The increased importance of finance is the main characteristic of the current capitalist system. At the international level, the increase in cross-border financial transactions signals what has been called 'financial globalisation' or 'international financialisation'. The rise of this system is associated with the emergence of money managers—professionals seeking the best possible return for their portfolios worldwide. From the 1990s on, this liquidity has started to reach those developing countries that have liberalised their capital accounts and has since then been flowing in marked cycles. Today's slumping stock markets and major exchange rate depreciation in several emerging markets may signal the end of one these cycles.

But what are the reasons for this cyclicity of capital flows to emerging markets? A seminal debate on this topic distinguishes between 'push' and 'pull' factors. While standard neoclassical theories would predict that higher returns due to lower capital stocks would 'pull' capital from richer to poorer countries, many scholars found that low returns in advanced countries were a primary cause of such movements, highlighting the importance of conditions external to emerging markets.

According to this framework, emerging countries' current outflows are due to a 'push factor', the (perspective of) changes in monetary policies in advanced economies; while different fundamentals lead to different scales of capital outflows.

However, such analyses do not take into consideration a main feature of emerging markets: the lower liquidity of their currencies in the international financial system (see Andrade and Prates, 2013). Currencies of advanced economies, chiefly the US dollar, serve internationally as a store of value, means of payment and unit of account. Emerging-market currencies do not, and are thus subject to wide fluctuations, following changes in global liquidity provision and the state of liquidity preference.

In the case of turmoil, exchange rate and asset depreciation might put at risk any gain from portfolio allocation in these countries, limiting such investments to periods of tranquility internationally, characterised by high liquidity provision or by low liquidity preference. In such a situation, portfolios will include riskier assets, such as emerging countries' assets.

Conversely, when the preference for higher liquidity increases, due to an increase in uncertainty, or when the availability of liquidity decreases, portfolios will be limited to the most liquid assets—such as those denominated in the most liquid currencies.

Liquidity is thus a main driver of financial flows to emerging countries, and the marked cyclicity of liquidity and, as a consequence, of flows to these countries increases their importance in determining exchange rate patterns—as investment takes place in blocks, at certain times only.

Another important aspect that increases this cyclicity is the influence of exchange rate gains in determining financial flows themselves: an exchange rate appreciation in a period of boom increases an investment's total return, and the expectation of higher returns increases inflows; in the bust phase, exchange rate depreciation leads to outflows as investors try to avoid losses. This captures perfectly emerging markets' current situation. Investors expect the end of a boom of liquidity with the change in monetary policies in the USA and outflows from emerging markets.

Fearing significant exchange rate depreciation, they quickly sell out these assets. As flows of funds, financial flows are related to capital stocks — in other words, outflows depend on the stock of liabilities accumulated in the boom phase. The impacts of changes in the international scenario are thus closely related to the developments of the boom phase; the potential exchange rate depreciation being intimately related to the prior appreciation.

The new configuration of capitalism, with the increased importance of finance, has important consequences for emerging countries. In this system, the role played by these countries is very specific: to provide high-return assets for portfolio allocation in periods of higher liquidity. To choose this type of integration in the international financial market, therefore, means to accept having the exchange rate, and asset prices, determined by international liquidity cycles. In light of recent events, such a choice would appear not be best suited to fostering sustainable economic development.

Reference: