A Portfolio Model of Capital Flows to Emerging Markets

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Summary

In the decade since the crises of the 1990's, emerging economies have generally experienced strong and uninterrupted economic growth with no major crises. Capital flows from industrial countries in the form of FDI, as well as portfolio and bond investment, have been strong. Sovereign spreads have been low by historic standards for a number of years. For most emerging countries, external accounts have swung sharply from positions of net deficits in the mid-1990's to generally strong surpluses at present. In addition, these countries have eliminated their financial vulnerabilities, displayed so clearly during the crisis years, by correcting the currency and maturity mismatches in their national balance sheets. Some countries have abandoned tight exchange rate pegs and moved towards flexible inflation targeting.

One general feature of emerging economies' recent experience, that differs from previous episodes of high capital inflows and economic growth, is the degree to which they have been participants in the globalization of financial markets. Many emerging countries have displayed growth in gross external financial assets and liabilities that are much larger than net positions. In this sense, their experience mirrors that of many advanced economies. Emerging economies have been accumulating large stocks of US treasury bills going into official reserve assets, but they have also been receiving large inflows of FDI and portfolio equity investment, as well as private bond market inflows.

This paper analyses the impact of financial globalization in emerging market economies, paying particular attention to the determinants of country portfolio positions. We explore the factors underlying the determinants of an optimal risk-sharing portfolio for an emerging market economy and an advanced economy. The emerging economy is characterized by a high country-specific productivity risk. We explore how international risk-sharing can be achieved under a number of alternative financial market configurations, ranging from a situation of no financial markets (i.e. no portfolio diversification) to one of complete markets. Of particular interest is an intermediate financial structure, where there is international trade in equity-FDI claims of the emerging economy as well as nominal bonds denominated in the currency of the advanced economy. This is meant in a general sense to represent the present structure of two way capital flows between emerging market economies and the advanced economies as described in the previous paragraph.