

Global capital competition

SK

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September 2013

Global capital competition

The race for attracting Global capital flows

September-December 2013

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www.developingfinance.org

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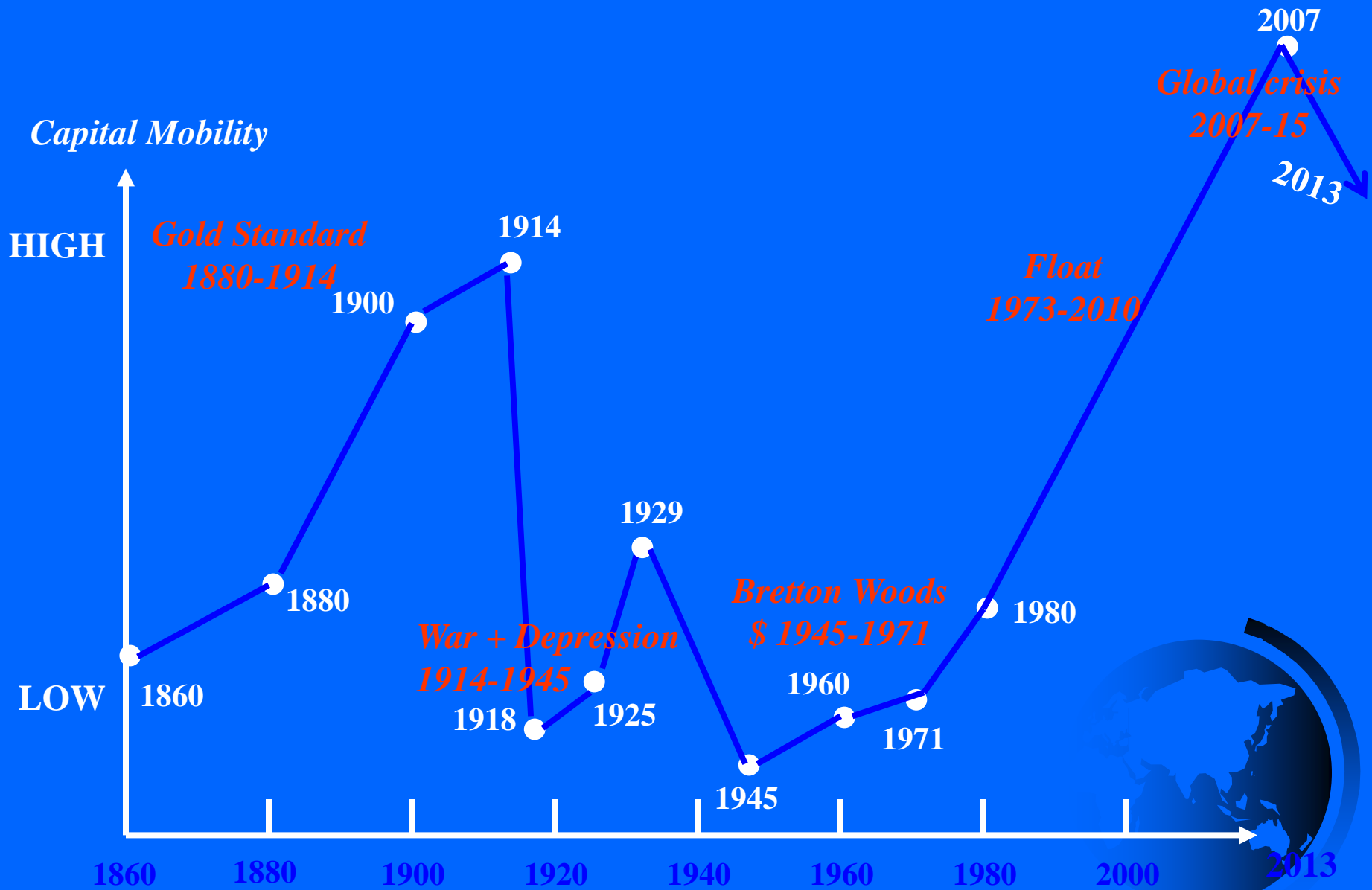
A few Misconceptions and Myths

☞ **Myth 1:** Financial Globalization is for ever: there is an ever wider capital mobility worldwide

☞ **Facts:** Don't take it for granted! There are sharp declines in capital mobility in times of crisis, and crises are numerous!



Stylized View of International Capital Mobility 1860-2013



Source: "Globalization and Capital Markets," Maurice Obstfeld and Alan M. Taylor, NBER Conference Paper, May 4-5, 2001.
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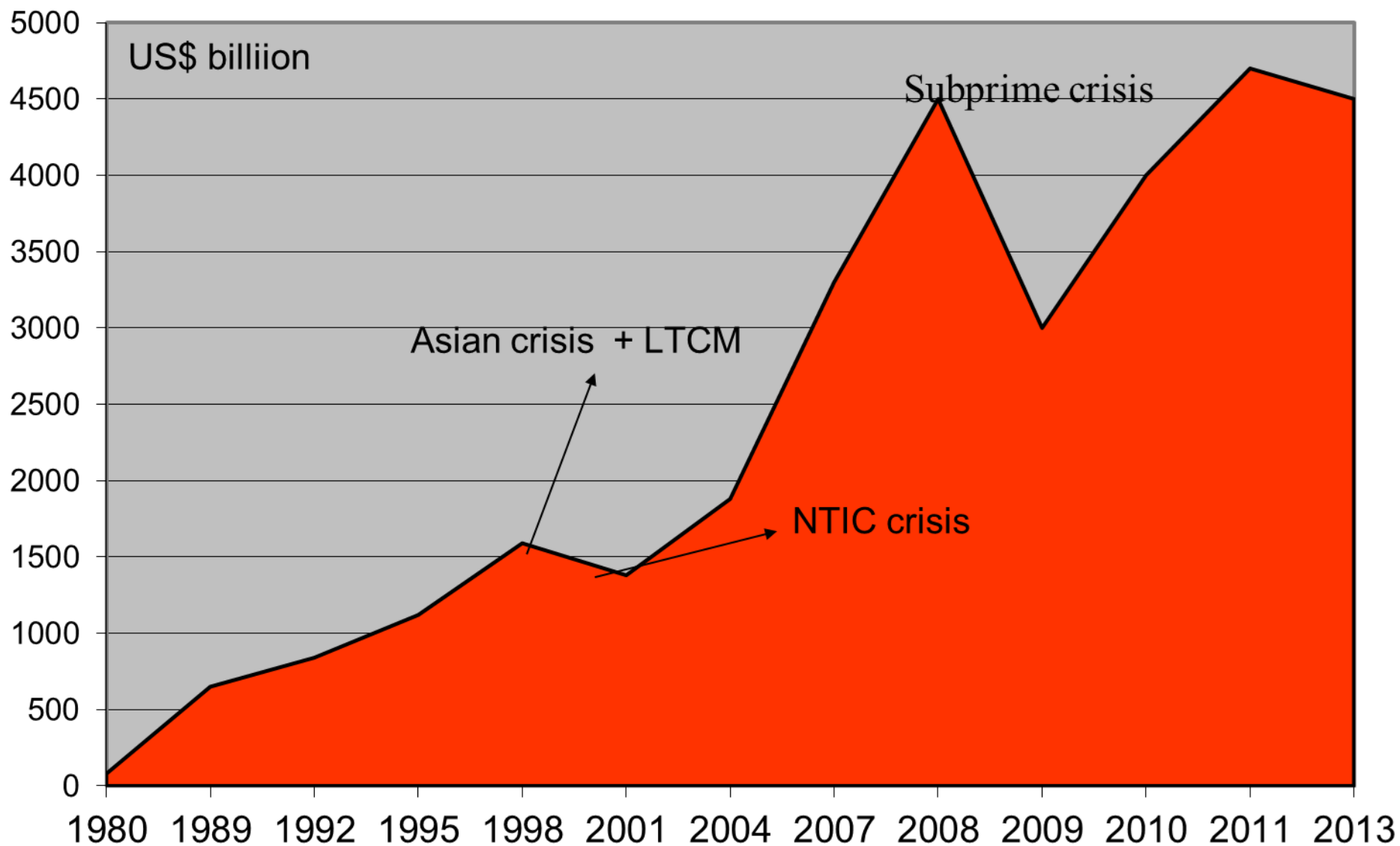
Global capital flows: crises and cycles

Cross-border capital flows fell sharply in 2008 and today remain more than 60 percent below their precrisis peak.

