EFFECTS OF INTERNATIONAL CAPITAL FLOWS

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Abstract: Main role of the capital market is to perform an efficient allocation of financial resources from those who have a surplus to those who have a deficit, i.e. to enable their easier meeting and faster transactions with financial institutions, instruments and wide range of financial services. Along with the growing volume of the surpluses and deficits expressed grows the need for an efficient financial market that will channel the excess funds to the end users in a simple way and with the least possible cost. Efficient financial markets are undoubtedly important in order to ensure an adequate provision of capital and economic growth. It is important for the portfolio of investor to be efficient, i.e. to bring the best yield for the given risk, i.e. to contain the slightest risk for the given yield level. In addition, the purpose of portfolio formation is to reduce the risk by combining different securities, i.e. by diversification of investments.

Key words: international capital market, risk, portfolio diversification, offshore banking, Eurodollar

INTRODUCTION

The market in which the residents from various countries trade in financial assets is called international capital market. That is not one market actually; it is about a group of closely related markets where the exchange of financial assets takes place, which has an international character. Trade in international currencies is conducted in foreign exchange market, which is an important segment of international capital market. Main participants in international capital market are the same as in foreign exchange market: commercial banks, large corporations, non-banking financial institutions, central banks. Like in the foreign exchange market, activities in international capital market develop within the network of the world's financial centres that are linked with sophisticated communication systems. However, financial assets, which is traded in international capital market includes stocks and bonds of various countries, as well as bank deposits denominated in their currencies.

International capital market, the gains from trade, risk...........

By providing a global payment system that reduces transaction costs, banks that are active in international capital market increase gains from trade that occur as a result of those transactions. Most activities that take place in international capital market represent the exchange of financial assets between the residents of various countries. Although the traders in financial assets are to some extent underestimated and seen as unproductive „speculators“, they actually make gains from trade that bring positive effects to all the consumers.

All transactions between residents of various countries fall into three categories: exchange of goods and services for goods and services, exchange of goods and services for financial assets and exchange of financial assets for financial assets. Generally, in the country, the trade that can be classified in one of those categories takes place at every moment. The graph – Figure 1 (it is assumed that there are two countries, domestic and foreign) illustrates three types of international transactions, and each of them implies a different series of possible gains from the trade. [1]

The second type of trade gains is generated on the basis of intertemporal trade, which represents the exchange of goods and services for the right to future goods and services, i.e. financial assets. When a developing country borrows from abroad (i.e. sells the bonds to foreigners) in order to be able to import the material for domestic investment projects, it participates in intertemporal trade. Diagonal arrows in the graph – Figure 1 stand for the exchange of goods and services for financial assets. If, for example, domestic country expresses current account deficit in trade with foreign country, it is actually a net exporter of financial assets into a foreign country, and net importer of goods and services from a foreign country. The lower horizontal arrow in the graph – Figure 1 represents the last category of international transactions, exchange of financial assets for financial assets.

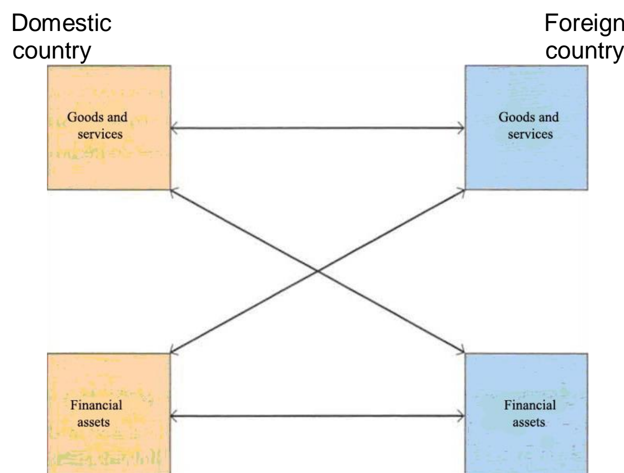

Figure 1 – Three types of international transactions

The figure illustrates – shows that residents of various countries can trade in goods and services for other goods and services, in goods and services for financial assets (i.e. for future goods and services) and in financial assets for financial assets. Based on all three types of exchange, the gains from trade are realized.

