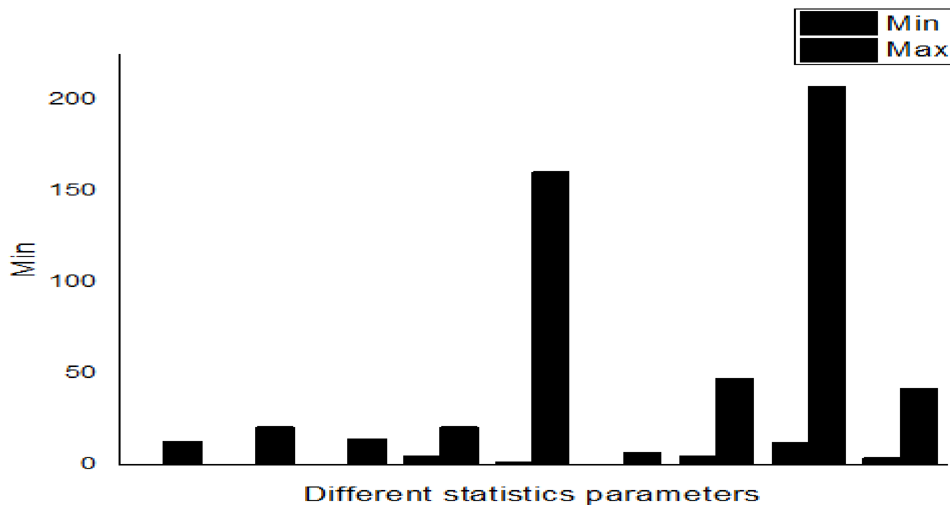

Figure: Different statistics parameters vs Maximum and minimum Variations

To Empirical specification that tests whether prudential regulation has achieved its objective in a growth framework. This amounts to examining the effect of volatile financial flows on economic growth in the presence of regulatory rules. We find that regulatory policies mitigate the negative growth effects of unstable capital flows and, by so doing, are effective in limiting financial system vulnerabilities. This finding holds across a variety of types and measures of capital flows, with indications that the dampening effect is more pronounced for gross flows, as well as across different aggregate instruments of regulation. Further results qualify that these outcomes are mainly restricted in the sample of middle-income countries, while countries that are relatively open, with deep financial systems and exposed to macroeconomic volatility experience lower marginal gains although they still benefit

CONCLUSION:

The more recent work shows that while the incidence of capital flow surges depends on external factors, including the extent of financial market liberalization and global financial

market integration. Moreover, the drivers of capital flows depend on the type of flows considered, thus the related in parallel, there are studies that support a non-linear growth effect of capital flows, this being subject to conditions in the recipient countries, such as the degree of financial development, the stock of human capital, and the quality of institutions. These considerations, however, have limited the analysis in the first moments of capital flows while, at the same time, have ignored the potential role of regulatory policies. Less than a handful of studies have explored the importance of the volatility of capital flows, illustrating its growth-retarding effect. The adoption and application of regulatory policies, on the other hand, have only been examined with respect to their effectiveness on short-term economic stability without any reference to its long-run implications. This paper fills the gap investigating the role of regulatory rules in the long-run growth process focusing on a particular channel: the way by which financial regulation affects the impact of financial volatility

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