Benefits and Risks of Free Flow of Capital
In Emerging Markets

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Abstract
Developing and emerging economies consider foreign financial resources as suitable to solve the problem of capital they need. Thus, they resort to international financial markets to finance their financial needs, using free flows of capital. The results of various studies done in the area under analysis indicate that liberalization of capital flows makes it possible for the countries having shortfall of financial resources to get access to surplus financial resources of other countries, providing the ground for the increase of competition, production, growth and welfare. Moreover, the ever-increasing growth that is occurring in combination and liberalization of international financial markets has led such markets to have more correlation with each other, and as a result of which, more effectiveness. Although liberalization of capital flows can lead to increase of growth and welfare in the countries that proceed to liberalize their financial market, such a deed can also be followed by some dangers. The evidence present about the recent and past financial crises indicates that liberalization of capital market can make a country susceptible to foreign shocks.

Keywords: Capital Market, Combination of Financial Markets, Liberalization of Capital Flow.

1. Introduction
Liberalization of financial and capital flows can play a fundamental role in the increase of growth and welfare. The recent years' flowing of capital in emerging markets has provided countries with opportunities for economical development and also problems for economical management (Dooley, 1996).
In general, those countries having surplus cash fund are always seeking to find opportunities for the investment of their savings, and Liberalization of capital flows makes it possible for the fund to be conveyed form the countries having surplus fund toward those having shortfall of it, hence increasing productivity in using resources, and leading to enhancement of welfare (Souza, 2004).
Moreover, broad participation of international investors in emerging markets has caused developed markets to have more relationship with other markets. As a matter of fact, it is through emerging financial markets including different financial institutes and funds that the participation provides the possibility to get access to the capital and financial resources of various countries (Ganapolsky and Schmukler, 1998).

Merging of international capital markets to get access to international capital flows can have different effects on various economic variables. Meanwhile, capital market as one of the most significant sectors of economy and financial market may be influenced by such effects. Therefore, it seems necessary to take this area (capital market) and the factors effective on individuals' participation in capital market into account so that to recognize the factors effective on individuals' decisions to remain their shares. Concerning the theoretical foundations existing in the area of factors effective on capital market, the present essay is intended to describe the effect of merging international capital markets and liberalization of capital flows as one of the factors effective on this market and on individuals' participation in it. Moreover, presenting a suitable theoretical literature in the area of the variable under analysis, the essay wants to provide suitable tools for other researchers and decision makers in capital market of the country.

2. Liberalization of Financial Markets

In a study using the model proposed by Rajan and Zingales (1998), Vlachos and Waldenstrom (2005) tried to investigate the effect of liberalization of financial market on the rate of growth and surplus value. The results of their study show that the industries that are highly dependent on being financed from outside in the countries that try to liberalize financial market will not experience higher growth of surplus value. In other words, growth of surplus value is unrelated to merging and liberalization of financial market.

The findings of their study indicate that liberalization of financial market will lead to increase in growth rate and generation of new firms among the industries that are highly dependent on being financed from outside (in the countries that have reached high levels of financial development). These findings are consistent with the ever-increasing competition and finance from outside (outsourcing).

The results of the above research show that liberalization of financial markets will stimulate the creation of new firms which in the long run will lead to increase of competition and production. Moreover, being financed from outside (outsourcing) will provide the possibility to establish new factories with low costs through getting access to capital flows resulted by liberalization of financial market.

Outsourcing will cause the chain of surplus value to be cut off which can be accompanied by the creation of new firms, increase of production and competition, zero growth in surplus value, and production of final good with low price.

Guiso et al (2004) believe that the merging of financial markets will have potential benefits for the firms having access to these similar markets (either being in America or in Europe). This can have a potentially strong effect on the growth of countries and the sectors inside them (such as production sectors).

Having analyzed 26 developed countries, Guiso et al (2004) proved that the countries having nearly small firms (small and medium firms) gain more benefits from the development of their internal financial markets. In other words, the merging of financial markets in such countries will be profitable only when the merging leads to the development of financial market. Actually, due to the fact that small and medium firms are probably less able to take advantage from the benefits of being accessible to markets and foreign financial mediators, merely getting access to international markets will not be so beneficial.

Grossman and Helpman (2002) in a study investigated the effect of international markets on stock market. The results of their study show that when a country take steps toward liberalization of capital market, the firms having qualification to offer goods to foreign customers will experience the average stock price of 15.1%. They state that liberalization of capital market reduces systematic risk, and will cause foreigners to remain their shares.