When an individual chooses financial assets, important factor that influences its decision is the risk of the yield on those assets. In case of other definite circumstances, people do not like the risk. The economists refer to such common tendencies of people as risk aversion. Specific financial assets of investors that invest in foreign currency assets and are not prone to risk depend on the ratio of its risk (measured by premium for risk) and the yield expected. [2]

The people who are not prone to risk evaluate the set of financial instruments (i.e. portfolio) not only on the basis of the expected yield, but also on the basis of the risk of that yield. In case that there is a risk aversion, people might want to keep bonds denominated in a several different currencies, even if their interest rates are not linked by the condition of the interest parity, if such a portfolio of financial assets offers them a desired combination of the yield and risk. Generally, the portfolio whose yield largely fluctuates from year to year is less desirable in relation to the one that offers the same average return, but more mildly fluctuates from year to year. This observation is a basis for understanding why the countries exchange financial assets. [3]

Portfolio diversification as a motive for international trade in financial assets

International trade in financial assets can provide both sides with the achievement of a better result by the opportunity to reduce the yield risk on their own wealth in that way. Reduction of risk that is achieved by trading provides both sides with the diversification of their own portfolios – to divide their wealth into a wide range of financial instruments and thus reduce the amount of money that was linked to each individual instrument. The economist James Tobin from the Yale University, creator of the theory about the selection of portfolio in relation to the risk aversion degree, has once described the idea of portfolio diversification in these words: „Don't put all the eggs in one basket". When the economy is open to international capital market, it can reduce the risk of its own wealth by putting some of the „eggs" into an additional foreign „basket". Such risk reduction is a basic motive for trade in financial assets.

Still, the countries can *reduce* the risk of using their own wealth by diversifying the portfolio at international level. Basic function of international capital market is to enable such a diversification. [1]

Trading in international financial assets can include the exchange of many different types of assets. Some of many types of instruments by which it is traded in international capital market include bonds and deposits denominated in various currencies, stocks, as well as complicated financial instruments of options

[1] For example: a country with a high production level can realize current account surplus and grant loans to the country with low production volume, by which it will partially reduce differences in consumption between countries, regardless of the state in which world economy is encountered. For that reason, it can come to overlapping of economic functions of intertemporal trade and direct exchange of financial assets. Intertemporal trade can, to some extent, replace direct exchange and vice versa, simply because different states of global economy occur in different time. However, generally, those two types of trade are not the perfect replacements.

of stocks. Purchasing real estates abroad or a direct acquisition of the factory located in another country are alternative ways of international diversification.

When trade in financial assets is considered, we should make a difference between debt and equity instruments. Bonds and bank deposits are debt instruments, given that the issuer needs to pay a fixed amount (the sum of principal and interest) regardless of the economic circumstances. In contrast, stocks are equity instrument: it is about the right to company's profit (and right to decision making) rather than about fixed payment and its cost effectiveness will vary depending on the circumstances. Similarly, the right to a specific quantity of kiwi which was traded in our example represents an equity instrument. Deciding about the stake of debt and equity instruments that they will have in their own portfolio, individuals and nations can arrange the things in such a way to move within desired level of consumption and investments despite various scenarios that can take place. [4, 5]

Dividing line between debt and capital is not so clear in practice. Even if cash payments on the basis of a particular instrument are the same in various countries of the world, real payment in an individual country will depend on the level of domestic prices and exchange rate. Besides that, it can occur that anticipated payment on the basis of a particular instrument is not realized due to bankruptcy, seizure of assets in foreign ownership by the current authorities etc. Instruments such as low-quality corporate bonds, which firstly appear as a debt, in reality can function as equity in the aspect of payments that depend on unreliable financial luck of their issuer. The same turned out for debt of many developing countries as well.

International banking and international capital market

When we speak about the structure of international capital market, we must stress that main participants in international capital market are commercial banks, corporations, non-banking financial institutions (such as insurance companies and pension funds), central banks.