Global cross-border capital flows,
\$ trillion¹



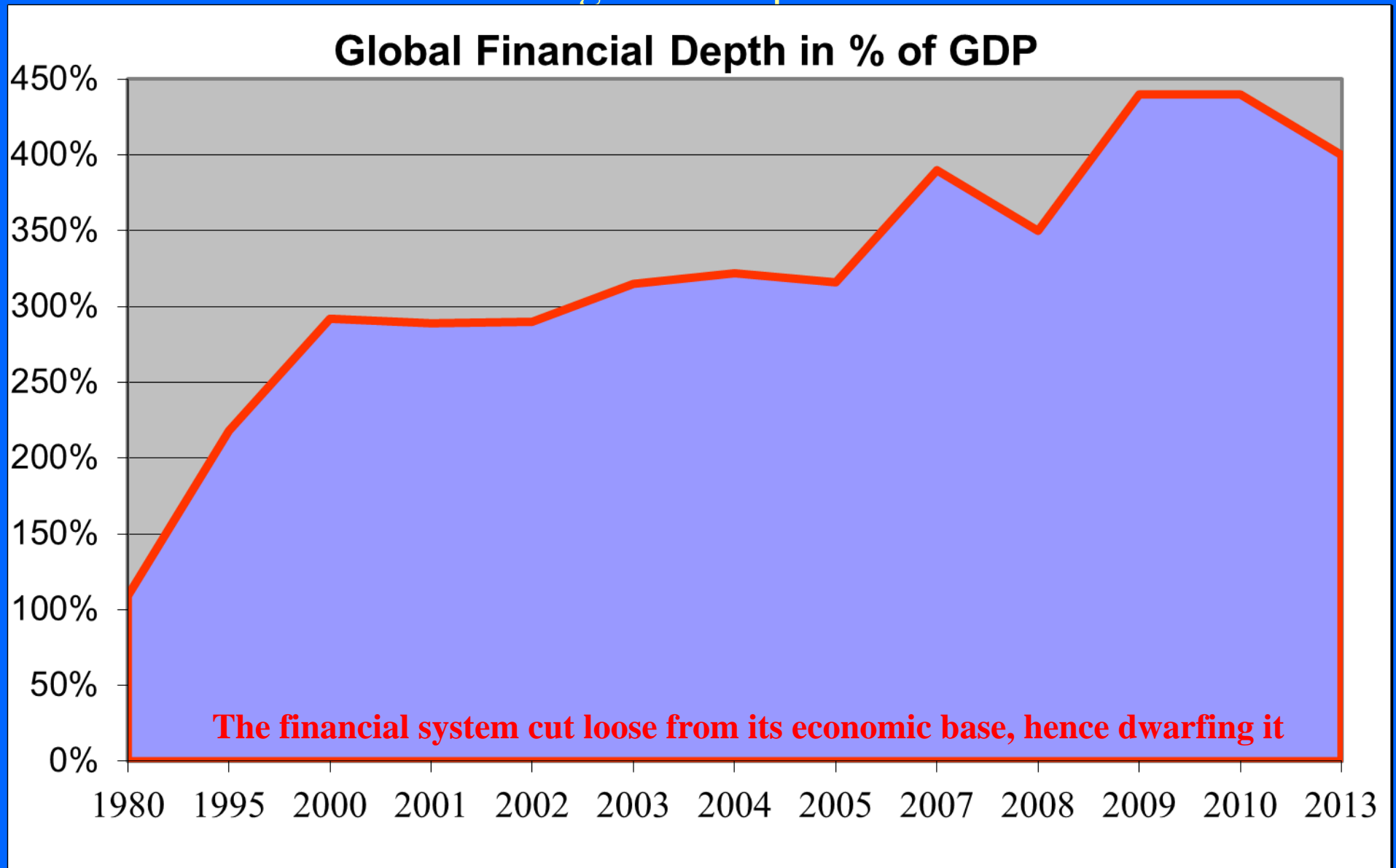
Daily FX Trading Transactions



Total central bank reserves: US\$10500 billion (45%)

The rise and fall of financial depth

Has the financial genie escaped from the bottle?

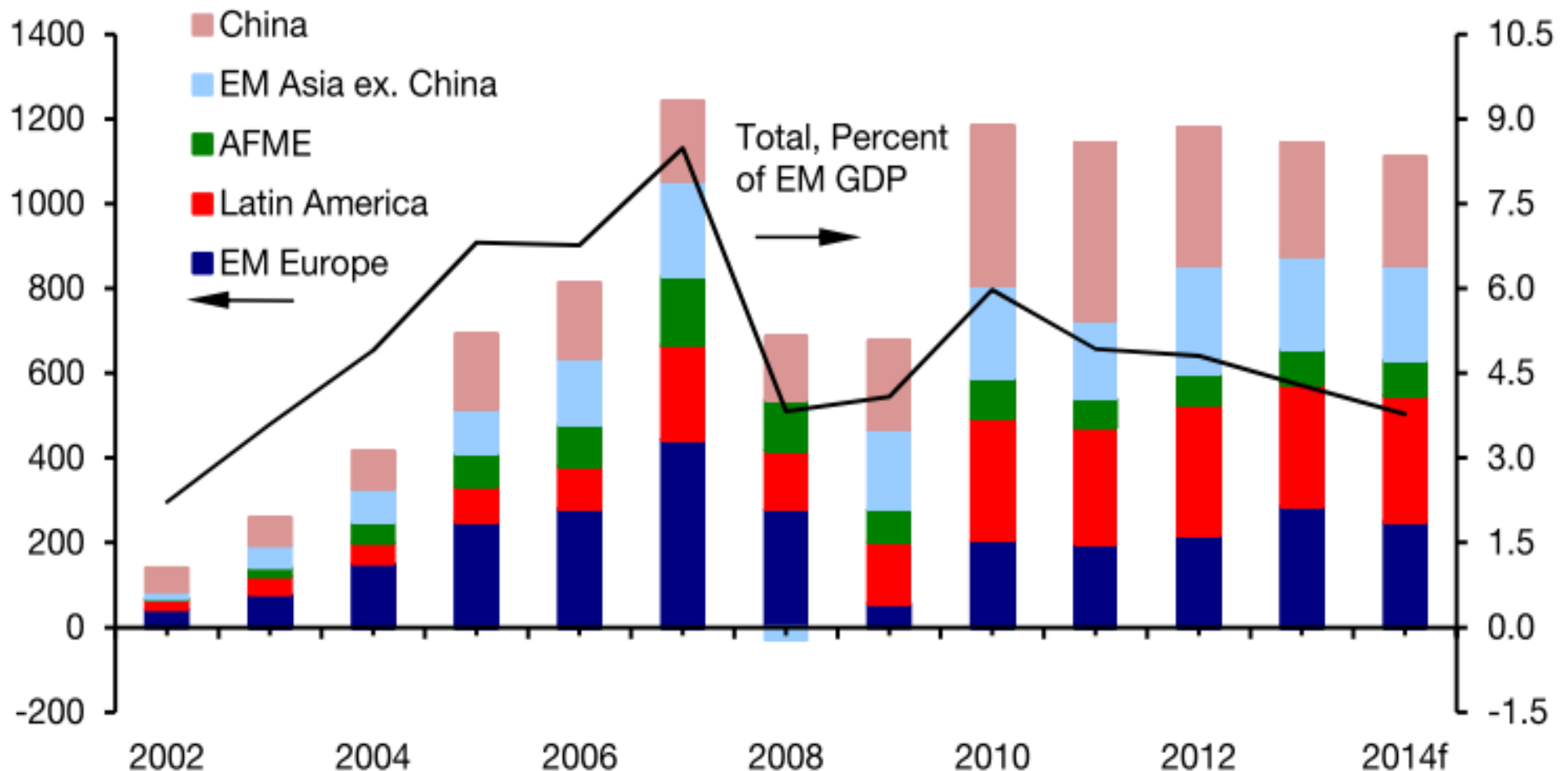


The rise and fall of net private capital flows to EMCs 2002-14

Emerging Market Private Capital Inflows, Net

\$ billion

percent of EM GDP



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A few Misconceptions and Myths

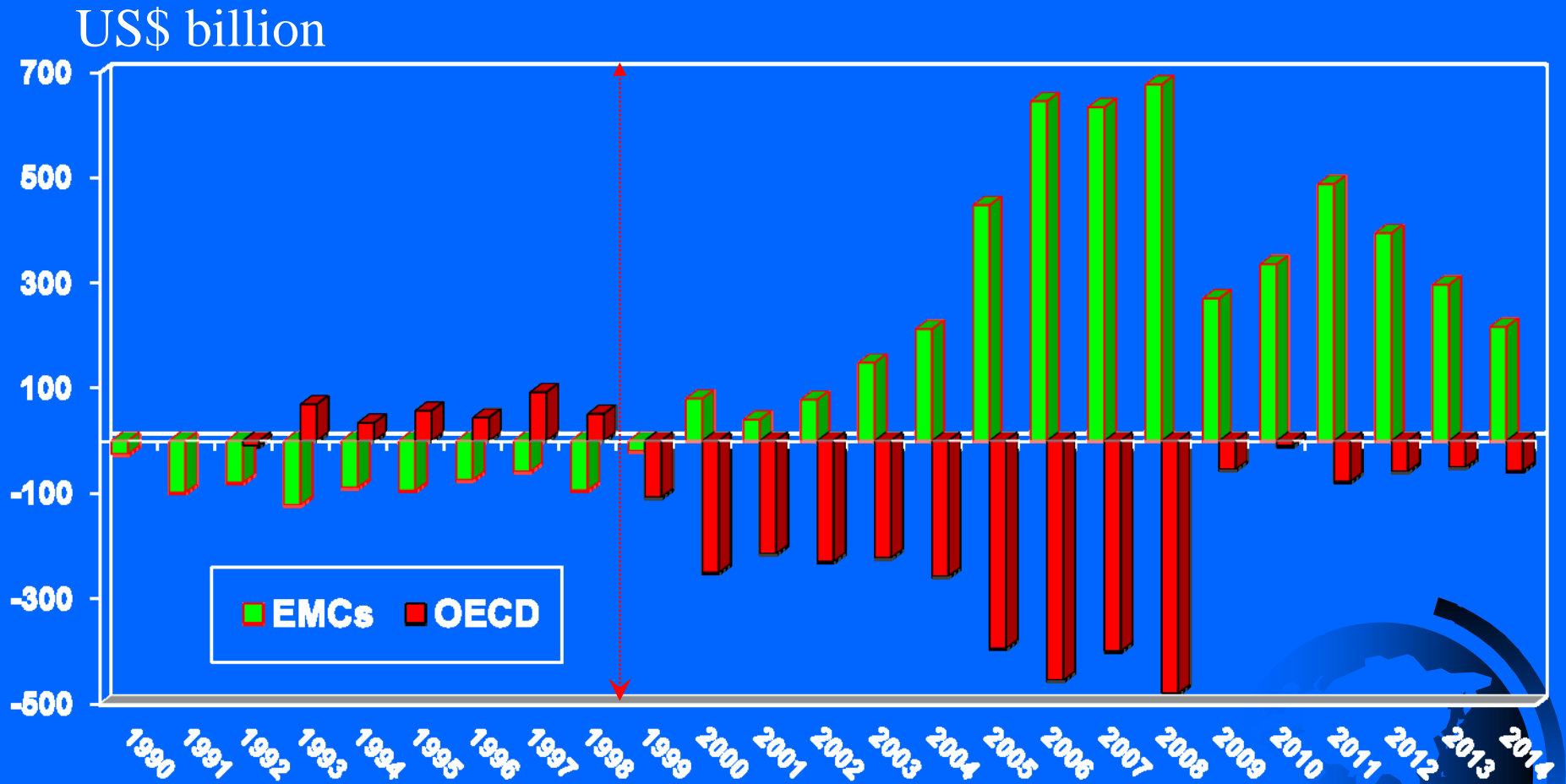
- ☞ **Myth 2: Capital flows from rich to poor countries**, which have $<$ capital and offer $>$ returns. By borrowing abroad, LDCs should be able to boost investment and growth rates!
- ☞ **Fact 1**: capital is flowing « uphill » and the US CAD is financed by emerging countries' purchase of US Treasury securities
- ☞ **Fact 2**: US bond yields are 2% lower than they otherwise would be, thanks to the purchase of US securities by China and other EMCs. If these countries loose their appetite for US assets, bond yields could jump and the dollar plunge!

