The Palgrave Macmillan

Submerging Markets

Rich Marino

The Impact of Increased Financial Regulations on the Future Growth Rates of BRICS Countries

Submerging Markets

This page intentionally left blank

Submerging Markets

The Impact of Increased Financial Regulations on the Future Growth Rates of BRICS Countries

Rich Marino

palgrave
macmillan

First published 2013 by
PALGRAVE MACMILLAN

Palgrave Macmillan in the UK is an imprint of Macmillan Publishers Limited, registered in England, company number 785998, of Houndmills, Basingstoke, Hampshire RG21 6XS.

Palgrave Macmillan in the US is a division of St Martin's Press LLC,
175 Fifth Avenue, New York, NY 10010.

Palgrave Macmillan is the global academic imprint of the above companies and has companies and representatives throughout the world.

Palgrave® and Macmillan® are registered trademarks in the United States, the United Kingdom, Europe and other countries

ISBN 978-1-349-34862-6 ISBN 978-1-137-29650-4 (eBook)
DOI 10.1057/9781137296504

This book is printed on paper suitable for recycling and made from fully managed and sustained forest sources. Logging, pulping and manufacturing processes are expected to conform to the environmental regulations of the country of origin.

A catalogue record for this book is available from the British Library.

A catalog record for this book is available from the Library of Congress.

10 9 8 7 6 5 4 3 2 1
22 21 20 19 18 17 16 15 14 13

This book is dedicated to the memory of Dr S. R. 'Larry' Epstein, Professor of Economic History at the London School of Economics. In the very short time that I had the privilege of knowing him, he was my professor and my graduate supervisor, but more importantly he taught me that even an old dog like me can learn new tricks.

This page intentionally left blank

Contents

List of Figures

List of Tables

Acknowledgments

Without question, no project can come to fruition without the support, encouragement, and professional guidance of others. In that regard, I would like to thank my editor Lisa von Fircks, Pete Baker, Stephen Rutt, Gemma d'Arcy Hughes, Beverley Copland, and the Palgrave Macmillan production team.

In support of my research findings, the book is documented with a number of figures and tables from various organizations. I would like to thank Teresa Evaristo of the International Monetary Fund, Mayya Revzina of the World Bank, Enestor Da Rosa Dos Santos Junior of BBVA Research, Anna Fedec of Trading Economics, Joana Isabel da Silva Malheiro and Dounia Boutamdja of the Organization of Economic Cooperation and Development (OECD) and the African Economic Outlook (AEO), Robin Koepke of the Institute of International Finance, Elena Katkova of the Russia Federal State Statistics Service, Christo Stoykov of the Schulich School of Business, York University, Toronto, Cathy Conkling-Shaker of the Inter-American Development Bank, The Bank for International Settlements' Basel Committee on Banking Supervision (BCBS) and Louis Green of Bankscope, published by Bureau van Dijk.

Part I

The Need for Increased Regulation

1
Introduction

The following book will examine the history of capital flows among the developed nations and the emerging markets from the 1990s to 2012. In terms of emerging markets, the analysis will focus on the BRICS: Brazil, Russia, India, China and now South Africa. Within this spectrum, it will use any number of analytical tools to measure capital flows and capital formation within the context of globalized markets. An analysis of capital flows relative to the emerging markets' GDP growth rates over time should help determine an expectation of future growth rates. The results found in the history will provide me with the basic framework from which to build a thesis to determine the impact of increased financial regulations on the future growth of the BRICS countries.

This is an important question because at this point in time we really don't know. For one thing, the lag time between the complete implementation of the new international financial reserve requirements (Basel iii) and the actual culminating effects among the global emerging markets is too great. As of this writing, there are a number of concerns beginning to surface from emerging markets with regard to fundamental GDP growth, that is inflation, deflation, unemployment, wealth distribution, and so on. These factors will obviously vary from country to country, but a so-called better than expected current GDP growth rate from an emerging market is not in and of itself a prediction of sustained growth if the global financial markets are constrained.

This book should be a valuable asset and serve as a condensed source to anyone in the world academic or global business community interested in the impact of new financial regulations and reforms relative to possible and probable future economic growth rates of the emerging market economies. Moreover my research results will provide an alternate springboard for further inquiry to explain the ongoing paradox between theoretical economic progress and the real inherent economic measurement found in the economic progress of the BRICS. In addition given my extensive analyses, the book could be a resource for any government agency that has a vested interest in the emerging markets.

