

MONETARY AND FINANCIAL CASH FLOWS AS DRIVERS OF FOREIGN DIRECT INVESTMENTS AT THE GLOBAL LEVEL

RADOVIĆ MARKOVIĆ Mirjana¹, VESIĆ Tamara², DJEKIĆ Marija³

¹ Akamai University, Hilo, (UNITED STATES OF AMERICA)

² Faculty of Business Economy and Entrepreneurship, Belgrade (SERBIA)

³ Faculty of Business Economy and Entrepreneurship, Belgrade (SERBIA)

Emails: mradovic@gmail.com; tamara.vesic@vspep.edu.rs; marija.djekic@vspep.edu.rs

JEL: E5, E4

DOI: 10.5937/intrev2202013R

UDK: 339.727.22(100)

COBISS.SR-ID 71617801

ABSTRACT

Following the 2008 economic crisis, there was a reassessment of the cross-border flow of capital and the policies that affect that capital. First, large, and volatile capital flows have created tensions between macroeconomic and financial stability. Second, investors' appetite for risk declines after the recent economic crisis. Various analyses show that this trend was reversed by 2014, with emerging and developing economies accounting for just under 60% of world GDP, while the share of advanced economies was just over 40%. In this paper, we analyse the flow of capital in modern cash flows, following the example of large financial systems. The aim of this paper is to determine how cash flows have moved from the world wars until today through financial institutions, and with the help of financial instruments.

Keywords: cash flows, direct investment financial institutions, financial instruments

INTRODUCTION

To get better understanding of monetary and financial flows we need to clarify what is global financial system and how does it function. Global financial system is system of frameworks, markets, institutions, and instruments that together facilitate international flows of financial capital [1]. We need to explain which markets, institutions, and instruments we mean by these and what are their jurisdictions.

Firstly, we will describe markets. The financial market is defined as an institution or arrangement that facilitates the purchase and sale of goods, services, and other items [2]. Financial market is an institution that facilitates the exchange of financial assets [2]. Baye distinguish three most basic types of markets: debt, equity, and financial services market. According to him in the debt market lenders provide funds for borrowers for predefined amount of time. In return borrower agrees to pay back same amount of money to lender, plus interest rate. Usually, individuals use debt markets to acquire money for purchase of houses, cars etc [3]. In terms of corporate borrowers, they use loans to obtain new equipment or to buy working capital. State and local governments use borrowing to finance various public projects and other expenditures. Equity markets facilitate trade of tangible asset like houses and stocks. New houses and stocks are sold on primary markets, while existing houses and stocks are sold on secondary equity market.

LITERATURE REVIEW

Monetary and financial flows are subject of academic attention for more than a century now. Just few years after First World War, Great Depression happened and according to IMF countries tried to shore up their failing economies by rising custom tariffs, depreciating their currencies, and forbidding its citizens to hold foreign currencies. World trade and living standards sharply declined in many countries during the period under review [4]. It is important to remember that Adam Smith in 1776 published “Wealth of nations” and argued that national wealth is not improved by stockpiling goods but rather trade [5].

Economic openness and international trade are important same as possibility to produce [6]. The Great Depression was one more setback for economic openness, but in the dawn of the Second World War world policy makers have again started to work on this issue in attempt to rebuild international economy [7]. In 1945, in United States of America, United Nations has held a conference known as Monetary and Financial conference. After deliberation among representatives, Breton Woods’s system has been presented. The plan involved nations agreement to system of fixed, but adjustable exchange rates. Result of this conference was that 44 nations have agreed on framework of the system and signed a document which included set of rules, institutions, and procedures to regulate international monetary system [8]. Two major institutions were created in the process, and those are International Monetary Fund and International Bank for Reconstruction and Development. This system lasted until 1971, when President Richard Nixon announced suspension of dollar convertibility into gold.

According to IMF’s article, attempt to revive same system has failed [9]. Since the collapse of this system IMF members were free to use any system that is not currency value connected to gold. New system allowed possibilities of currency value to flow, adopting another country currency, joining currency block, or creating monetary union. Opposite the fears that after Breton Woods system fail period of rapid growth will end, the transition went very well and floating exchange rate facilitated adjustments to external shocks ever since. According to the same article, the IMF has introduced lending instruments to help the countries who had problems with payment balances to solve current problems [9].