Where do capital flows come from?

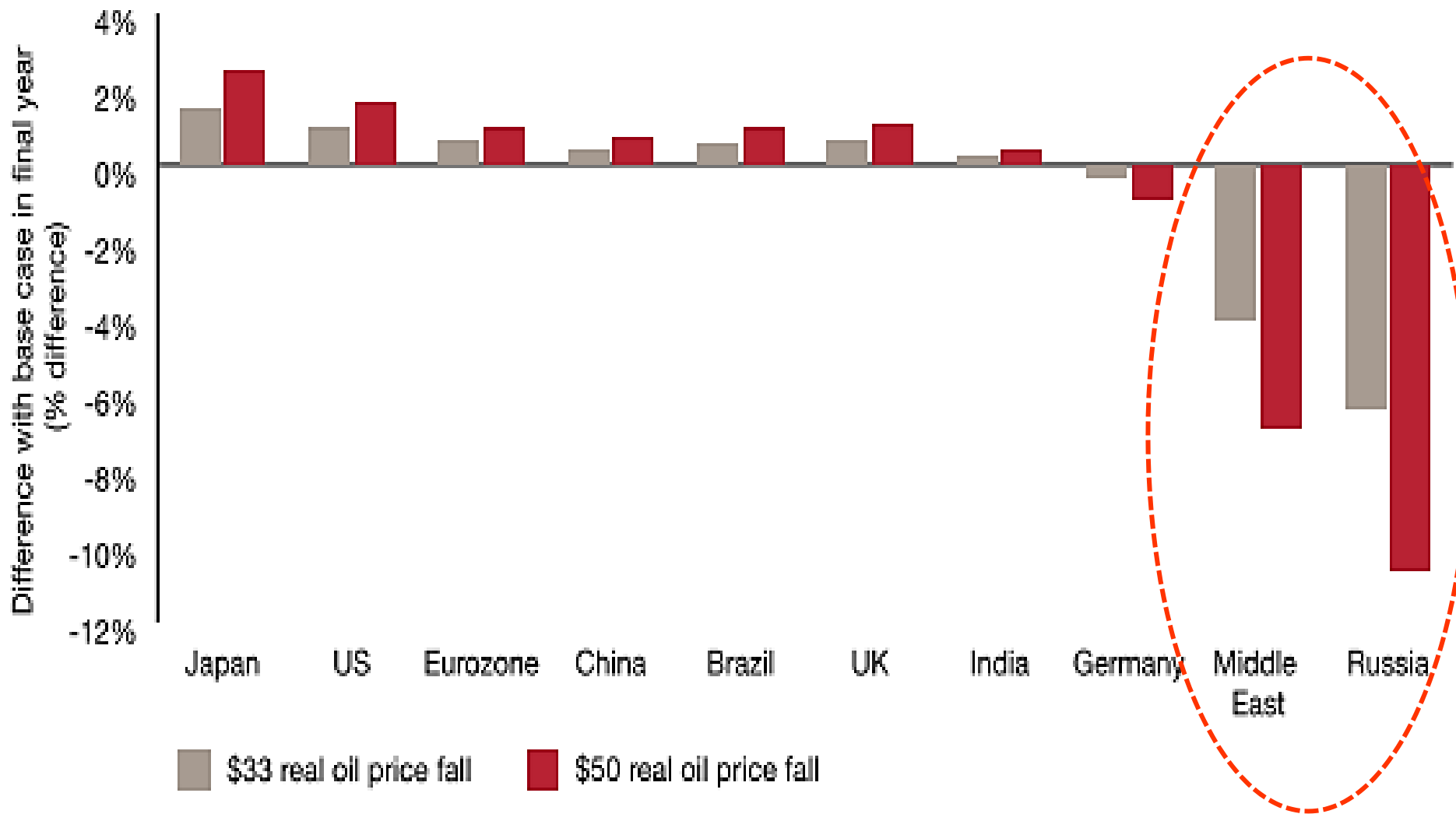


Who finances whom?

Current account balances of OECD (34) and EMCs (160)



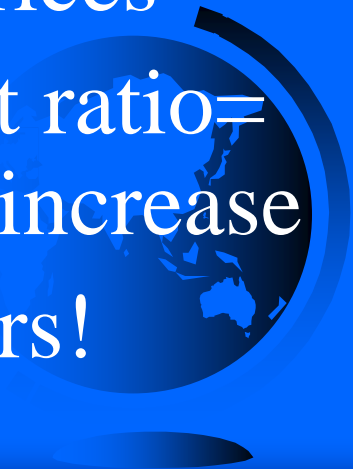
Global financial consequences of the Shale gas revolution: change in current account balance as % of GDP



Source: PwC analysis using NiGEM

Why do EMCs show such large CA surpluses and rising reserves?

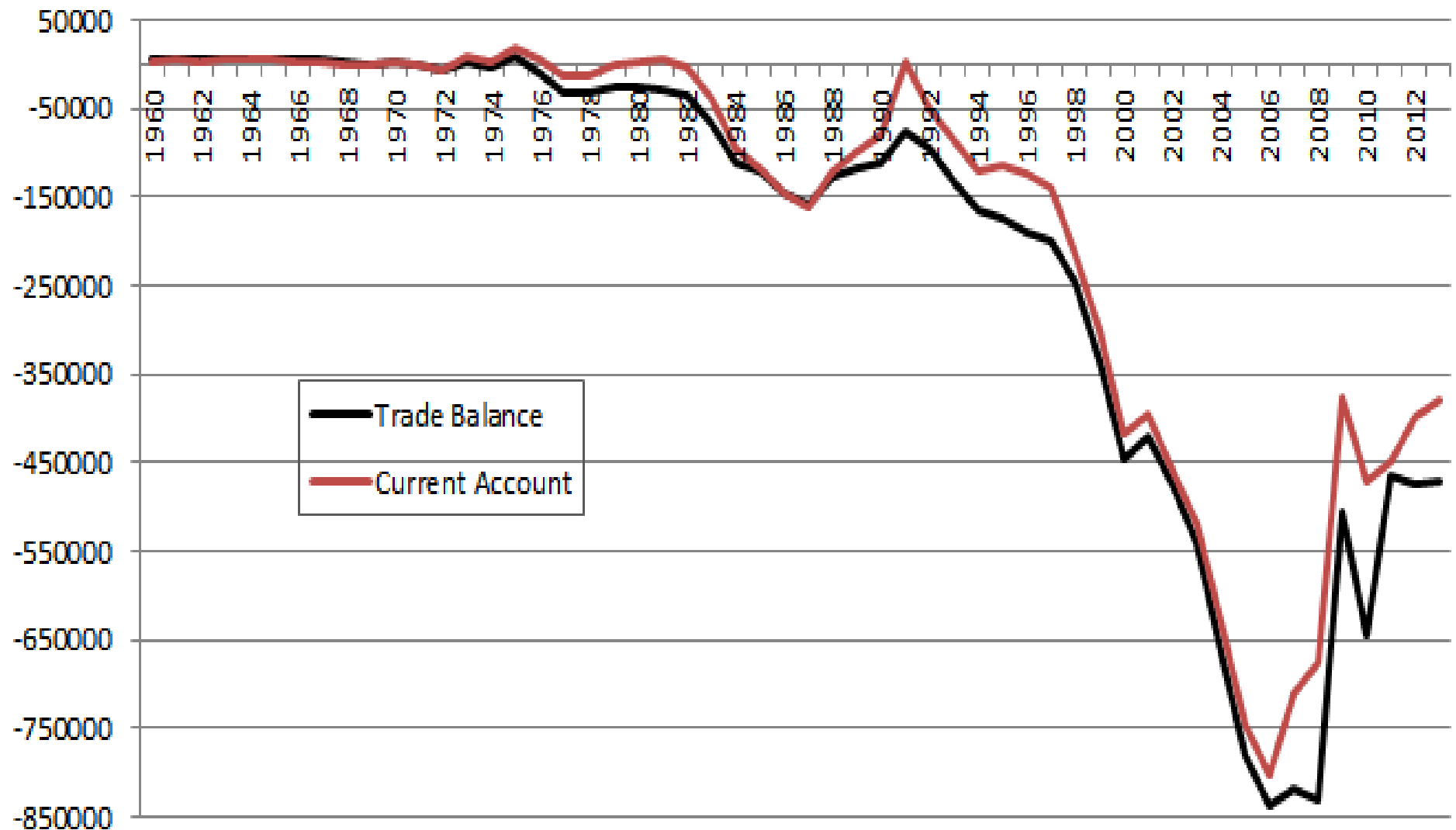
1. 1982 debt crisis + 1994 Tequila crisis + 1997 Asia crisis + 1998 Russian crisis + 2001 Argentina crisis + global crisis 2008-13
2. Strong IMF-monitored adjustment + economic and trade liberalization
3. Surge in raw material and oil prices
4. Devaluation + Boost in investment ratio =
Current account surplus + Reserve increase
5. Improvement in debt indicators!



3. Myths and misconceptions

- ☞ The richest developed countries with strong financial systems have surplus savings, hence capital exports
- ☞ Facts: most of developed countries live « beyond their means » and must import capital
- ☞ EMCs' dynamic growth boosts savings relative to investment, hence a current account surplus (China!).