Included in the research design which will facilitate the basis for the book are specific data accumulated from the OECD's new global macroeconomic model mainly in Chapter 10. This particular model is much more summarized than the previous OECD models. The simulation's inherent segmentation provides a more lucid grasp of specifics according to regional categories. In terms of global trade and financial origination, it's weighted more positively in nation-specific policy interests combining 'short term Keynesian styled demand dynamics in line with reliable neo-classical supply-side economics'.[1] Its vigorous equity consistency underscored by the treatment of international income streams relative to international assets and liabilities provide invaluable statistics while retaining the standardized logical treatment of international trade. In terms of asset valuations, the model delineates the overall influence of domestic expenditures and financial and housing market activities relative to interest rates, exchange rates, and house and equity prices emphasizing the pivotal importance of its aggregate data collection. In the end, the new model illustrates the dynamics of wealth and wealth effects characterized by the creation of asset prices found in the diffusion of financial markets in relation to national and international economic shockwaves.[2]

Chapter 2 will analyze the regulatory history (cause and effect) of the United States from the Panic of '07 to 2012. Chapter 3 will complete the process of an analysis of measured capital flows and capital formation within the context of globalized markets from the 1990s to 2012. Chapter 4 will analyze current and forecasted GDP of selected emerging markets including the BRICS. Chapters 5 through 9 will provide an analysis of capital flows to each BRICS nation beginning with Brazil in Chapter 5. Chapter 10 will offer the conclusion by answering the following two questions: Will the new increase in financial regulations restrict capital flows to the emerging markets (BRICS)? If so, will this result in lower future growth rates for the BRICS?

Obviously, developing nations where resources for the most part are in short supply stand to benefit most from free capital flows. The liberalization of global capital is usually considered a boon for developing nations; capital drives economic mobility, improves productivity and efficiency, lowers the unemployment rate, increases the standard of living, and equally important, it gives the developing nation a seat at the table with other global economic powers, but there is a downside. Please note the following statement by Manuel Guitian, former Director of the IMF's Monetary and Exchange Affairs Department:

> But capital flows also expose countries to external disturbances and can have a destabilizing effect. The dangers of sudden *outflows* are well understood, but capital *inflows* also carry risks – they may create difficulties for monetary policy management and inflation control as well as for exchange rate stability and export competitiveness. This is particularly true in countries with vulnerable financial sectors and inappropriate macroeconomic policies.
>
> The long-running debate about the desirability of unrestrained capital movements intensified in the wake of the financial crisis that rocked several Asian economies in 1997 and 1998. Do capital controls have a role in today's world economy? What other steps can be taken, at both the national and the international levels, to help countries minimize the potentially disruptive effects of capital flows on their economies.[3]

The ongoing debate about advantages and disadvantages of capital flows dates back to Bretton Woods: 'the new cooperative international monetary order'.[4] In fact in the original Articles of Agreement of the International Monetary Fund, this issue is addressed. In terms of capital mobility, the Articles of Agreement provide leeway for member countries to monitor and control global capital inflows and outflows. Article VI, Section 3 permits controls 'as are necessary to regulate international capital movements' and in Article VI Section 1, the IMF 'may request a member to exercise such controls'.[5]

The debate became particularly heated in the 1970s in the midst of sky rocketing oil prices and sky rocketing stagflation. The arguments centered once again on how much government intervention should a nation impose on its capital inflows and outflows and just how much should be left up to the private sector economy. Bretton Woods delivered the message that governments and policies play a fundamental role in the nation's economy. 'Governments were expected to take responsibility for the basic economic objectives and economic performance.'[6]

Obviously that's not the case today. Most free market countries take the position that the private sector economy without government directives offers the best possible road to overall prosperity, and most citizens would probably agree at least in principle. However, at times it can be difficult for any of us to defend a free market system that almost took us over the edge in 2008 by trading deceptive securities and then to make matters even worse, Wall Street's primary culprits stood in line and asked the government to bail them out.

Capital flow mobility is nothing more than a synonym for a global economy. Free capital outflow mobility offers the home nation very little if anything in return. However, it can provide exceptional rates of return for investors and corporations who are able to understand the investment intricacies and climate of the destination country, for example buying Chinese stocks on the Shanghai Stock Market. Unfortunately for most people, this would be a very difficult task. Consequently if any of them wished to participate as an investor, most would have to buy a mutual fund, an exchange traded fund (ETF) or possibly an ADR (American Depository Receipts), which by the time the investment washes down to that level is usually diluted with commissions, management fees, underwriting charges and so on.

