# MACROECONOMIC EFFECTS OF CAPITAL FLOWS : KAZAKHSTAN CASE

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## 1. CAPITAL FLOWS

In the economic literature, there are a variety of definitions on the capital flows. According to Calvo(1994), the capital flows are the increase in net international indebtedness of the private and the public sector during a given period of time and are measured by the surplus in the capital account of the balance of payments. Some economists add the net omission and error item in the balance of payments to the capital account surplus in order to express capital flows (Yeldan (1997), and Uzunoğlu (1994)). And, they consider their inflows and outflows as hot money inflows and capital flight, respectively. Errors and omissions are not exactly identical to unrecorded capital flows. They also cover various measurement and recording errors, registration delays and unreported imports that are not related to capital flight, and hence, it may be misleading to think of all errors and omissions as capital flight or hot money.

## 2. LITERATURE SURVEY

Capital account liberalization plays a crucial role in inducing the capital flows, it is firstly essential to discuss economic and politic preconditions for maximizing gains of the capital flows and restricting their destructive effects before putting it in place.

### 2.1. Preconditions For Capital Account Liberalization

Mathieson and Rojaz-Saurez suggest that the policies before transition to capital account liberalization must include macroeconomic and financial policies that help reduce the differences between domestic and international financial market conditions as well as remove or reduce restrictions that inhibit the flexibility of wages and the prices of goods and assets. They state that one of the key macroeconomic preconditions for opening the capital account is a fiscal reform that significantly reduces the fiscal deficit and finances the remaining deficit in a non-inflationary manner.

**Wilberg and Dezseri offer a list of preconditions for the liberalization of inflows, outflows or both, by reviewing several literatures. It includes:**

**(i) A stable macroeconomic structure characterized by the absence of high and unstable inflation.**

**(ii) Liberalization of financial markets and well-functioning domestic financial institutions.**

**(iii) Current account liberalization**

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**(i) Fiscal discipline**
**(iii) A policy regime that investors regard as permanent.**
**(iv) The existence of arrangements to limit the erosion of the tax base.**

Among the preconditions argued by Quink and Evans are the followings:
(i) Internationally competitive interest rates
(ii) Prudential regulations and requirements
(iii) A strengthened capacity to adapt fiscal policy so as to keep resource pressures from arising when private demands mount
(iv) An initial adjustment of the exchange rate to a realistic level.

In the issue of sequencing reforms, a number of economists, notably McKinnon(1973) and Kruger (1984), favored the so-called classical sequencing approach. This strategy gives priority to foreign trade liberalization, followed by the liberalization of domestic markets, completing the sequence by removing the restrictions on the capital account of the balance of payments.

Cooper (1998) argues that capital mobility in the presence of significant distortions to trade will result in a misallocating of the world's capital and, indeed even a worsening of the economic well-being of the capital-importing country. The basic argument is that, if capital flows freely into labor rich country that protects its capital – intensive industries (a common occurrence especially with respect to steel and automobile production), the world's capital stock will be misallocated, the country's national product at world prices will be decreased. Economies of scale and taxes on the earnings of foreign capital mitigate but not eliminate the reduction of national income. Consequently, free movement of capital is likely to become allocationally efficient only after trade barriers have come down substantially, particularly barriers on capital – intensive activities in labor-rich countries.

Massad (1998) suggests a range of conditions to benefit from the capital account liberalization significantly. These preconditions can be summarised as follows: (i) local interest rates must not be much higher than international rates, so as to avoid massive capital inflows and exchange rate appreciation (ii) exchange rate flexibility is necessary if monetary policy is to remain autonomous (iii) if it is not possible or credible to limit deposit guarantees, the financial system should be adequately regulated and supervised (iv) a flexible fiscal policy is desirable to save more in periods of capital inflows and to cover periods of increased capital outflows (v) financial indicators of solvency and liquidity should be strong and fiscal accounts should be healthy (vi) sound macroeconomic position must be kept in good condition, in terms of a low inflation, and a sustainable current account deficit.

Guitian ((1997) discusses preconditions for the capital account liberalization. He notes these conditions as the followings: (i) a stock of foreign reserves to cushion possible capital reversals (ii) the establishment of macroeconomic stability at a realistic rate of exchange (iii) a sustainable fiscal position (iv) a liberal domestic financial system.

But, he also introduces opposite arguments that the capital account should be opened with no prior conditions. It can be argued that an open capital account will constrain domestic policies to the extent necessary to bring balance and stability to the economy. That is, market powers bring discipline policymakers' decision to follow consistent with international environment as a result of capital account liberalization. For example, open capital flows will

bring about a realistic exchange rate rather than require it ex ante and domestic financial liberalization can also be seen as an outcome of, rather than a prerequisite for, external financial opening. Clearly, in the extreme, neither of these two approaches will likely to apply to any actual country's economy. Neither should the opening of the capital account wait until all desirable conditions are in place; because such an event is unlikely to occur. Nor should it proceed in the absence of a minimum of favorable domestic economic conditions. Balance between these two extremes is necessary.

