Press points for Chapter 3:
The Quality of Domestic Financial Markets and Capital Inflows

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Key points

- **Capital flows to emerging markets (EMs) can enhance economic development, but also pose policy challenges for some countries.**

- **A better developed domestic financial market increases the volume and helps reduce the volatility of capital flows to EMs in the medium-term.**

- **By adopting a medium-term financial market development focus, EMs will be better equipped to maximize the benefits of capital inflows while cushioning the domestic financial system from the potentially destabilizing effects of abrupt capital outflows.**

- **Supervisory and prudential measures have a key role to play in addressing the health and stability of the financial system.**

Capital flows to emerging markets (EMs) have increased sharply with flows to EMs growing almost sixfold in the last five years. While such flows can increase investment and enhance economic development they can also be difficult to accommodate and pose policy challenges for some countries. The chapter thus asks the following questions: What financial policy actions can EM countries take to best deal with uncertainty about the level and volatility of capital flows? Aside from strong macroeconomic fundamentals, does a well-functioning domestic financial market increase the level of capital inflows and reduce their volatility?

The chapter examines domestic "micro" financial factors—such as equity-market liquidity and institutional quality—to determine their effect on the level and volatility of capital flows. A large sample of 56 developed and emerging market economies is examined with annual data from 1977 to 2006. Analysis over a shorter time period (1998-2006) includes additional institutional quality variables such as corporate governance quality and accounting standards.

Our results indicate that, over the medium term, a better developed domestic financial market increases the volume and helps reduce the volatility of capital flows to emerging markets. Specifically, although economic growth expectations are a primary determinant of the level of capital inflows, equity market liquidity and financial openness also help attract capital flows. Moreover, greater financial openness is associated with lower volatility of capital flows. We also show that improvements in a broad set of institutional quality variables are correlated with lower volatility of capital inflows.

These results, which are consistent with the views expressed by institutional investors, point to the advantages of focusing on the medium-term goal of improving the quality of domestic financial markets. In addition to strong macroeconomic fundamentals, countries will be better equipped to live with potential capital flow volatility if they have deep and liquid equity markets within a well-regulated system, and strong institutional quality across a broad range of indicators, including corporate governance, accounting standards, the rule of law, and control of corruption.

The analysis highlights the importance of transparency in relation to both policies—macroeconomic and microfinancial—and economic and financial data. Private institutional investors have repeatedly stressed the importance of timely and accurate data and good communication with the investor base, as factors that contribute to the effective management of capital flows.

By adopting a medium-term financial market development focus, EMs will be better equipped to maximize the benefits of capital inflows while cushioning the domestic financial system from the potentially destabilizing effects of abrupt capital outflows. Notwithstanding cyclical variations in capital flows, the increasing integration of financial markets and the underlying trend of financial globalization is likely to continue. Recipient countries can increase their resilience to the volatility of capital flows and safeguard financial stability by strengthening their financial systems.

Loosening or eliminating restrictions on residents' capital outflows can help ease pressures from large capital inflows. Outward investment will also lead to internationalization of capital across EMs and, therefore, can be a welcome means of risk diversification.

Supervisory and prudential measures have a key role to play in addressing the health and stability of the financial system. Ideally, however, they are best used to address prudential considerations such as rapid credit growth or unhedged foreign exchange exposures; that is, to ensure the soundness of the domestic financial system, rather than designed to alleviate pressures stemming from capital inflow surges.

Capital controls should be used only as a last resort and as part of a broader framework of macroeconomic policies and prudential measures. They may be able to throw sand in the gears of a surge of short-term speculative inflows under certain circumstances, especially if the infrastructure for their imposition is already in place. Often, capital controls are circumvented or their effectiveness diminishes over time.