Prior to the 2008 crisis, the international capital flows as a percent of GDP showed more of an erratic penchant depending on a number of variables mainly the economic opportunities available in the home countries. For example in 2002, $700 billion flowed into the United States while roughly $200 billion flowed out of the United States. Obviously, these numbers change from year to year, but the types of international capital flows remain pretty much constant: bank and other investments, direct investment, and portfolio investment.[7]

Foreign direct investment (FDI) is considered by most to be an investment made by a firm as opposed to an individual. When a business enterprise in one country takes control or takes an ownership position (more than 10% of the shares of the objective entity) in a business enterprise in another country generally that's considered a foreign direct investment. This kind of an investment is often the result of a synergy between the two firms, for example Mitsubishi Bank owns 20 percent of Morgan Stanley. It's very important to note that the 'political, economic and legal stability recipient country also matters. Investors are reluctant to establish ownership of foreign companies or set up business abroad if corruption or political or social instability are likely to jeopardize operations.'[8]

Typically, foreign direct investment amounts to roughly 25 percent of capital inflows. Historically of that percentage, usually 40% of the total capital inflows are destined for the United States, Canada, the United Kingdom, Japan and the Eurozone. However, these numbers are the annual average prior to the 2008 crisis and this is also an important part of this manuscript which will be discussed in complete detail in the conclusion. In the 1990s, the United States was by far the largest recipient of foreign direct investments while an additional 30 percent went to the emerging markets allowing for privatization of state owned companies in Latin America and Eastern Europe.

Portfolio investment takes place when investors take a noncontrollable position in passive ownership either through publically traded stock, privately held stock, partnership interest, or venture capital in the form of participating equity at a future date. This particular investment also includes corporate bonds and government bonds.

For the most part and with the exception of privately held stock, partnership interest, and venture capital, portfolio investments are highly liquid especially if the securities are traded on a public exchange. The economic conditions of the recipient country is an important factor in the decision making process. In the case of foreign ownership, an investment in a particular company is in many ways the same as an investment in a particular country; the two are synonymous with one another. By the same token if characteristics change in either the company or by exogenous forces in the recipient country, an investor can liquidate the position in a timely fashion.

It's not unusual for countries to receive large sums of capital inflows in one year only to watch the same inflows exit the next year due to an increase in economic and political instability, for example Korea, Mexico, Russia, Brazil and Argentina in the mid to late 1990s and the first part of the 2000s. In these situations, there were overriding concerns that the private sector plus the governments of these emerging market countries were on the wrong track to pay their financial obligations without inflating their way out of debt which turns hard currency investments into soft currency returns.

In terms of the United States, portfolio investment in US government securities by foreign capital inflows has gone from 3 percent of total capital inflows in 2001 to 33 percent in the first three quarters of 2003 to roughly 42 percent of the total capital inflows in 2010.[9] In the time period between 2001 and 2010, the resulting increase in US Government backed securities represents the shift in thinking that embraces a 'safe haven' as opposed to a more risky asset class like equities.[10]

Another major investment associated with capital flows is bank investments. Bank investments by foreigners amounts to roughly 25 percent of the total and that's a number that remains fairly constant. This particular investment includes obviously deposits by individuals, firms, and governments. It also accounts for loans to foreign entities, for example foreign corporations, foreign business partnerships, independent firms, and to a lesser extent, individuals. Most of these lending relationships occur when additional capital is needed by a foreign business entity that has set up shop in a designated country.[11] Borrowing money in a country other than the home country has many benefits: the funds are not subject to currency translations so the exchange risks have been eliminated; the borrowed funds are in the same currency as the day to day business transactions and it establishes an insider's business relationship which is vital for a long term commitment to flourish.

Over the years bank investments have been more prevalent in the developed nations as opposed to the emerging markets. Interestingly enough, from 1992 to 1996 the percentage of capital flows earmarked for bank investments to the emerging markets amounted to roughly 28 percent, but that number declined to only 3 percent from 1997 to 2002 and there really isn't that much difference today. A recent report written by the Federal Reserve Bank of Dallas claims that 'the recent private inflows of capital to emerging markets have been more than offset by government investments into safe foreign assets. Thus, on net, total capital – private and public – is actually flowing upstream: from labor-abundant, fast growing emerging market economies to capital-rich advanced economies.'[12]

Capital flows have distinct advantages. First off, capital inflows provide countries with capital for investment beyond the country's bank deposits. Moreover an increase in investments supports decreased unemployment, which will result in an increase in domestic output. When foreign and domestic investors have access to untapped markets, this generally facilitates a broader and more diversified investment base with decreased risk and increased yield.