The fall of Berlin wall and dissolution of Soviet Union have enabled IMF to become universal institution [10]. According to next IMF’s article, global capital flows fluctuated between 2% and 6% of world GDP in period from 1980 to 1995 [11]. As a result of financial integration process, capital flows have increased considerably. In academic circles, there is still a debate on potential benefits and risks of this integration. According to data published by McKinsey Global Institut, capital flow reached its maximum with rising to 20.7% of World GDP in 2007 and soaring after Economic crisis in 2008 [12].

Years of rapid financial integration made world economy more integrated than ever. New technologies, including electronic banking, made access to financial markets easier than ever and raised cross-border capital flow to historically highest level [13]. But after the financial crisis capital flows decreased and this caused financial integration to reverse [14], [15]. Cross border capital flows decreased by 60% [12].



Fig. 1. Capital crash as percentage of global GDP in early 2000s

Source: [12]

RESEARCH RESULTS AND DISCUSSION

Financial services market allows to companies or individuals to purchase financial services. Examples of these services are usage of ATM transactions, brokerage services etc. Secondly, we will write about institutions. In economics, financial institutions are institutions that provide financial services for its clients. Depository and non depository institutions both serve financial markets [16]. Depository institutions accept deposits from individuals and firms and use them as funds to participate at debt market by creating loans or purchasing debt instruments like bonds and treasury bills. Commercial banks are largest and the most important depository institutions. Main source of their funds are deposits. They have various functions on the markets, including financial intermediation and selling insurance. Mutual funds sell shares to investors and invest their capital in wide choice of assets. In return investors receive earnings from these assets. Insurance companies protect individual from risks. Life insurance companies accept payments from individuals in exchange for contracted payments in the event of the insured's death. Pension funds provide income for people who retire. They can be state or private owned.

Brokerage firms connect buyers and sellers of financial assets. Furthermore, it is important to explain several other institutions. First important institution we need to explain is International Monetary Fund.

According to available data from official site, IMF is an international organization that provides financial assistance and advice to member countries [17]. According to their presentation, the IMF's primary purpose is to ensure stability of international monetary system, the system of exchange rates and international payments that enables countries, and their residents, to transact with each other. These goals are to archive the IMF advice its members on macroeconomic policies, exchange rate, government's budget, and money and credit management. The IMF also assess financial sector of the country and its regulatory policies, structural policies and additionally may offer financial assistance to nations who need to correct balance payments. Therefore, the IMF oversees maintaining and supporting economic growth and high level of employment. Based on cases of Tanzania and Jordan we can conclude that the IMF had mixed results approach to countries problem solving. But on the level of international financial flows, we can conclude that the IMF has served its purpose and it has been very useful. In 2015 total lending maximum was reached in 2012 with loans value standing at 99.7 billion USD [18].

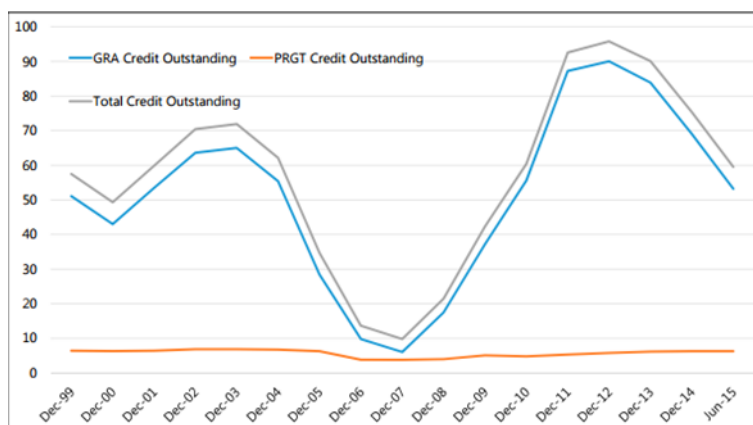


Fig. 2. Total credit outstanding during in period 2000-2015.