## 2.2. Effects of Capital Flows on Macroeconomic Variables

Standard open economic models predict that capital inflows lead to excessive expansion of aggregate demand- or macroeconomic overheating. This expansion is likely to be reflected in inflationary pressures, real exchange rate appreciation, and widening current account deficits.

These models assume an economy with two goods – traded and nontraded- and a representative consumer with perfect foresight who maximizes utility by choosing sequences of consumption of the two goods over time, under competitive prices and budget constraint. Accordingly, in these models a decline in world interest rates induces income and substitution effects in the capital – importing country by creating increases in consumption and investments, a decline in savings, and a deterioration of the current account.

This is realized with the following mechanism: The substitution effect encourages present consumption, which becomes cheaper than future consumption as declining interest rate make external borrowing less expensive. That is, the future consumption is substituted with the present consumption. Therefore, the current consumption spending increases and, in turn, current savings decrease. The income effect arises from the decreasing of present value of external debts due to declining interest rates relatively. In this process, if the sensitivity of investment expenditures to interest rates is high, current investment expenditures increase. Within this framework, saving-investment gap, which also means current account deficit, increases, and thus, the gap is filled with capital inflows.

However, the exchange rate regime and the amount of international reserve accumulation will largely determine the effects of capital inflows on inflation and the real exchange rate. Under a free float, a positive shock to the capital account generates no change in international reserves and monetary aggregates, but creates a nominal exchange rate appreciation that induces a current account deficit. Under fixed exchange rates, the intervention of the monetary authorities required to defend the parity will lead to reserve accumulation and increases in the money supply, lower domestic interest rates, and higher domestic asset prices. The result is an expansion of aggregate demand with a rise in domestic inflation once excess capacity is absorbed. Under these circumstances, the real exchange rate appreciates because of higher internal prices. In intermediate and most frequently adopted regimes, and under imperfect capital mobility, the authorities defend a predetermined nominal exchange rate, while pursuing a target for monetary aggregates. In this regard, the amount of reserve accumulation is a policy choices: The more aggressive the accumulation, the lower (higher) the pressures on the nominal exchange rate (inflation). The real exchange rate appreciates according to the extent what inflation rates overpass depreciation rate of nominal exchange rate.

An alternative definition of real exchange rate is expressed as the ratio of the prices of nontradable goods to those of tradable goods. Hence, increases in domestic investment and consumption expenditures with increasing monetary aggregates put upward pressure on the relative price of the nontraded goods since they are more limited supply than traded goods. Thus, these increases cause the exchange rate to appreciate. That appreciation, which makes tradables cheaper, will, in turn, create incentives to reallocate factors from the production of tradables toward the production of nontradables, and to switch consumer expenditure from nontradable to tradable goods. The final result is a real appreciation, a larger nontradable sector, a smaller tradable sector (import and export –competing sectors), and larger current account deficit. The real appreciation occurs either through an appreciation of the nominal exchange rate (under a floating exchange rate system) or through an increase in the nominal price of the nontradable goods in relative to tradable goods (in a fixed or preannounced exchange rate system).

In addition, real exchange rate appreciation is more likely when capital inflows finance consumption rather than investment. Also, the behaviour of public sector consumption may also be influencing the real exchange rate: the greater the contraction in fiscal expenditure at the time of capital inflows, the weaker the extent of real exchange rate appreciation.

If the flows take the form of FDI, it relieves pressure on the appreciation of the exchange rate and reduces reserve accumulation because these flows are usually not intermediated through the domestic banking system, which results in a comparatively smaller money and domestic credit expansion, and are used in financing investment goods, which are mostly imported.

Finally, real appreciation sometimes causes capital inflows as opposite to popular view indicating that the appreciation of real exchange rate is caused by the capital inflows. In fact, capital flows are an endogenous response to perceived changes in relative rates of return between domestic and foreign assets, which, in turn, are affected by the overall policy stance. Thus, the pressure on the relative price of non-traded goods could be the result of combining expansionary fiscal policy with relatively tight monetary policy, since this combination tends to generate changes in interest rates differentials that encourage capital flows.

### 2.3. Other Effects

By opening the capital account, the central bank losses some of its autonomy in monetary policy, because it is less able to control domestic demand. An open capital market immediately confronts national authorities with a decision over controlling either interest rates or exchange rates. The limitations that open capital account place on monetary policy are summed up by the idea of the "inconsistent trinity" or the " open-economy dilemma". That is, a country cannot simultaneously maintain fixed exchange rates and open capital market while pursuing a monetary policy oriented toward domestic considerations. Governments may choose only two of the open capital account, fixed exchange rate and, full flexible monetary policy. If monetary policy is geared toward domestic considerations, either capital mobility or the exchange rate target must be forgone. If fixed exchange rates and integration into the global capital market are the primary goal, monetary policy must be subjugated to these ends. In a closed economy that applies capital controls, domestic markets, the especially short-term markets, are isolated from international markets. In this environment, authorities have essentially option to target interest rates and exchange rates simultaneously, and to control domestic demand effectively.