Technology transfer through foreign direct investment provides emerging economies with a technological infrastructure that would normally be reserved for developed nations. With that said, there are and have been cases where the technology patents have been ignored and pirated, but that's the subject of another book. Along with technology transfer is management technique transfer that affords the developing nation a more cost effective process which should result in a decrease in overall production costs and an increase in productivity. Capital inflows provide the receiving country access to a variety of investment alternatives which will stimulate domestic investment pools and reduce overall capital cost. In addition, increased capital inflows are a boon for the financial sector. The financial sector comingles the domestic funds with capital inflows, which increase the capital available for projects, but more importantly the country's financial infrastructure becomes more efficiently streamlined making the cost of finance more competitive. The key to a successful financial sector is risk minimization. A larger capital base minimizes risk because it affords more diversification as opposed to a financial sector that relies on a few sectors, for example a predominantly agricultural nation or a nation rich in mining precious metals with little or no manufacturing (exports natural resources and imports finished goods).

Research has proven that countries that are open to foreign direct investment grow their economies at much faster pace than countries that are not. It only stands to reason that if a nation's resources are finite then through foreign direct investment this limited economic structure becomes not necessarily unlimited, but definitely expanded. However, capital inflows may not always be the correct panacea. There are instances when an increase in capital flows may become a detriment as in the case of a developed country like the United States:

> During the 1960s and 1970s, U.S. domestic saving and investment were of comparable size, roughly 20 percent of gross domestic product (GDP). This meant that the current account balance was quite small. The average from 1960 to 1979 showed a surplus of about 0.3 to 0.4 percent of GDP. This surplus was equivalent to a capital outflow and a corresponding increase in the U.S.'s ownership of foreign assets relative to foreigners' ownership of U.S. assets. Starting in the early 1980s, the U.S. saved less and became increasingly dependent on outside capital to finance its domestic investment. In 2006, the U.S. current account deficit was at its highest, 6 percent of GDP. The U.S. became a net borrower, and other economies – including emerging markets – now own a significant portion of U.S. assets.[13]

However in this instance, the United States is more the exception than the rule. An increase in capital inflows to a developing nation is usually the catalyst for an increase in economic activity. Earlier, I mentioned that bank investments had tapered off in most developing nations directing capital inflows to either foreign direct investment or portfolio investment. Within the context of portfolio investment in developing nations, the purchase of government bonds in those particular countries have historically been less appealing to investors as opposed to private sector equities, which in the past have grown at staggering growth rates. There are developing countries that offer very competitive yields to attract capital, but foreign investors normally take a hard look at something like that due to national economic uncertainty. Moreover equity performance historically has outperformed even the most attractive government bond yields and there are times when a developed nation offers very high yields on intermediate term bonds and they are still very slow to move in the market.

For example as of this writing, Greece's ten year government bond has a yield of roughly 35 percent compared to a ten year US treasury bond with around a 3 percent yield. Clearly, this is a strong indication that Greece may not be able to sustain a 35 percent yield. While sovereign defaults are usually uncommon, they do occur, and when they do, the systemic side effects can be very worrisome and enormous due to possible contagion. This explains the leeriness by investors whenever a high yield government bond is offered especially when they are foreign investors.

Ironically, the connection between trading regulations, reserves, capital flows, and capital flows bundled in inexplicable derivatives begins with the collapse of Bretton Woods in 1973 that set the stage for a dramatic increase in contemporary financial globalization of the developed nations. Unfortunately, this particular collapse helped usher in the contagions and crises of the 1990s and laid the foundation for the subprime debacle and the Great Recession of 2008. With that said, the collapse of Bretton Woods undoubtedly produced a more elastic world economy which included the formidable emergence of the emerging markets (BRICS).

The free flow of capital from the developed world into the BRICS was relatively low in the mid to late 1970s, but the global financial world witnessed a healthy increase of free flowing capital to the emerging markets in the 1980s through to the mid-1990s. However in 1997, there was definitely a setback due to the Russian and Asian financial crises, but it should also be noted that beginning in 1997 there was an inordinate increase of private capital flows to those countries in the form of foreign direct investment, FDI.

Beginning in the 1990s, the term emerging markets (BRIC) became synonymous with staggering GDP growth rates, which obviously spawned a greater need for capital funds. World financial intermediaries, that is mutual funds, pension funds, and insurance company funds worked their way into the emerging markets' financial systems through international banks to capitalize on the exceptional growth rates.[14] Moreover, the emerging markets were able to generate additional