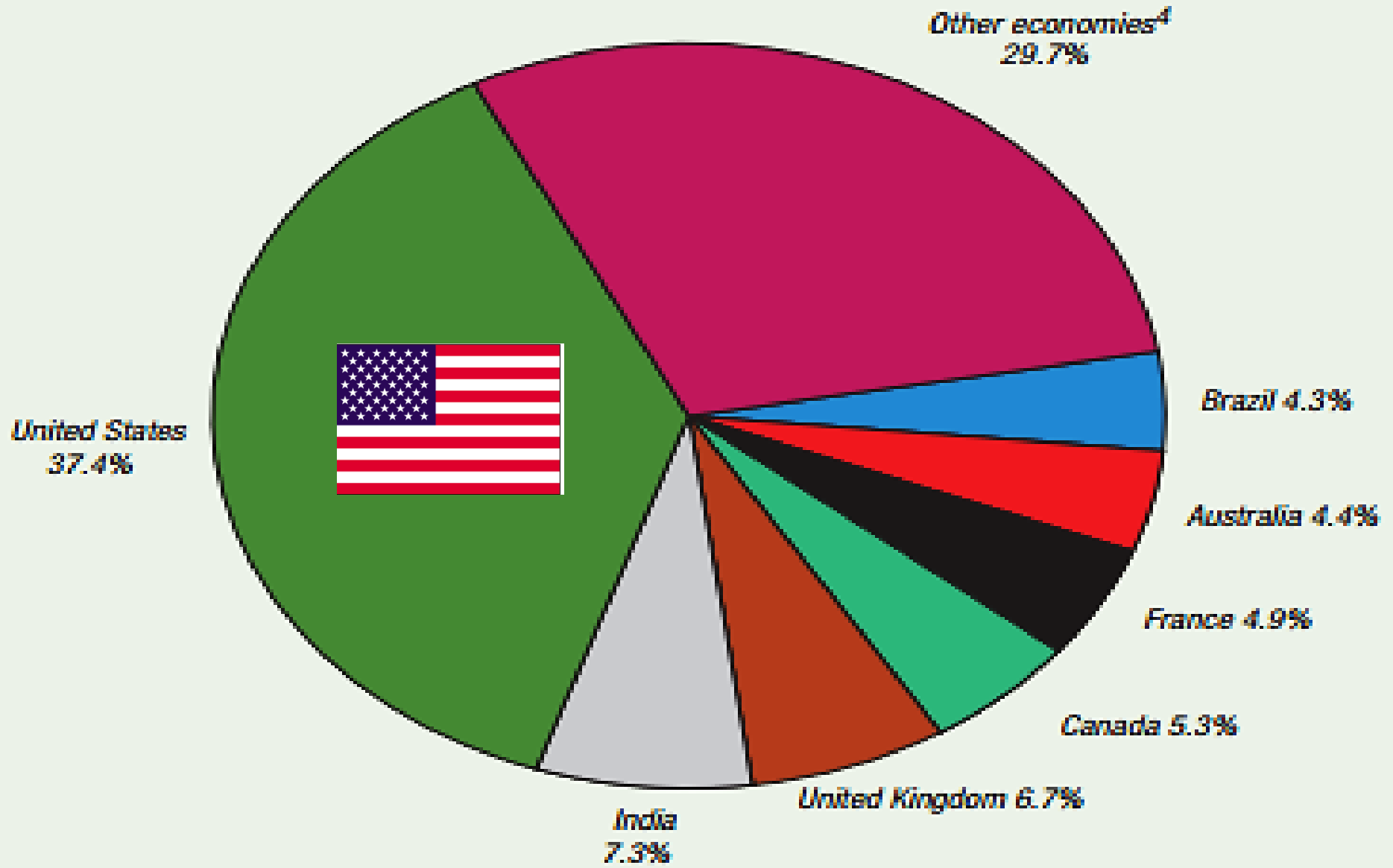
US structural trade and current account deficit 1980-2013



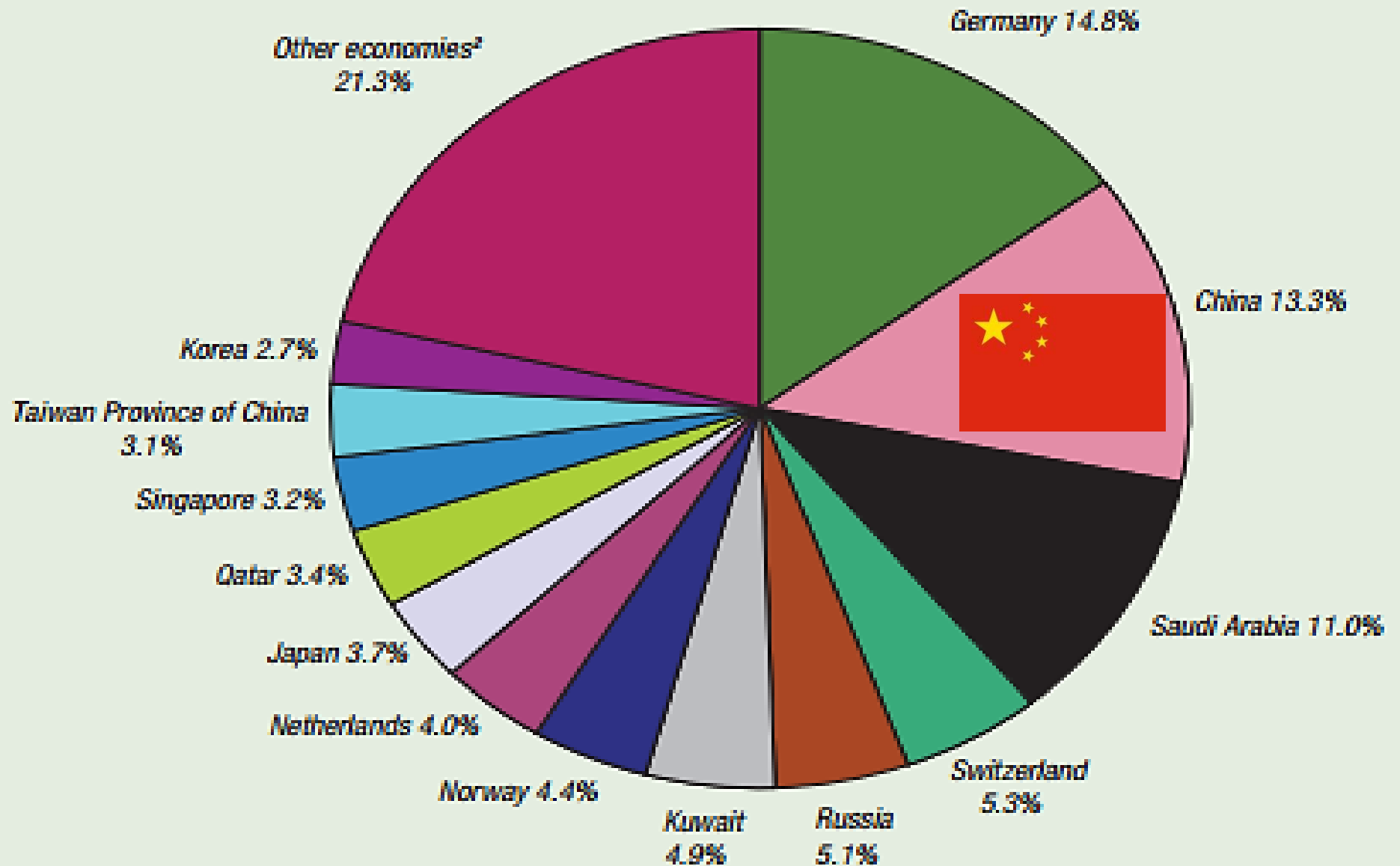
Global competition in financial markets



Living beyond its means: Major net Importers of Capital



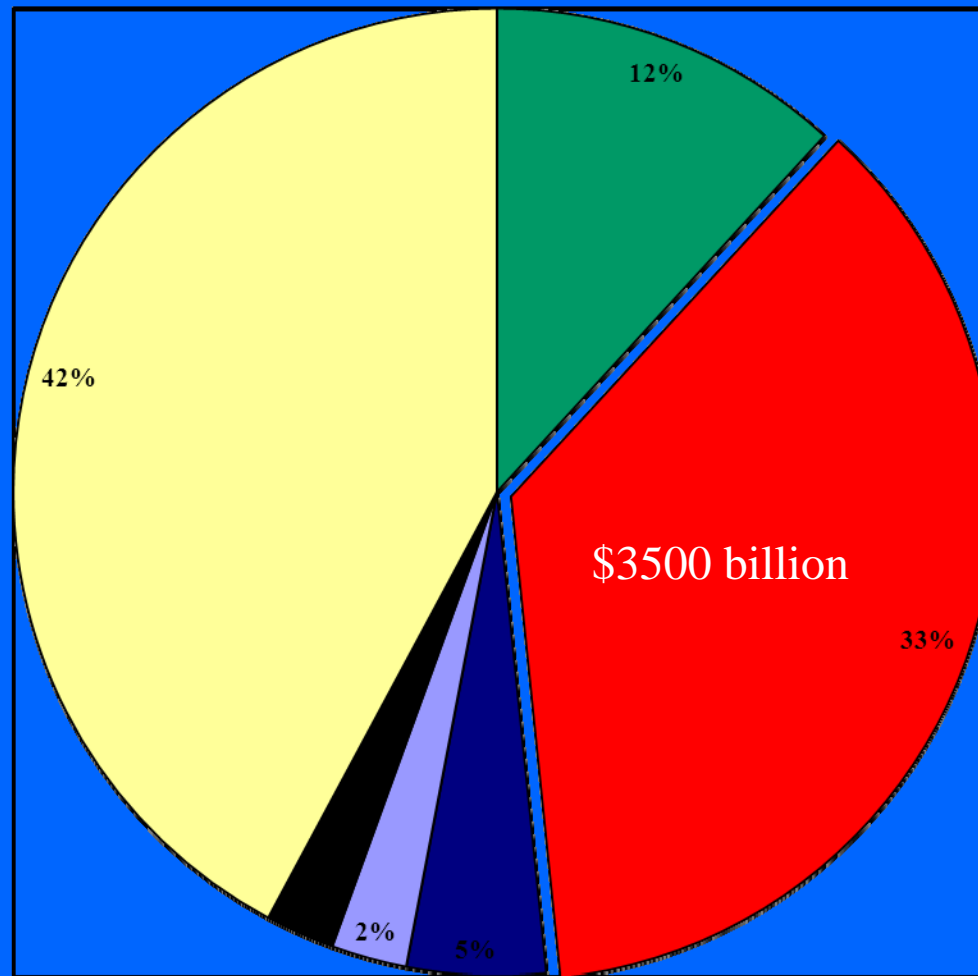
Net saving countries: Major Exporters of Capital