Source: [11]

Second important institution is the World Bank. According to available data from official site, World Bank Group was established in 1944 to rebuild post war Europe under the International Bank for Reconstruction and Development. Today the World Bank is international institution that fights poverty [19]. They offer development assistance to middle and low-income countries. By giving loans and advising both public and private sector they are trying to help countries to fight poverty. The bank encourages its clients to implement policies that support sustainable growth, health, education, and social development. Third important institution is central bank. Central bank is institution that is responsible for emission, regulation of monetary and loans flows in every country [20]. Goals of every central bank are stability of exchange rates, prices, and market. Most important tasks of central bank are to implement monetary policy, to govern foreign exchange reserves and to oversee payment balances [21]. Today financial system is consisted of domestic oriented policies, and each country central bank first takes care of price stability,

allowing currency value to flow. Majority of countries allow free flow of currencies, although some countries still impose restrictions. Monetary systems of different countries correspond indirectly through responses to each other's policies. It is often the case that central banks set up their policies while watching the policies introduced by the ECB or FED. ECB is independent monetary institution which has a role of central bank for countries which are part of European Monetary Union.

The FED is central bank of United States of America. FED is conducting national monetary policy, supervising, and regulating banks and other important financial institutions to preserve stability of prices.

The following figure shows movement of ECB interest rate in previous decade.



Fig. 3. Benchmark rate in ECB

Source: [22]

Thirdly, we will talk about instruments. Financial instruments are defined as any contract that gives rise to a financial asset of one entity and a financial liability or equity instrument to another entity [23].

These instruments can be cash or derivative instruments. Financial instruments can act as a mean of payment [24]. Money market instruments which are the most liquid is traded in money market. In this group, it is important to mention commercial paper, treasury bills, Eurodollars, and federal funds. Next important set of instruments are capital market instruments. In contrast to money market instruments capital market instruments have maturities of more than one year, which includes corporate stocks, corporate bonds, mortgages, consumer and commercial loans and municipal bonds. Important group of instruments are international financial instruments [25]. Tremendous growth has occurred in international financial instruments in recent years. In following figure, we can see the graph of long-term interest rates movement in Germany.



Fig. 4. Long term government bond yields

Source: [22]

From the graph we can conclude that interest rates have significantly decreased since 1980. In 1980 interest rates were high as 11.4% in USA, and 8.5% in Germany. In long run we can see also that in 2015 they were around 1.9% and 0.3% respectively. Future of current environment might go to extent where interest rates could be in negative zone. Also, it is very important to note that different countries have different maturities.

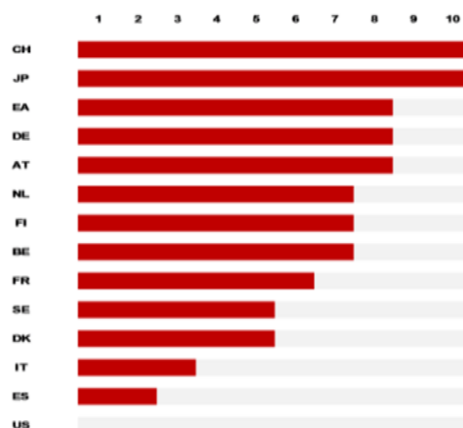


Fig. 5. Government bonds with negative yields

Source: [22]

Fourthly, we will talk about capital flow. Capital flow to emerging markets is known as volatile and pro-cycle [26]. Huge inflow of foreign capital cycle has been often accompanied with their subsequent leave. For a developing-successful country one of the key requirements for development is low cost of money borrowing. Motive for foreign investors to invest in developing countries is bigger interest rate.

With higher risks higher interest comes, since developed countries are marked as safer for investment interest rates are lower. This results in situation that investors from rich countries invest in developing countries because of lower index of security which results in higher interest rates. It is important to note that investors' appetite for risk is declining after the last crisis. To attract investor's countries must integrate, for this some basic requirements must be fulfilled, like having functional financial system, being part of international institutions, banking sector etc. Reason for this is that investors need certain degree of security and ways of financial flows to transfer their resources. Development of electronic banking in recent years has made this process much easier. In Policy recommendation from 2015 global GDP based on purchasing-power-parity basis provides evidence of emerging market economies performance [27]. In 1980 more than 65% of world GDP was created in advanced economies, while emerging and developing economies had less than 35%. By 2014 that trend has reversed and emerging and developing economies took a little less than 60% of world GDP, while advanced economies share was a little more than 40%. According to same study this gap will increase in future years in favour of emerging and developing economies.