Arteta et al (2001) in a study reinvestigated the evidence regarding the relationship between liberalization of capital market and growth. The results of their research showed that there is some evidence for the existence of a positive relationship between the above variables. However, they believe that the relationship is different as far as time and the way to liberalize the flow of capital are concerned.
The results of their study indicate that there is a weak similarity between the effects of liberalization of capital market in the countries having high income. Moreover, the effects of positive growth of liberalization of capital market in the countries having strong institutions are stronger. In order to analyze the effect of liberalization of capital market on investment growth, Henry (2000) examined 11 developing countries that had already liberalized their financial markets. The results of his study proved that in the first year the rate of investment growth in 9 countries were higher than the median of the investment rate before capital market was liberalized. However, after the liberalization of capital market occurred, this amount reached to 8 and 10 countries in the second and the third years, respectively. The findings of the above research indicate that in all the countries being analyzed as the sample of the study the average rate of investment growth during the three years exceeded 22% on average. In a study using Cross-Sectional Time Series Model, Bekaert and Harvey (2000) investigated the effect of liberalization of capital market on capital cost. The results of their study show that capital cost will always reduce with liberalization of capital market. Rodrik (1998) in a study showed that liberalization of financial market has no effect on the growth of GDP. However, Edwards (2001) maintains that liberalization of capital market has positive effect on economic growth.

3. Risks of Liberalization of Financial Market

Pintus (2004) in a study proved that those economies that broadly borrow from international financial markets are highly exposed to the danger of unpredicted fluctuations. To him, limitation to borrow from foreign countries can support any economy against such fluctuations. On the other hand, the results of his study indicate that with respect to the taxes being progressive, transferring of international capitals will lead to instability in the performance of accurate estimations. Souza (2004) states that although on the one hand liberalization of capital flows can lead to increase of growth and welfare in the countries that proceed to liberalize their financial market, the deed can on the other hand be followed by some dangers. Referring to the evidence existing about the recent and previous financial crises, he maintains that liberalization of capital market can make a country vulnerable to foreign shocks. The results of Souza's research show that big capital flows can easily lead a country to face dangerous financial crises, if the country has weak financial sectors, inappropriate risk management and inadequate regulations and supervisions. He believes that some of the recent financial crises including those of East, Asia, Mexico, Russia, Brazil, and Turkey in the late 2001 and the early 2002 were related to liberalization of capital flows in those countries.

4. Liberalization of Financial Markets and International Financial Crises

According to Ganapolsky and Schmukler (1998), concerning that capital markets in Latin America are increasingly merging into each other, it is more probable than the past that foreign shocks influence other countries. The results of their study indicate that liberalization of capital market and participation of international investors in emerging markets will cause financial markets to have more relationship with each other increasing the possibility of similar decisions to be made among emerging financial markets especially in the period of crisis. They state that correlation existing among financial markets in Latin America is more than the correlation in financial markets in America. On the other hand, the results of the above research indicate that the correlation having appeared among financial markets in Mexico, Argentina and Brazil after the financial crisis was more than the past. As a matter of fact, the correlation existing among the prices of securities in Brazil and Argentina reached from 41% to 69% and the correlation of the prices of securities in Brazil and Mexico increased from 31% and to 64%. The above also research shows that during the period of crisis correlation among the securities of Argentina, Brazil, and Mexico amounted approximately to 80%. In fact, the correlation between capital markets of Argentina, Brazil, Chile and Mexico had a significant increase compared to the time before crisis period. For example, the correlation between the financial markets of Brazil and Chile reached from 15% to 78%. The results of Ganapolsky and Schmukler's research indicate that in consequence of the occurrence of crisis in Mexico, other financial markets of Latin America had reactions similar to that of Chile's.
financial market. This implies the existence of relationship between financial markets in Latin America.

5. Conclusions
Concerning the different functions of financial markets in national economy including provision of saved resources and directing them toward economic productive activities, pricing of funds and capital, giving out information about such markets and analyzing the information and distributing economic risk, it seems necessary to pay attention to the factors that can affect the possibility of individuals' participation in capital market.

With respect to the research literature existing in the area of factors effective on capital market, the essay examined the variable liberalization of international financial markets and its effects on capital market as one of important factors present in the area under analysis.

The research literature accessible in this area is indicative of the existence of relationship between the above variables, stating that the ever-increasing combination and liberalization of international financial markets has led such markets not only to have more correlation with each other but also to be more influenced by such actions (combination and liberalization).

Liberalization of capital flows makes it possible for funds to be transferred from the countries having surplus toward those having shortage, hence increasing productivity in using resources and leading to increase of welfare.

Liberalization of financial markets makes it possible to establish new factories with low costs through getting access to capital flows; hence it is an incentive stimulating the creation of new firms, which in turn will be followed by increase in competition and production.

The results various studies in this ground indicate that Liberalization of capital market and participation of international investors in emerging markets will cause financial markets to have more relationship with each other, increasing similar decisions among the emerging markets especially in the period of crisis.

Although on the one hand liberalization of capital flows can lead to increase of growth and welfare in the countries that try to liberalize their financial market, the deed can on the other hand be followed by some dangers. As a matter of fact, the evidence existing about the recent and previous financial crises show that liberalization of capital market can make a country vulnerable to foreign shocks.

The theoretical literature present in the area under analysis states that if a country has weak financial sectors, inappropriate risk management, and inadequate regulations and supervisions, then big capital flows can easily lead to dangerous financial crises in the country.

References