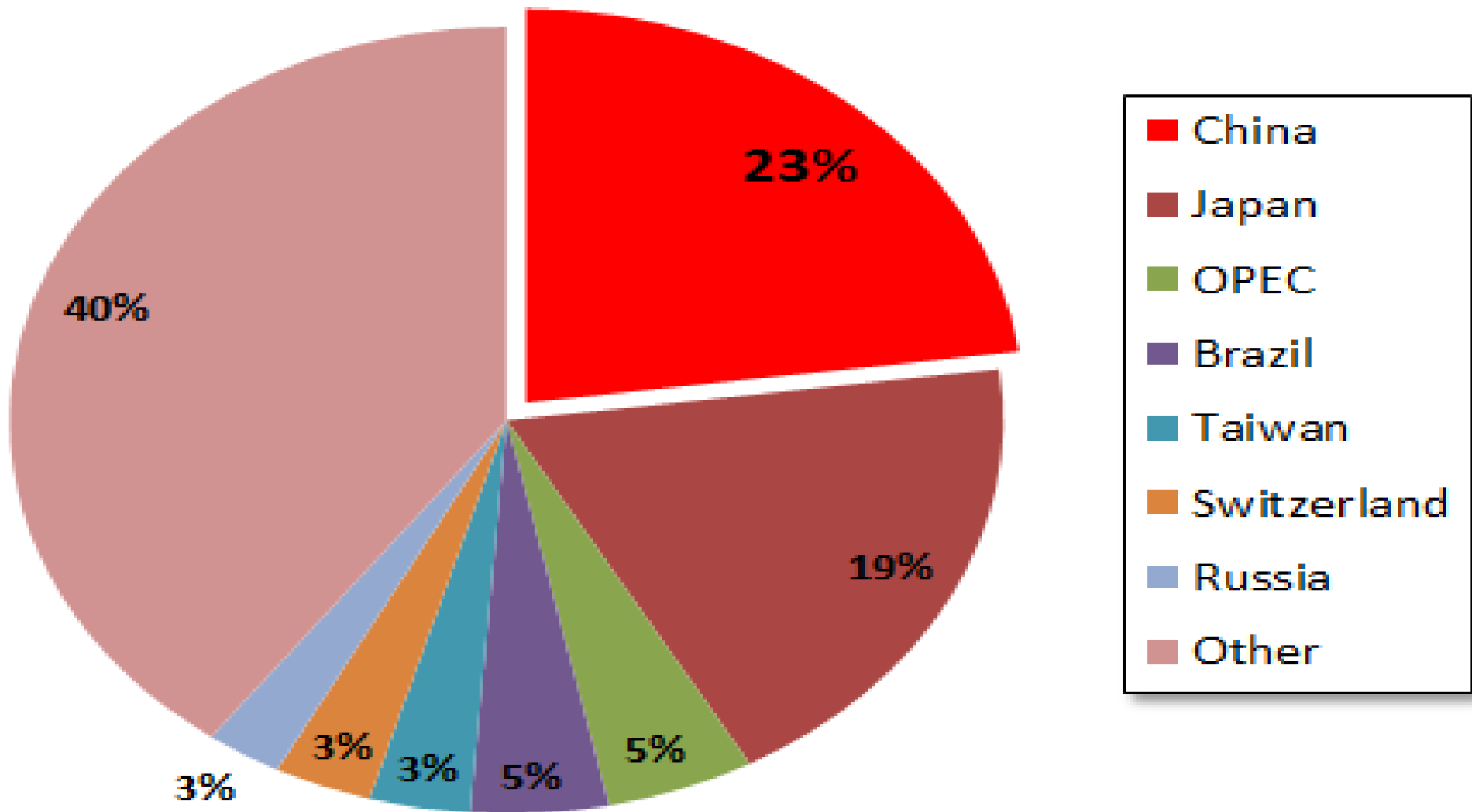
Source: IMF 2013

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China's hard currency reserves



China holds nearly ¼ of foreign holding of US debt



A few Misconceptions and Myths

- ☞ **Myth 4**: Bulk of capital inflows to developing countries stems from **official**, bilateral and multilateral, creditors (IFIs and Paris Club)
- ☞ **Facts**: Official net capital flows to EMCs are close to zero (6% of total net flows). External financing comes from **private** creditors, mainly FDI and capital markets, i.e., bonds



Sources of external financing

Official (bilateral + multilateral)

- Paris Club (government to government credits)
- Export insurance credit
- IFIs
- RDBs
- Debt cancellation

Private

- FDI
- Portfolio Investment
- London Club (International bank loans)
- Working capital lines
- ST Trade credits
- Bonds & International debt securities
- Arrears and rescheduling



Emerging Market Economies: Capital Flows

\$ billion

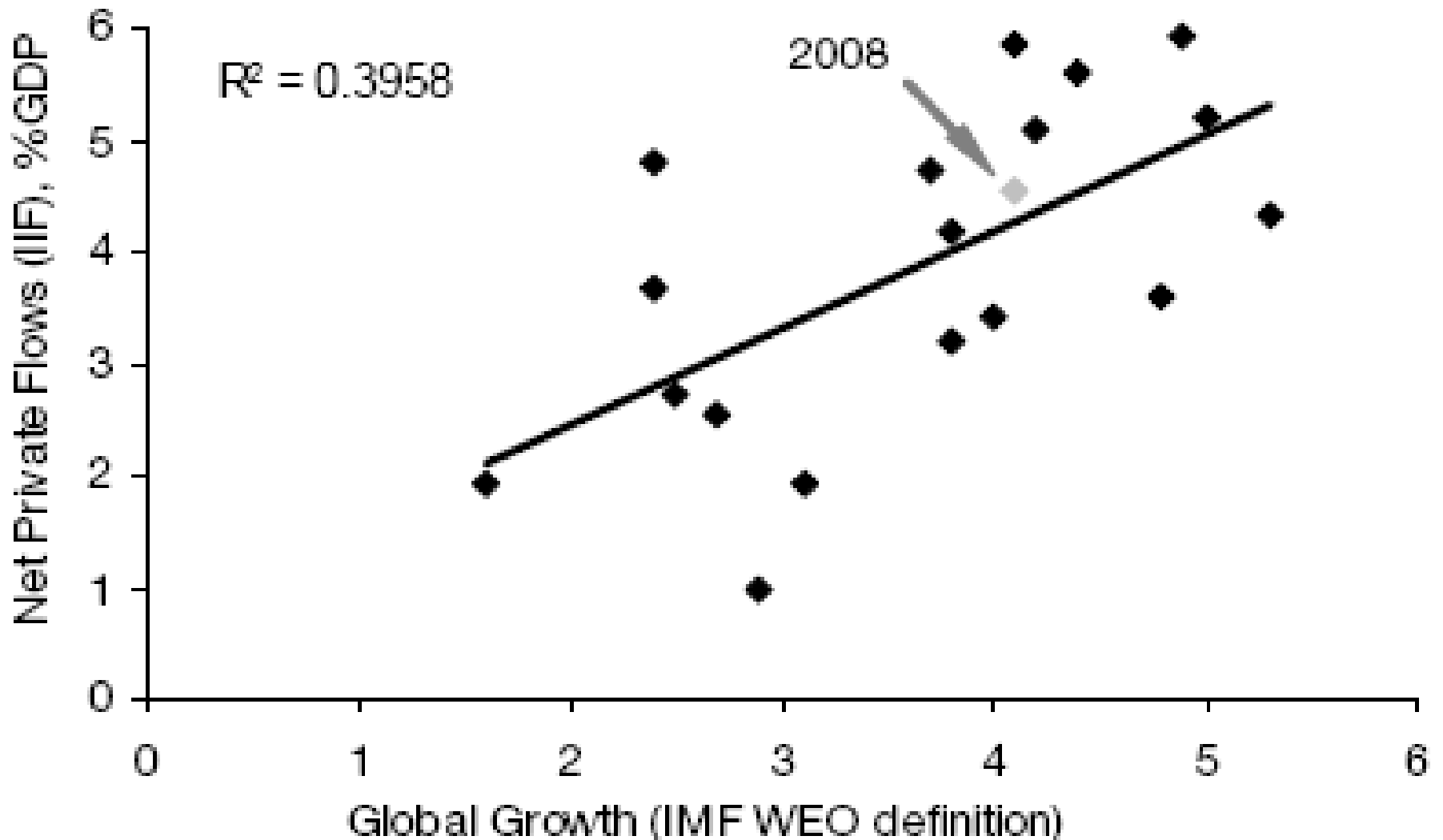
	2011	2012e	2013f	2014f
Capital Inflows				
<i>Total Inflows, Net:</i>	<u>1207</u>	<u>1212</u>	<u>1187</u>	<u>1167</u>
Private Inflows, Net	1146	1181	1145	1112
Equity Investment, Net	598	670	631	633
Direct Investment, Net	593	545	541	523
Portfolio Investment, Net	5	125	89	110
Private Creditors, Net	548	511	514	479
Commercial Banks, Net	195	121	144	154
Nonbanks, Net	353	390	369	325
Official Inflows, Net	61	31	43	55
International Financial Institutions	17	4	6	21
Bilateral Creditors	44	27	37	35

A few Misconceptions and Myths

- External financing leads to debt increase, hence looming liquidity and solvency problems.
- **Facts:** Indebtedness is a key ingredient of socio-economic development process (in the US as much as in Germany, Korea or Japan!) to close the I/S gap
- The key issue is how is the debt invested, i.e., the relationship between maturity profile of debt flows and of investment projects, as well as the relationships between interest rates and rate of return!
- Reinhart and Rogoff (2009) have empirically established that a developed economy with $> 90\%$ of GDP in public debt can barely manage it; that ceiling is at 60% of GDP for EMCs (questionable!)