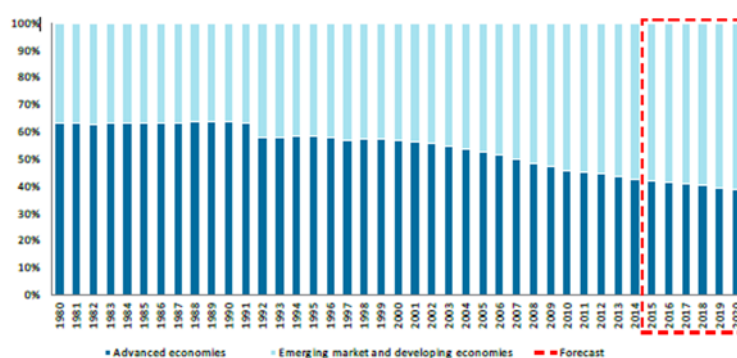


Fig. 6. Total GDP

Source: [27]

CONCLUSION

Capital flow can rise challenges for policy makers [27]. For developing economies this kind of capital inflow can lead to appreciation of real exchange rate. This was found as one of important causes of financial crisis [28]. Furthermore, capital flows can complicate macroeconomic management and undermine monetary policy independence even when exchange rates are flexible [29]. To summarize, large and

volatile capital flows can create a tension between macroeconomic stabilization and financial stability. Capital inflow can affect various financial variables including leverage, debt, risk-taking, real estate, credit spreads etc. This can lead to macro disturbances. As the graphs show the emerging markets were much more resilient to impact of crisis in early stage of the crisis. After 2008 capital inflow in emerging markets recovered quickly and reached near levels before crisis, but recent data shows that they are declining. Foreign direct investment remained below its long-term average for last three years. The decline in net capital inflow has been influenced by EME currencies trend of weakening [30]. In last two years, we have witnessed rising of dollar value, but since the beginning of the 2016 EME currencies have started to recover loses [31]. Based on this we can notice that developing countries and emerging markets will face challenges in terms of designing economic policies that will secure benefits of capital inflow and reduce the vulnerability to their withdrawal.

Finally, we can conclude that the economic crisis of 2008 showed a close link between the crisis and the decline in the level of economic globalization in the world. In addition to actual trade flows and foreign investment, it also covers the extent to which a country restricts capital and trade flows [32].

REFERENCES

- [1] Li, H., Refalo, J., Maisondieu-Laforgue, M. (2020). National corruption and international banking. *Global Finance Journal*. In press, available online 6 May 2020 on link <https://www.sciencedirect.com/science/article/abs/pii/S1044028319302121>
- [2] Khnana, P. (2005). *Advances study in money and banking*, Vol 1. Atlantic Publishers & distributors, New Delhi.
- [3] Zerbib, D. (2019). The effect of pro-environmental preferences on bond prices: Evidence from green bonds. *Journal of Banking & Finance*, Vol 98, pp. 39-60.
- [4] Kindleberger, D. (1997). *Economic Laws and Economic History*, Cambridge University Press.
- [5] Smith, A. (1776). *An Inquiry into the Nature and Causes of the Wealth of Nations*, W. Strahan and T. Cadell, London.
- [6] Semančikova, J. (2016). Trade, trade, openness macroeconomic performance. *Book of proceedings from 19th International Conference Enterprise and Competitive Environment*, pp. 407-416.
- [7] Butaru, F., Chen, B., Clark, B., Sanmay, D., Lo, A., Siddique, A. (2016). Risk and risk management in the credit card industry. *Journal of Banking & Finance*, pp. 218-239
- [8] Davis, D., Korenok, O., Lightle, J. (2019). Liquidity regulation, banking history and financial fragility: An experimental examination. *Journal of Economic Behavior & Organization*. In press, available online on site: <https://www.sciencedirect.com/science/article/abs/pii/S0167268119302793>, date of access 25th March 2020
- [9] IMF, the end of the Bretton Woods System (1972-81), Downloaded from <https://www.imf.org/external/about/histend.htm> on 7th March 2020
- [10] Katsenelinboigen, A. (1980). *Soviet Economic Thought and Political Power in the USSR*, 1st Edition, Pergamon.
- [11] IMF, Globalization and Crisis 2005-present, Downloaded from <https://www.imf.org/external/about/histglob.htm> on 1st March 2020.
- [12] McKinsey Global Institute. (2013). *Financial globalization: Retreat or reset?* Download from <https://www.mckinsey.com/featured-insights/employment-and-growth/financial-globalization> on 26th February 2020.
- [13] Ahmed, S., Bangassa, K., Akbar, S. (2020). A study on trust restoration efforts in the UK retail banking industry. *The British Accounting Review*, 52, (1), In press, available online on site
- [14] Vukovic, M., Martinov, D., Mazic, Z. (2020). Analysis of supply and demand for electronic banking services in the South Bačka region. *Economic themes* 58(1), pp. 131-148.
- [15] Abdullayeva, S. (2021). Some of the Factors Fostering Positive Thinking, *International Review*, No. 3-4/2021, pp. 131-149.
- [16] Erman, E., Johari C., K. Chronopoulos, D., Scholtens, B., Sobiech, A., O.S. Wilson, J. (2020). Deposit insurance and bank dividend policy. *Journal of Financial Stability*, Vol 48, In press,