The choice between fixed and floating exchange rates should not be viewed as dichotomies. In reality, the degree of exchange rate flexibility lies on a continuum, with exchange rate target zones, crawling pegs, crawling zones, and managed floats of the various other kinds residing between the extremes of floating and irrevocably fixed. Indeed, the notion of a "free" float is an abstraction with little empirical content, as few governments are willing to set monetary policy without some consideration of its exchange rate effects. However, the greater the attention given to the exchange rate, the more constrained monetary policy in pursuing other objective.

The capital account liberalization holds significant potential benefits. First, free capital flows allow the international economy to attain the efficiency gains created by specialization in the production of financial services. As with trade in goods, countries will find it more efficient to import than to produce some financial services. Many wholesale a financial service, whose production entails economics of scales, scope, or risk pooling, may often be obtained most efficiently through importation.

Second, capital account convertibility can promote dynamic efficiency in the financial sector. Increased competition from abroad will force domestic producers to become more efficient and stimulate innovation and improve productivity.

Third, removing capital controls can also improve the global intermediation of resources from savers to investments if international financial markets price the risks and returns inherent in financial claims appropriately. Under such conditions, global savings can be allocated to the most productive investments. In addition, enterprises will be able to diversify their activities abroad more easily and adopt new technologies and managerial techniques, especially those involving the use of new financial products to manage risks and finance investments.

Fourth, the capital account liberalization allows residents to hold an internationally diversified portfolio of assets, which reduces the vulnerability of their income streams and wealth to domestic financial and real shocks. Furthermore, the removal of capital controls may facilitate an economy's access to international financial markets and reduce borrowing costs.

## 3. CAPITAL MOVEMENTS TO ALL DEVELOPING COUNTRIES AND KAZAKHSTAN

Foreign Direct Investment (FDI) inflows increased from $62.8 billion (3.6 percent of GDP) in 2004 to $116 billion (4.6 percent of GDP) in 2006, accounting for over one-third of the total to all developing countries, with most of the flows concentrated in Russia ($28 billion), Turkey ($19 billion), Poland ($12 billion), and Hungary ($9 billion). Major privatizations and mergers and acquisitions in several countries, notably Kazakhstan, Turkey, Hungary, and Ukraine, contributed to the strong gains in FDI inflows to the region.

Reflecting the improved trade balance, the current account deficit narrowed sharply to $200 million (around 1% of GDP) from $1.2 billion in 2001. Net FDI inflows were substantially less than the exceptionally high amount recorded in 2001, a capital account surplus continued to ensure an overall payments surplus. Gross international reserves (including assets held by

the The National Fund of the Republic of Kazakhstan) increased over the year by $1.3 billion to $5.1 billion at end-2002. The National Fund of the Republic of Kazakhstan's assets increased by about $700 million to $1.9 billion, while National Bank of Kazakhstan's official reserves rose by about $600 million to $3.1 billion, a level equal to 3.5 months of imports of goods and services. Total external debt is estimated at about $18 billion at end-2002 (about 74% of GDP); public sector debt accounted for only $2.9 billion of the total. The fact that official reserves exceed public sector external debt reflects one aspect of Kazakhstan's striking success in attracting FDI in its development effort.

## 4. CONCLUSION

The short-term capital movements, which heavily were comprised by bank credit and foreign exchange deposits. The short-term capital movements demonstrate usually some unstable characteristics: volatility, reversibility, high motion, and huge bulky. They do not contribute to the long-term growth of any economy. These facts support the view that the capital flows were not driven by long-term growth prospects, sound fundamentals, and stable macroeconomic environment; in contrast, they were largely triggered by speculative motives.

In Kazakhstan, the capital flows were heavily channeled through the banking sector and as the banking sector transferred a significant portion of its funds to public sector, there is an implicit case that the capital flows were attracted by some macroeconomic imbalances.

In Kazakhstan, a given the current state of the banking sector the theoretical arguments emphasized before suggest that the capital inflows might have increased the vulnerability and fragility of the sector as a result of increasing bad loans, nonperforming assets, foreign exchange rate risks, imperfect asset pricing, and mismanaged risks. In fact, the large existence of government securities in the banks' assets substantially mitigated and diminished these risks. But, this case is not sustainable in the long run.

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***Ана тілі дегеніміз- сол тілде жасаған, жасап келе жатқан халықтың баягысын да, бүгінгісін де, болашағын да танытатын, сол халықтың мәңгілігінің мәселесі.Ана тілін тек өгей ұлдары ғана менсінбейді, өгей ұлдары ғана аяққа таптайды.***

***Ғабит Мүсірепов***