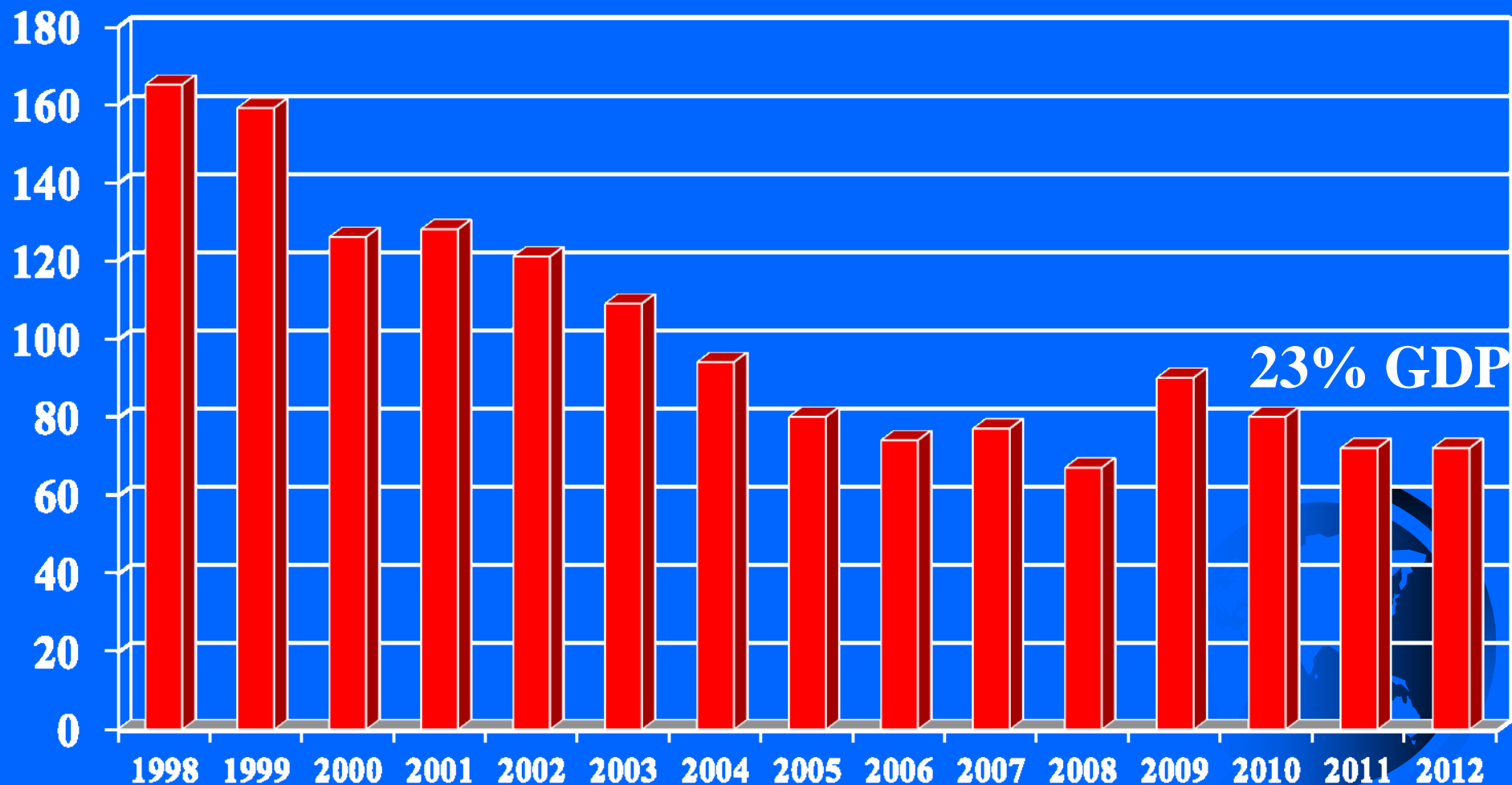
External Financing helps boosting GDP growth

1990-2007

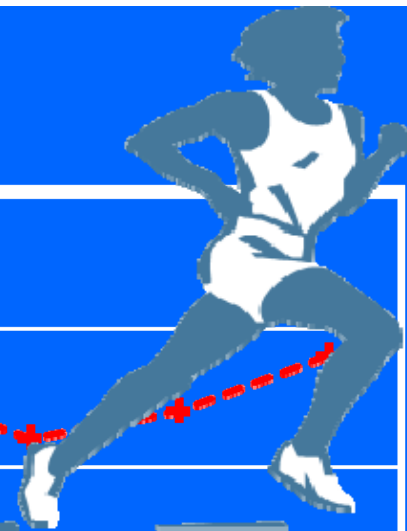
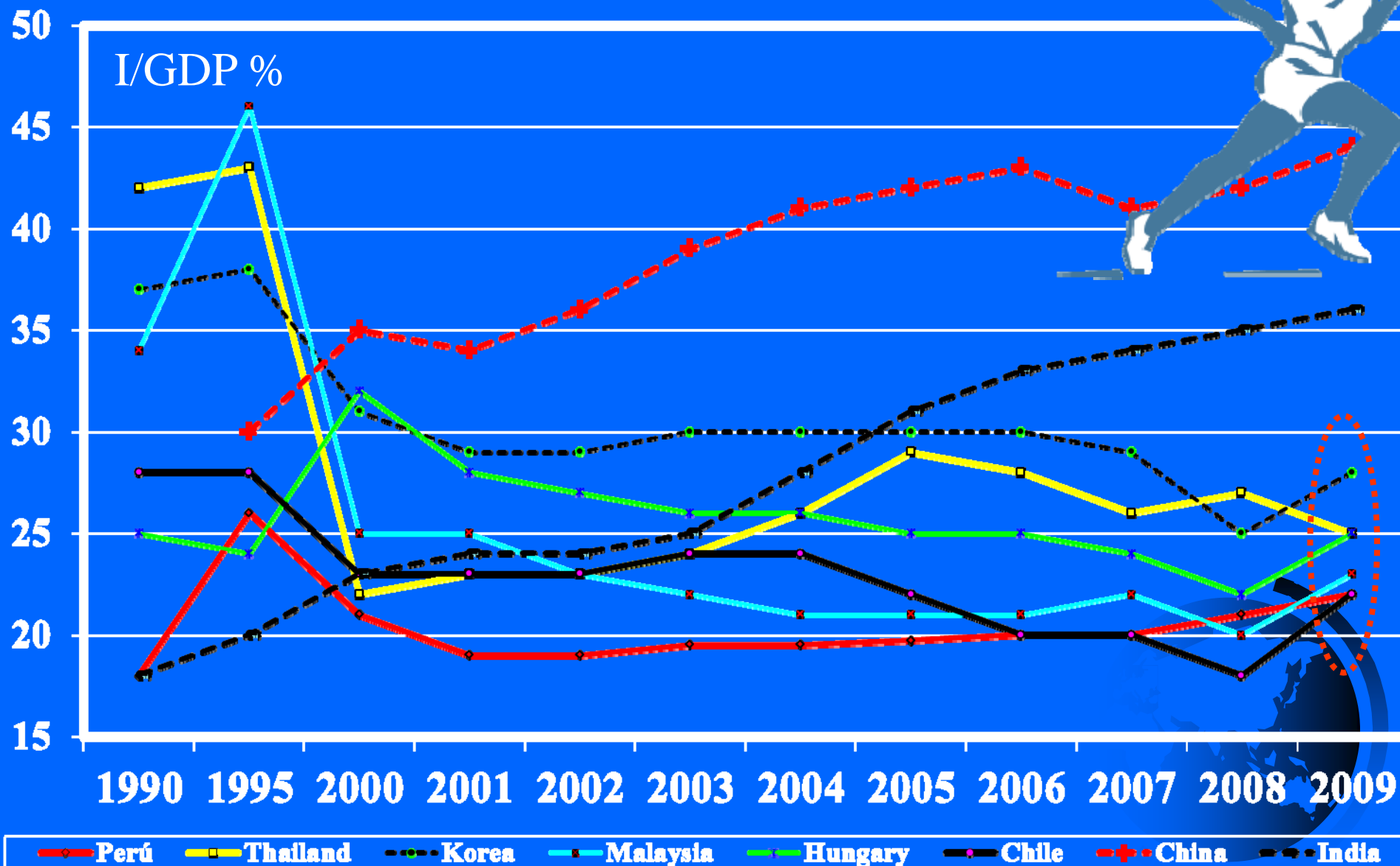


Successful economic adjustment:

Improvement in EMCs' solvency ratios (drop in Debt/X %)

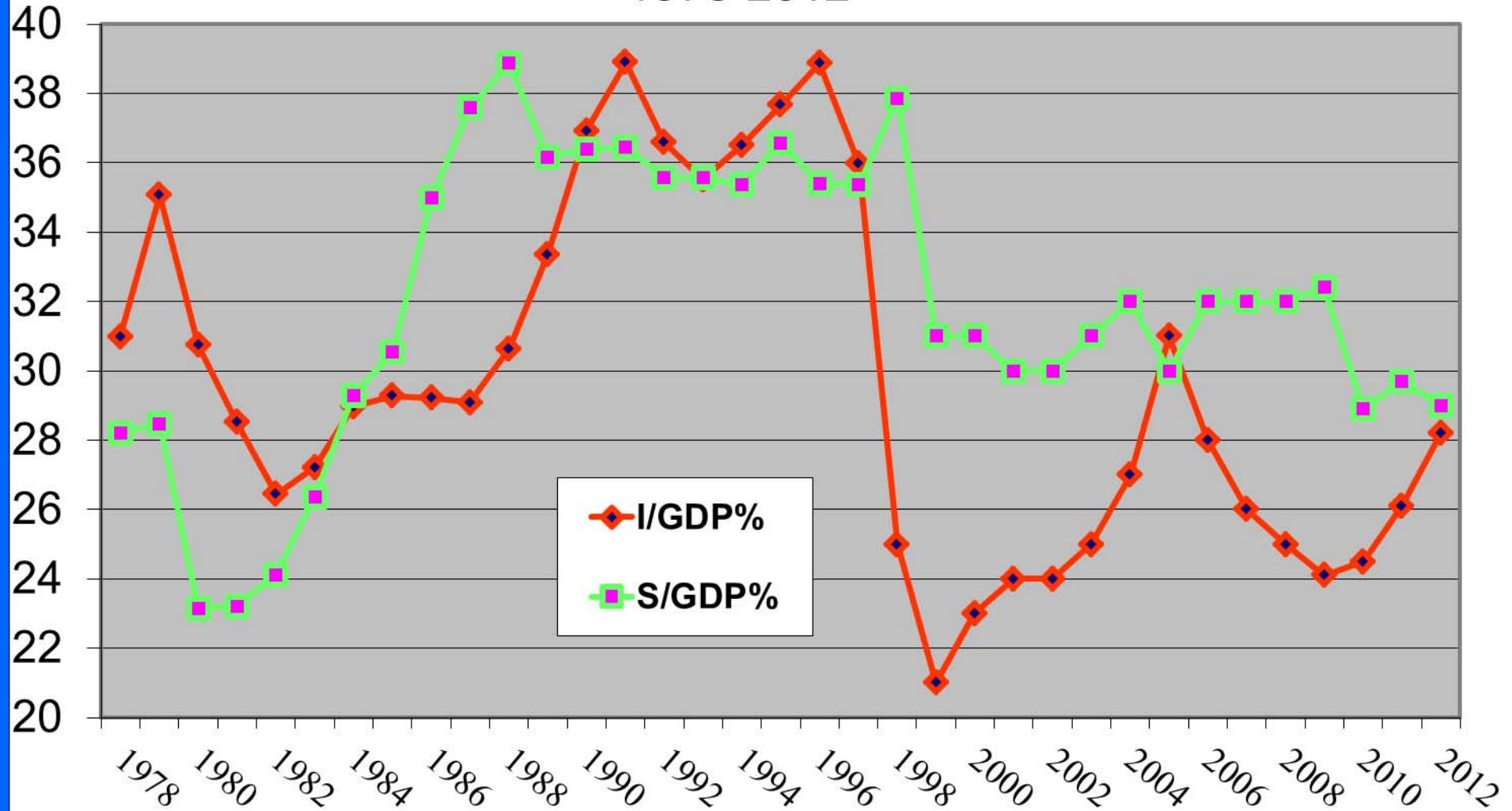


The dynamics of investment



National Savings and Investment dynamics

Investment and saving rates in Thailand
1978-2012



A few Misconceptions and Myths

☞ **Myth 5:** FDI is the prime source of long-term financing of developing countries