- available online on link: <https://www.sciencedirect.com/science/article/pii/S1572308920300231>, date of access 27th May 2020
- [17] IMF, Cooperation and reconstruction, Downloaded from <https://www.imf.org/external/about/histcoop.htm> on 04th May 2020.
- [18] McDermott, C., Coad, L. Helfgott, A., Schroeder, H. (2012). Operationalizing social safeguards in REDD+: actors, interests, and ideas. *Environmental Science & Policy*, Vol. 21, pp. 63-72.
- [19] Fardoust, S., Kanbur, R., Luo, X., Sundberg, M. (2018). An evaluation of the feedback loops in the poverty focuses of world bank operations. *Evaluation and Program Planning*, Vol. 67, pp. 10-18.
- [20] Vukosavljevic, D. (2012). *Bankarsko poslovanje*, Visoka škola za poslovnu ekonomiju i preduzetništvo, Beograd.
- [21] Kosutic, A., Hadzic, M. (2019). Investments of the EBRD in the infrastructure sector of Serbia. *International Review* No. 1-2, pp. 39-63.
- [22] ECB. (2015). Trading economics, Available on site: <https://tradingeconomics.com/euro-area/interest-rate>, data of access 26th April 2020.
- [23] Deloitte. (2020). IAS 32, Available on site: <https://www.iasplus.com/en/publications/e-learning/ias-32-presentation>, data of access 16th April 2020
- [24] Vesic, T., Jevtic, D. (2019). Uloga i značaj interne revizije u javnom sektoru. *Trendovi u poslovanju*, Sveska 2, Br. 14, pp. 102-109.
- [25] Muhović, A., Subić, J. (2019). Analysis And Impact of Main Macro and Microeconomic Factors on The Growth of Npl-S In the Emerging Financial Markets. *Economica* Vol. 65, No. 4, pp. 21-30.
- [26] Bonizzi, B. (2017). International financialisation, developing countries and the contradictions of privatised Keynesianism. *Economic and Political Studies*, Vol. 5, pp. 21-40.
- [27] World Economic Forum. (2015). *The Global Financial System: Policy Recommendations for the Future*.
- [28] Gourinchas, P., Obstfeld, M. (2012). Stories of the Twentieth Century for the Twenty-First. *American Economic Journal: Macroeconomics*, 4(1), pp. 226-265.
- [29] Rey, H. (2013). Dilemma not Trilemma: The Global Financial Cycle and Monetary Policy Independence, paper presented at the Jackson Hole Symposium, August 2013. Available at <http://www.kansascityfed.org/publications/research/escp/escp-2013.cfm> Revised version forthcoming as a CEPR Discussion Paper.
- [30] Aničić, J., Aničić, D., Kvrđić, G. (2019). Sustainable Growth and Regional Competitiveness of Serbian Economy. *Economica*, Vol. 65, No. 2, pp. 65-69.
- [31] Đekić, M., Nikolić, M., Milićević, R. (2019). Causes, Manifestations and Representation of the Shadow Economy with Reference to Serbia. *Economica* 65(3), pp. 103-114.
- [32] Radović Marković, M., Đukanović, B., Marković, D., Dragojević A. (2021). *Entrepreneurship and Work in the Gig Economy – The Case of the Western Balkans*, Routledge, London, United Kingdom.

Article history:

Received 18 January 2022

Accepted 30 May 2022