Commercial banks are central institutions in international capital market, not only because they control the mechanism of international payments, but because they perform a large number of various financial tasks. Bank liabilities mainly include deposits with different maturities, while its assets mainly include loans approved (to corporations and governments), deposits in other banks (interbank deposits) and bonds. Multinational banks largely deal with other types of transactions, related to financial assets. For example, banks can *guarantee* the placement of corporative shares and bonds by assuming the responsibility, for the corresponding fee, find the buyers for that securities by the guaranteed price. One of the key facts related to international banking is that banks are often allowed to perform abroad the tasks that they are not allowed to perform in home countries. That type of regulatory asymmetry has accelerated the growth of international banking during the last 40 years. [6, 7]

Corporations – particularly transnational, such as Coca-Cola, IBM, Toyota and Nike – routinely finance their own investment projects relying on foreign sources of funds. In order to reach the mentioned financial sources, corporations can sell shares that provide the owners with the right to claim on the corporation's assets or to use financing on the basis of debt. Debt financing often appears in form of loans from international banks and with their help or with the help of other institutions; when the enterprise needs long-term loans, it can sell corporative debt instruments in international capital market. Corporations frequently issue the bonds denominated in currency of the financial centre in which bonds are offered for sale. However, corporations are increasingly looking for new strategies of denominations that will make their bonds attractive for a wide range of potential buyers. [8]

Non-banking financial institutions, such as insurance companies, pension funds, common funds and hedge funds, have become important players in international capital market since they began to trade in foreign financial assets for the sake of diversification of their own portfolio. *Investment banks* are particularly significant, for example Credit Suisse, Goldman Sachs and Lazard Freres, which are not banks actually, but institutions that are specialize in granting the placements of corporative and (in some cases) state shares and bonds.

Central banks have routinely participated in international financial markets through interventions in foreign exchange market. In addition, other government agencies often borrow abroad.

Growth of international capital market

Using any measure, the volume of transactions in international capital market has grown more rapidly than world's GDP from the early 70's up to today. One of the main factors that have influenced such a development of events is that the countries, starting from the industrial part of the world, have gradually eliminated barriers for cross-border movement of private capital.

One of the main causes of such development of events is related to the regime of the foreign exchange rate. A country that fixes the exchange rate of its own currency and simultaneously allows international capital movement, actually sacrifices the control over the domestic monetary policy. Based on

that, we can conclude that the country cannot simultaneously acquire more than two items from the following list:
1. Fixed exchange rate.
2. Monetary policy aimed at accomplishing domestic objectives.
3. Free international capital movement.

This results in a "trilemma" for determining the policy regime – so, it is trilemma, not dilemma, given that there are three options: 1 and 2, 1 and 3 or 2 and 3. During the gold standard, for example, countries have abandoned monetary policy in favour of the fixed exchange rates and freedom of international payments, opting for the monetary system based on points 1. and 3. from the above list.

When the industrialized countries abandoned fixed exchange rates after Bretton Woods period, they have chosen the system that enabled them to combine the international mobility of capital with monetary policy aimed at domestic objectives. However, because of that they fell behind in enabling greater freedom for international trade in financial assets. Individual member countries of the European Economic and Monetary Union have gone a different way when it comes to their mutual exchange rates. Transfer of competencies that refer to monetary policy on the common central bank, they have abandoned the item 2. and chosen the items 1. and 3. On the other hand, euro fluctuates in relation to other foreign currencies, and euro zone entirely aims its monetary policy to the accomplishment of internal macroeconomic goals, with a simultaneous enabling of freedom for cross-border payments. [9]

One of the most striking features of today's industry of commercial banking is that banking affairs have obtained a global feature and that the banks with their subsidiaries have stepped outside domestic countries in international financial centres.

The term offshore banking is used to describe the affairs that foreign branch offices of the banks perform outside the country they come from. Banks can perform foreign affairs within any type of the three institutions:

1. Branch office that is located abroad, which arranges for granting the loans and transfer of funds, but it does not receive deposits.

2. Subsidiary bank that is located abroad. Subsidiary banks differ from local banks by the fact that foreign bank, as an owner, controls the operation. They are subject to the same regulations as the local banks, but simultaneously they are not the subject of the regulations of the country from which the equity bank comes.

3. Foreign *subsidiary* that simply represents the office of domestic bank in another country. Subsidiaries perform the same tasks as the local banks and they are usually subject to both local and domestic banking regulations. Very often, however, subsidiaries can use the advantages of cross-border differences in regulations.