☞ **Fact:** Though developing countries are considered as key target markets, the bulk of FDI flows continue moving toward developed countries (>56%)



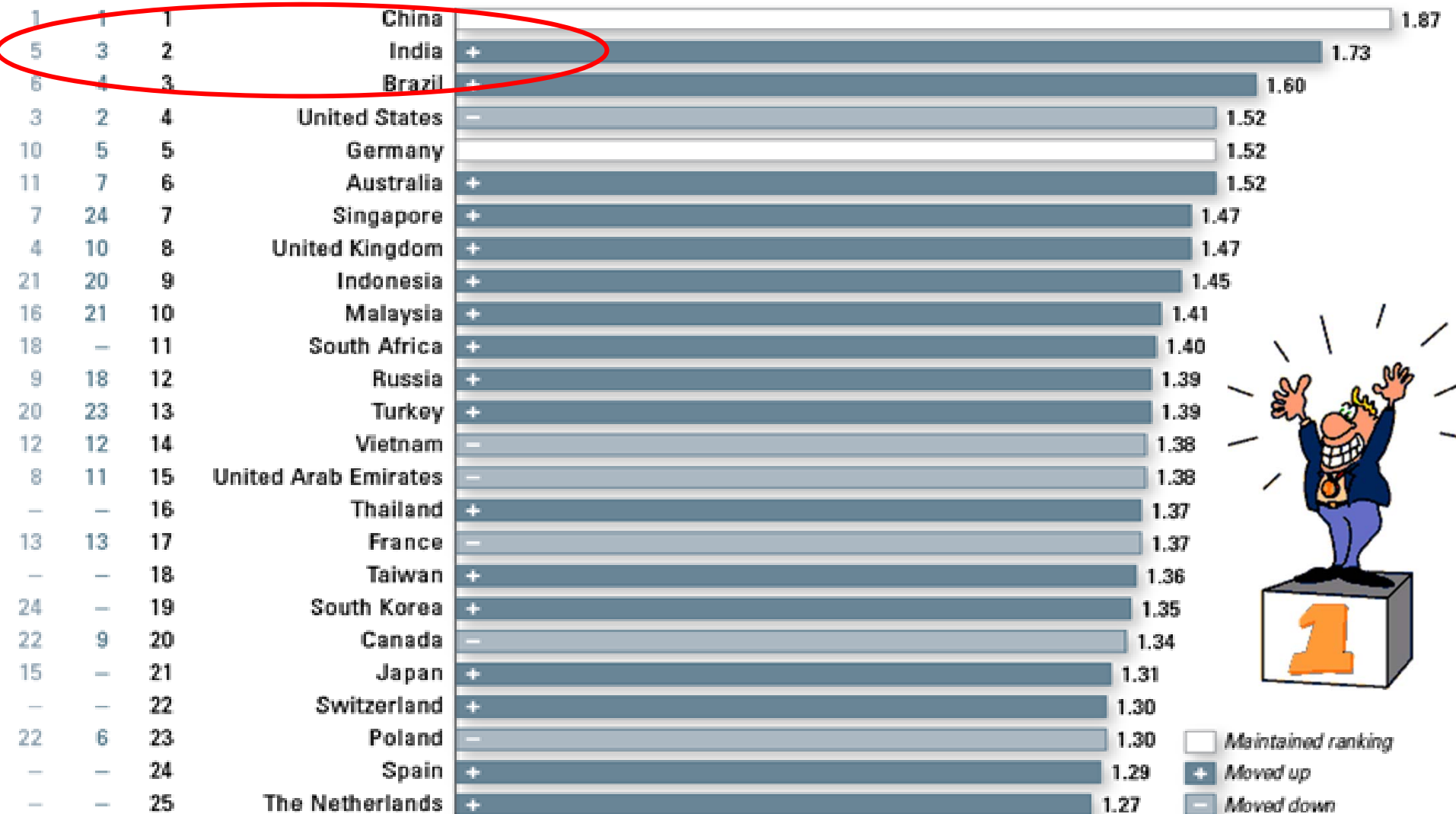
What is FDI?

- **Foreign direct investment** = purchase of real assets abroad for the purpose of acquiring a lasting interest in an enterprise with a degree of operational influence
- **Greenfield investment:** new investment in a physical structure in an area where no corporate facilities previously existed (complete ownership and therefore full control over management)
- **Strategic partnerships:** formal alliance (joint venture, licensing agreement, distributorship, or agency contract)
- **M&As:** two or more companies decide to pool their assets to form a single new company. Hence, one of the previously existing companies ceases to exist.

FDI global confidence index A.T.Kearney

Ranking

2007 2010 2012



 Maintained ranking
+ Moved up
- Moved down

Low confidence

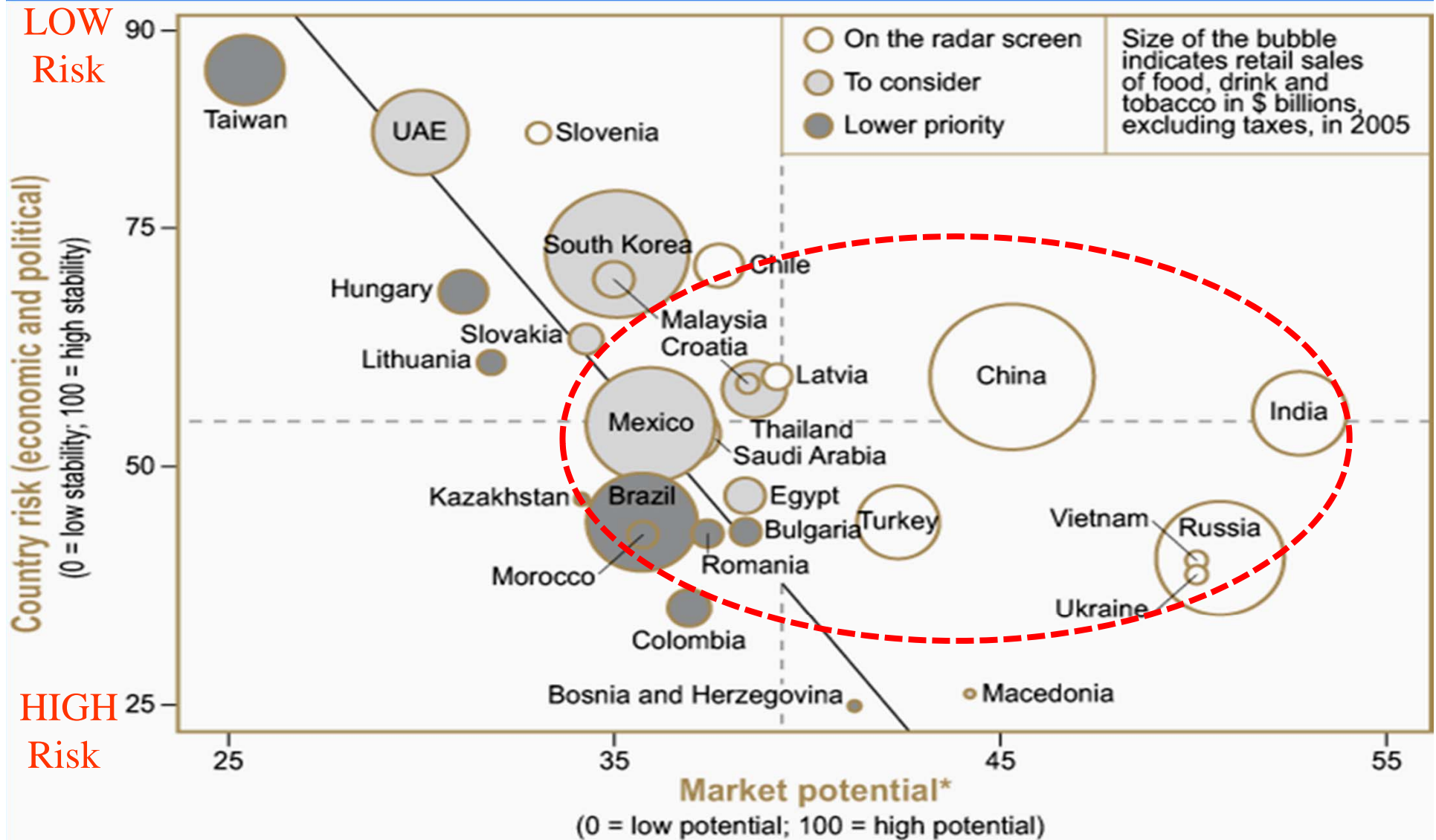
Values calculated on a 0 to 3 scale

High confidence

These fast growing Emerging market countries are considered prime targets of FDI by global private and institutional investors!



The most attractive EMCs

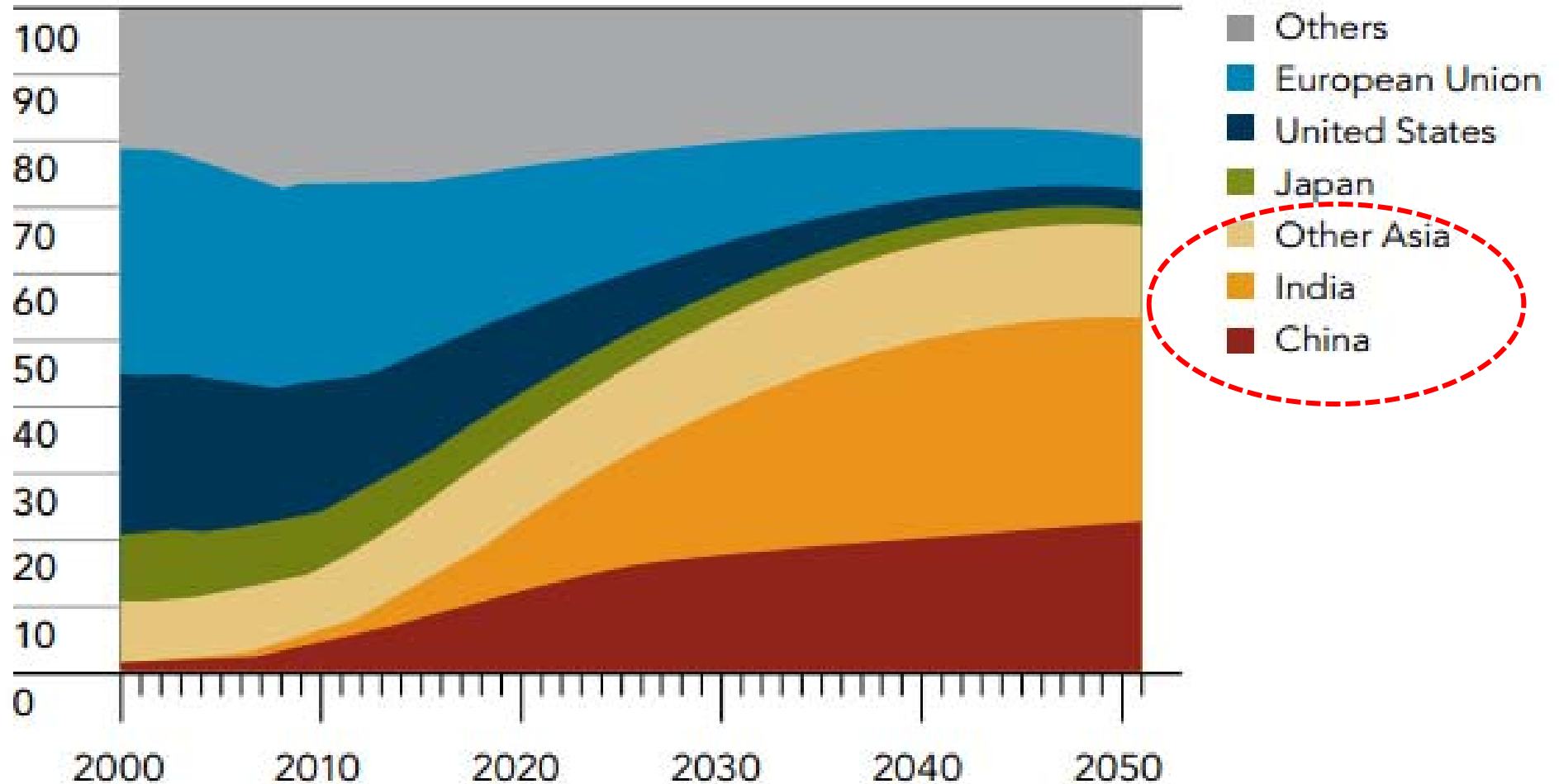


* Based on weighted score of market attractiveness, market saturation and time pressure scores
Source: A.T. Kearney

Targetting the growing middle-class?

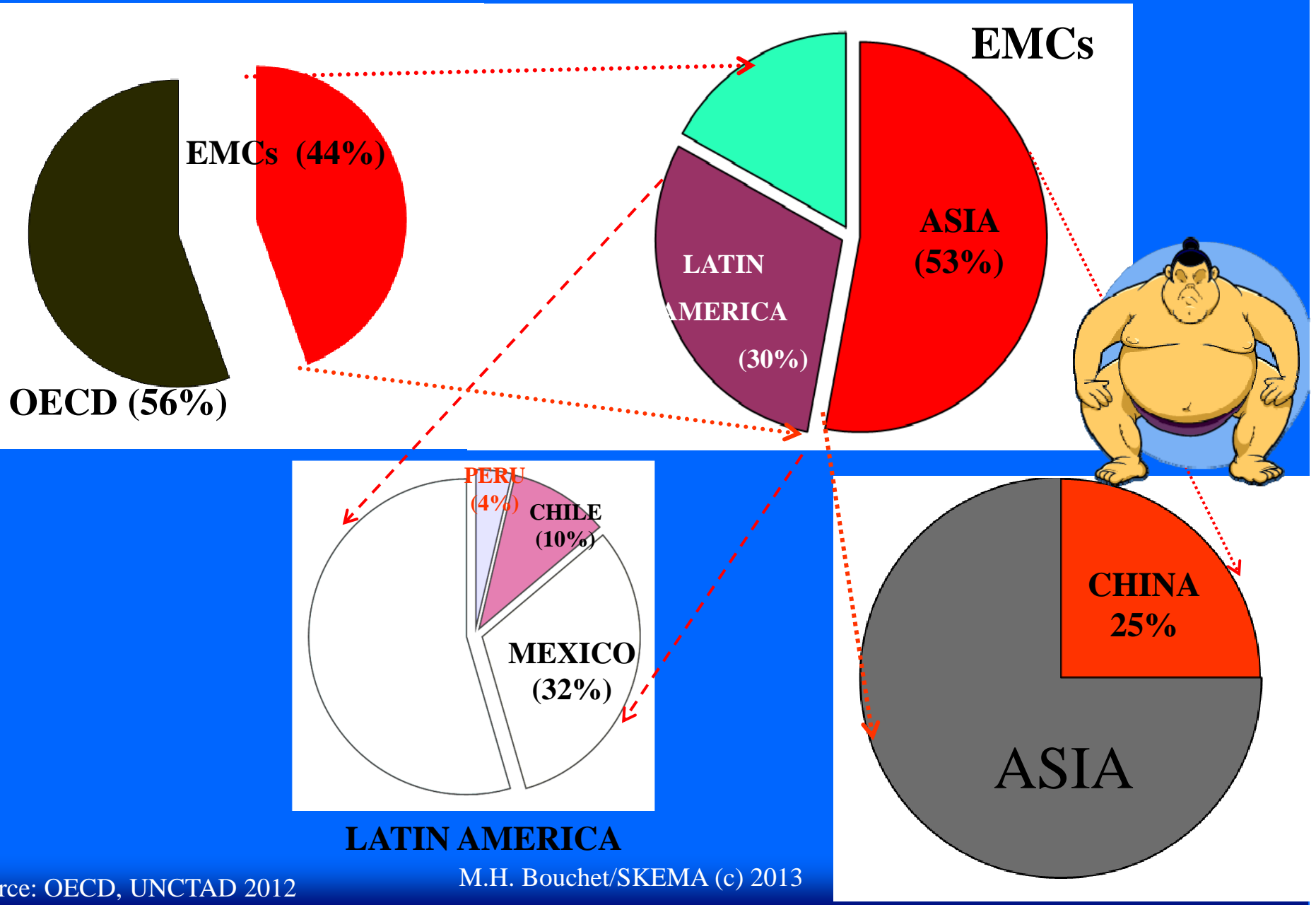
SHARES OF GLOBAL MIDDLE-CLASS CONSUMPTION, 2000-2050

Percent



Source: OECD.

GLOBAL FDI FLOWS= \$1500 billion



A few Misconceptions and Myths

☞ **Myth 6:** Rating agencies can assess, measure and rank «**global risk**»

☞ **Facts:** Rating agencies such as S&Ps, Moody's and Fitch systematically missed the train. Shortsightedness added a model risk to market risk and country risk, hence no early warning signals!



➤ See: Bouchet, Clark & Gros Lambert: Wiley, NY, 2005.

➤ <http://www.cfr.org/united-states/credit-rating-controversy/p22328>



Main rating agencies?

- **S&Ps (1860)**
 - **Moody's (1909) 40% market share**
 - **Fitch IBCA (1913)**
 - **COFACE (1946)**
 - **Dagong Credit Rating Co (1994)**
 - **Euler-Hermes**
- 95% market share



Shortcomings of rating agencies?

☞ Criticisms:

- ☞ * Power without accountability
- ☞ * Rating shopping by companies
- ☞ * Conformity and sociocultural bias
- ☞ * Punishment of disobedient firms/countries that do not request a rating
- ☞ * Procyclical bias, hence following the majority opinion of market participants without any early warning signals nor predictability track record
- ☞ * Spill-over effect!



Ratings = Poor early warning signals?

☞ South Korea was rated as Italy and Sweden until as October of 1997! But has been downgraded abruptly to junk bond status during the 1998 crisis

☞ « *There were no early warnings about Korea from us or, to the best of our knowledge, from other market participants and our customers should expect a better job from us* »



Ratings and the US subprime mortgage-backed securities market

- Rating agencies kept a AAA rating for debts whose collateral was rapidly deteriorating!
- Ratings agencies failed to warn investors about the risk of complex financial instruments: In 2007, as housing prices began to tumble, Moody's **downgraded 83%** of the \$870 billion in mortgage securities it had rated at the AAA level in 2006.
- Summer 2013: the US SEC accused former Goldman Sachs trader Fabrice Tourre of misleading investors in a crisis-era deal that cost them \$1 billion

Challenge: how measuring liquidity and market value risk?



Russia attracts large capital inflows
thanks to gas-driven revenues... and despite bad ratings!

Economic Freedom	139 / 177	Heritage Foundation
HDI	67 / 177	UNDP
Ease of Doing Business	112 / 185	World Bank
Credit Rating	B	Coface
Credit Rating	BBB	Fitch
Country risk	158 / 209	OECD
Growth Competitive Index	67 / 144	World Economic Forum
Opacity Index	46 / 59	PriceWaterhouseCoopers
Corruption Index	133 / 174	Transparency International

World Bank: « Doing Business » in 2013

10 Parameters

Ranking does not take into consideration the macroeconomic framework nor organized crime

1. Singapore
2. New Zealand
3. HongKong
4. USA
5. UK
6. Denmark
7. Ireland
8. Canada
9. Australia
10. Norway

29. France

91. China

120. Russia

126. Brazil

132. India

182. Congo



Conclusion:

How to assess sustainability of capital flows?

1. Economic and financial risk analysis
(quantitative)
2. Socio-political framework, institutional development, and structural reforms (qualitative)
3. Resilience to crisis: Economic growth is not sustainable development