Growth of offshore trade in currencies takes place simultaneously with the growth of offshore banking. Offshore deposit represents a bank deposit denominated in some other currency and not in the currency of the country whose resident is the bank, for examples, deposits in yens in London Bank or dollar deposits in Zurich. Great part of deposits that are traded in foreign exchange market are offshore deposits. Offshore deposits are usually referred to as Eurocurrencies, which is in a way illogical given that great part of Eurocurrency trading takes place in non-European centres, such as Singapore and Hong Kong. Dollar deposits located outside the USA are called Eurodollars. Banks that accept deposits denominated in Eurocurrencies (including Eurodollars) are referred to as euro banks. The appearance of the new European currencies, euro, has brought even more confusion in the existing terminology!

Cause of the rapid growth of offshore banking and trading in currencies was the growth of international trade and change in the nature of corporative activities that were increasingly taking the multinational character. Eurocurrency trading is another form of the natural step aside and expansion of the world trade in goods and services.

However, the growth of international banking after the 60's cannot be explained by the growth of the world trade. Another factor that influenced it is desire of the banks to avoid domestic state regulations related to financial activities by transferring a part of their operations abroad and the area of foreign exchange trading. In recent years, the tendency of countries to open their financial markets to foreigners has enabled international banks to compete for new jobs at the global level.

The growth of Eurocurrency trading illustrates the significance of all the mentioned factors that have influenced the internationalization of banking. Eurodollars are created in the end of the 50's as a response to the needs that have occurred due to the growing volume of international trade. European companies that were engaged in trade, very often had the need to keep certain dollar amounts or to borrow dollars. Europeans were often finding it cheaper and more convenient to do business with local banks that were familiar with circumstances in which those firms were encountered. A growing number of currencies, except for dollar, were becoming convertible after the 50's and thus the number of offshore markets for them was increased.

Although the convenience of business with local banks was a key factor for the generation of Eurodollar, the growth of Eurodollar's trade in the earlier phase of its existence was also encouraged with the previously mentioned factor: official regulation.

The history of Eurocurrencies shows in which way the growth of world trade, financial regulation and political circumstances have influenced the formation of the existing system. However, the main factor that influenced on continuous profitability of Eurocurrency trading is regulation. Strict regulations are introduced for deposits in domestic currency that represents a way to maintain control over domestic money supply; simultaneously the banks are given great freedom when it comes to the operations with foreign currencies. However, deposits in domestic currency owned by foreign clients can obtain a special treatment if the regulators evaluate that they can isolate domestic financial system from the changes in demand for foreign financial assets.

Bank collapses when it is no longer able to fulfil its obligations to depositors. Banks use the funds of depositors for granting loans and purchase of other assets, however, some bank's debtors can be found in the situation that they cannot pay their loans or the value of bank assets can drop for some reasons. In such circumstances, the bank can be in a situation that it cannot pay the deposits anymore.

A particular feature of banking is that financial health of the bank depends on depositors' confidence in the value of its assets. If the depositors start to believe that it has come to the drop in larger part of bank's assets, each of them will wish to withdraw their funds and deposit them in another bank. The bank that faces with a mass loss of deposits will very likely stop operating, even in case that assets on its balance sheet are essentially healthy. The reason is that a large part of bank's assets is not liquid and that it cannot be sold rapidly so that banks could fulfil their obligations related to the payment of deposits without significant losses for the bank. [10] For that reason, in case of a financial panic, bankruptcy does not need to stop only on those banks that did not manage their own assets well. It is in the interest of each depositor to withdraw his money from the bank if all depositors do so, even if the bank's assets are essentially healthy. It is obvious that bankruptcy inflicts enormous financial damages to individual depositors who lose their money. However, besides individual losses, bankruptcy of the bank can harm overall macroeconomic stability of the economy. Problems of one bank can easily be transferred onto the health of other banks if there is a doubt that they have granted loans to the bank that is encountered in crisis at that time. Such a general loss of confidence in banks undermines the payment system on which the banking is based. A great number of bank's bankruptcies can be caused by drastic reduction of banking system's ability to finance investment and consumer needs, due to which the aggregate demand is reduced – all that leads the economy in the state of crisis.

Good management in banks takes precautions for the bankruptcy prevention, even if there are no detailed regulations. However, we should always have in mind that bankruptcy costs by far exceed the damage that bank owners will suffer in that case. For that reason, some banks, having in mind only their interests and without paying attention to consequences of bank's bankruptcy on the society, can enter a lot greater risks than it would be desirable for the society as a whole. Besides, even the banks that have developed cautious investment strategies can collapse if the rumours about their financial problems start spreading. Many of precaution measures contained in banking regulations that were introduced by today's states are the consequence of the experiences of those countries during the Great Depression.

The prescribed required reserves are the main instrument of monetary policy through which the central banks influence the relationship between monetary base and monetary aggregates. Simultaneously, the prescribed amount of the required reserves obliges the banks to keep a part of their assets in liquid form so that they could easily use it they are faced with a sudden outflow of deposits.

Difference between assets and liabilities of the bank represents the net value of bank, and it is also known as *bank capital*. Bank capital is own capital that bank's shareholders acquire when they buy bank's shares. Having in mind that it is equal to bank's assets, which the depositors do not claim, it provides the bank with an additional security margin in case that the rest of its assets become riskier. Banking regulators determine the minimum required level of bank's capital with the aim to reduce the system's vulnerability to banking crashes. The other rules prevent the banks from keeping the assets that are „too risky", such as common shares whose prices are expressly hesitant. The banks are also faced with the rules that prevent granting loans of the excessive part of their assets to one client only or one corporation.

In international banking, primarily, there is no deposit insurance. Systems of national deposit insurance can protect both domestic and foreign depositors; however, available insurance amounts are always too modest to be able to cover deposit amounts that appear in international banking. Interbank deposits are particularly unprotected.

However, the absence of required reserves is the main cause of Eurocurrency trading. And while euro banks acquire competitive advantages due to the fact that they can avoid the separation of obligatory reserves, which is actually the reason for which the costs for society appear because the stability of banking system is lost. There is no country that can solve that problem alone by imposing the required reserves to

the overseas subsidiaries of its own banks. On the other hand, due to political and technical difficulties and fears of one number of countries that they could lose the existing banking jobs by more strict regulations, the agreement is still not reached in a uniform set of regulations at the international level.

In international environment, it is getting more difficult to conduct the supervision whether the banks keep the prescribed capital level and respect the restrictions linked with financial assets. Regulators in central banks usually monitor the consolidated balance sheets of domestic banks and their subsidiaries abroad. However, they are not so detailed when it comes to other forms of organizing the banks abroad that are not that much related to the parent bank, but whose financial result can also affect the solvency of the bank observed. Banks could often use that benefits by transferring riskier jobs, that domestic regulators could bring into question, into in the areas where the authorities ask less questions. Besides, very often it is not clear which group of regulators is responsible for watching the mentioned financial assets of the bank.

Internationalization of banking has weakened protection measures that prevent banks' bankruptcy and it has created the need for an urgent development of effective protection measures that will suit modern needs. Offshore banking includes a vast scope of interbank deposits – roughly, private banks hold about 80% of Eurocurrency deposits. High level of interbank deposits indicates that the problems that affect an individual bank can be very dangerous and that they are rapidly spread onto the other banks with which the bank mentioned has established business relations. Due to „domino“ effect, disorders at the local level can consequently start banking panic at the global level. As an answer to those threats, governors of the central banks of 11 industrial countries have founded a group named Basel Committee in 1974., whose job was to achieve „better coordination of supervision that is conducted by national authorities, and it concerns the international banking system...“ (group is named by Basel in Switzerland, the city in which central bankers meet and in which the Bank for International Settlements is located). Basel Committee is still the most significant forum for cooperation between the regulators of banking sector that come from various countries.

In Basel Committee in 1975, an agreement was reached, called Concordat, in which the responsibility for supervision of multinational banking institutions was divided between the countries from which those institutions come and the host country. Besides, Concordat required the exchange of information about banks between regulators of the country of origin and host country, as well as „giving permissions for inspections by the country of origin or in the name of it on the territory of the host country." [2]

The most significant change in international financial relations concerned the increasing importance of emerging markets as sources and destinations for the flows of private capital. Emerging markets are actually the capital markets of the poorer countries in development that have liberalized their own financial systems in order to provide the trading in private assets with foreigners. Countries such as Brazil, Mexico, Indonesia and Thailand have become, after 1990, the destinations for the inflow of private capital from industrial countries.

However, it turned out that the emerging financial market institutions are generally weaker that those in industrialized countries. Their vulnerability has contributed to the appearance of serious financial crises in the period from 1997-1999. Besides other problems, developing countries often lack experience when it comes to banking regulations, they have weaker prudential and accounting standards than developed countries and they are prone to automatically offer guarantees to domestic banks that they will pull them out if they fall into trouble.

As a result, it is now considered that internationally accepted „the best practice“ when it comes to the regulation standards needs to be expanded on the countries of the emerging market. Basel Committee has published *Basic principles of effective supervision of banks* in September of 1997, which were generated in cooperation with representatives of many developed countries. In that document, there are 25 principles for which it is considered that they represent a minimum of the regulations required that refer to the effective supervision of banks, and include issuing the permissions for the work of banks, supervision methods, prescribed reporting that the banks need to conduct and cross-border banking. Basel Committee and IMF monitor the implementation of those standards (revised in 2006) worldwide.

International activities of non-banking financial institutions are the following point that can potentially cause problems. International cooperation in the field of banks supervision has gone a long way since the early 70's until today, so that regulators now begin to cope with the problem of a growing number of non-banking financial institutions. They have an important task. The collapse of major insurance houses, for example, such as banks collapse, can seriously disrupt domestic payments and lending net. Growing securitization (when financial assets of banks turn into liquid market forms) and trading in options and other derivates has made it more difficult to regulators to obtain a clear picture of global financial flows by analyzing banks' balance sheets only.

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[2] In that sense, the review of Concord was given by W. P. Cook from the Bank of England, representative of Basel Committee in „Developments in Cooperation among Banking Supervisory Authorities” Bank of England Quarterly Bulletin 21 (June 1981), pp. 238-244.

Conclusion

When the people are *not prone to risk*, the countries can gain thanks to the exchange of risk assets. Gains from trade are manifested as the reduced consumption risks in each country. International *portfolio diversification* can be implemented through the exchange of *debt or equity instruments*.

International capital market is a market where the residents of various countries trade in financial assets. One of its most important components is the foreign exchange market. The banks are in the centre of international capital market and many of them do business outside the mother country, i.e. outside the country where their headquarters is located. Regulations, as factors, have encouraged the development of *international banking.* The same factors have encouraged the *offshore trade in currencies,* i.e. trade in bank deposits denominated in currencies of other countries, and not in the currency of the country from which the bank comes, nor in the currency of the country in which the bank (subsidiary) is located. On the other hand, *Eurocurrency* trading, in whose case the basis for international loans are convertible currencies that are not legal tenders in the markets concerned is also encouraged by the absence of requirements related to required reserves when it comes to euro banks.

The generation of Eurocurrency deposits does not occur due to the fact that currency leaves the country of its origin; all it takes is that euro bank accepts the obligation for deposit denominated in that currency. Eurocurrencies, therefore, do not represent a threat for the control that central bank conducts over domestic monetary base.

In most cases, offshore banking is not protected by measures that are imposed by national authorities in order to prevent the bankruptcy of domestic banks. In addition, possibility for the banks to relocate their business out the borders of mother country has undermined the effectiveness of supervision that is conducted by central banks. From 1974, *Basel Committee* of the supervisor of banking sector of industrial countries works on increasing regulatory cooperation at the international level. The agreement Concordat of that group, from 1975, has assigned the responsibility to countries to monitor banking institutions and enabled the exchange of information. However, there is still the uncertainty about the obligations of central banks as *lenders in the last instance.* That uncertainty illustrates the attempt of international authorities to reduce the *reputational hazard*. The trend of *securitization* has increased the need for international cooperation in monitoring and regulating non-banking financial institutions. The same is with the increase of the number of *emerging markets*.

International capital market has contributed to the increase of international portfolio diversification from 1970 up to these days, but is seems that volume of diversification is still insufficient in comparison with predictions in economic theory. Similarly, some observers have claimed that the scope of intertemporal trade, measured by the balance of current accounts, is low. Such claims are difficult to evaluate without detailed information about the functioning of global economy that are still unavailable. Clear evidence is obtained on the basis of comparing the interest rates at international level and those evidences point out to market's well-functioning. Yield rates on similar deposits issued in main financial centres have approximately the same values.

International capital market enables the residents of various countries to diversificate their own portfolio by trading in risk assets. Furthermore, providing a rapid international flow of information about investment possibilities throughout the world, the market assists in allocation of global savings and its utilization in the most productive way.

Seemingly unfinished scope of international portfolio diversification has not yet encountered a sharp condemnation of the world capital market. The market has certainly contributed to the astonishing increase of diversification in recent decades, despite some remaining barriers to international capital movement.

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