Money Manager Capitalism, Capital Flows and Development in Emerging Market Economies: A Post Keynesian-Institutionalist Analysis

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I. Introduction

Conventional theory holds that capital flows from developed countries to developing countries generate significant benefits for the latter. These benefits primarily include a better access to capital and higher efficiency of capital allocation. However, this theory is challenged by reverse resource transfers from developing countries to developed countries, that is, emerging market economies (EMEs) as a whole have been net exporters of capital. In addition, volatile capital flows have been associated with increased severity and frequency of financial crises in EMEs. Financial fragility and instability caused by free capital flows significantly undermine the efficiency of capital allocation.

Despite the sobering reality, mainstream economists continue advocating financial liberalization, only adding a few conditions such as getting the sequencing right or building the necessary "thresholds" (Fischer 1998; Summers 2000; Mishkin 2006)[1]. A recent effort by mainstream economists to justify financial liberalization has been to explore the indirect benefits of capital flows. According to Kose et al (2006), the most significant benefit of free capital flows is not that the latter provide development financing but rather, capital flows contribute to favorable institutional changes in EMEs. These indirect effects, dubbed "collateral effects", include financial market development, institutional development, better (corporate) governance and macroeconomic discipline. These indirect effects in turn increase total factor productivity growth as well as reduce consumer volatility, and hence promote long term growth.

Although the attempt to consider the institutional impacts of capital flows is laudable, mainstream economists have failed to depart radically from the flawed efficiency market theory and the advocacy for capital liberalization. One major defect of their theory is that it ignores the evolving nature of the capitalist system in the advanced capitalist countries, where *private* capital is seeking for investment opportunities in EMEs. The establishment of money manager capitalism (MMC) in the advanced countries has affected the types and features of private capital flows, which in turn shape the influences they have on the recipient EMEs. In this paper, we will look into the major characteristics of private capital flows from the countries where MMC prevails. Next, we will focus on the impacts of private capital flows to EMEs on financial development and on macroeconomic "discipline". Finally, we will provide some concluding thoughts.

II. MMC and Global Institutional Investors

[1] The notable exceptions include Rodrik (1998), Baghwati (1998) and Stiglitz (2002) who have called for restraining capital flows.

Capitalism is an evolving and complex social system. Since the 1970s, the financialization process has been accelerating in western advanced capitalist countries. Money Manager Capitalism, which emerged since 1946, has developed into a full-fledged system (Minsky 1996)[2]. There are several defining features of the system; the ones that interest us the most include first, the rise of institutional investors and second, the added layer of financial intermediation by institutional investors. Institutional investors, or managed money, include pension funds, mutual funds, hedge funds, private equity, and insurance companies and so on[3]. In MMC, "the proximate owners of a vast proportion of financial instruments are mutual and pension funds" (ibid., 358).

Institutional investors have grown tremendously in OECD countries and exerted sweeping influences on the economies. Based on the OECD data (2008), assets under institutional management in 17 OECD countries have increased from $21.3 trillion (in constant 2000 dollar) to $40.3 trillion during 1995-2005, a whopping 89% increase; the asset to GDP ratio has increased from 110% to 126%. As of the end of 2008, $61.6 trillion of assets are under institutional management (see Figure 1)[4]. With the growing assets, institutional investors increasingly purse active investment strategies over time. Take the US pension funds as an example, more than 50 years ago, following the "prudent man" principle, pension fund managers invested most of the assets in fixed income instruments that are typically safe, such as government and corporate securities. Today, pension funds are much more willing to take risks and invest in corporate stocks, real estate and commodity futures. 79% of the institutional assets in UK in 2008 are under active management that seeks above-the-market returns. There are many factors that led to the heightened preference for risks by institutional investors. At the macro level, price instability in the 1970s rendered fixed income investment undesirable, and continuous financial innovations opened up many novel and seemingly lucrative investment venues. At the micro level, profit maximization motives and competitive pressures drive fund managers to take on greater risks for higher returns.

<Figure 1 here>

Aside from growing in size and riskier in behaviors, there is also increasing concentration in the money management industry. Based on a survey by "Pensions and Investments" conducted in the mid 1990s, among more than 2000 money managers (including banks, trust companies and investment advisors), the top 5 fund managers have a market share of 20% and the top 20 have a market share of 40% (Bloomestein 1998). This trend has continued, as of Q1 2009, the 5 largest global money managers accounted for 31% of the market share whereas the top 10 managers took up more than 66% of the market share (Pensions and Investments 2009). It is projected that advances in information technology, the increasing need to make large investments and the intensifying competition will lead to a small number of mega firms (assets of $100 billion or more) and specialist boutiques, thus eliminating mid-sized firms (Global Investment 1996). The

[2] For a Minskian analysis of the evolution of the capitalist systems, one is referred to Minsky (1990) and Whalen (2001).

[3] Here I use institutional investors and money managers loosely, although strictly speaking, institutional investors may manage their portfolio in house or employ professional money managers to do the work.

[4] The recent global financial crisis has cost institutional investors billions of dollars. For instance, the US's total institutional assets have reduced by 21.3% to reach $22.25 trillion at the end of 2008. The total share of institutional assets to total US financial assets has reached a historical low record of 15.8% since the 1980s (Conference Board 2009).

growth of institutional investors has generated far-reaching influences on the financial industry (Bloomestein and Funke 1998), the production sector (Brown 1998) and the households (BIS 1998) within OECD countries. But their impacts extend beyond their origin countries.

Since the late 1970s, institutional investors have replaced banks to dominate cross-border portfolio flows. International investments by institutional investors accelerated since the 1980s and especially the 1990s, during which 50% of capital flows to EMEs were portfolio flows by institutional investors (the rest including mainly direct investment or official flows) (Davis and Steil 2001, 301). As shown in Table 1, portfolio inflows to EMEs were quite volatile in the late 1990s and the early 2000s; but since 2003, portfolio inflows grew rapidly, from the trough of -$14 billion to $442 billion as of 2007. The share of portfolio inflows in the total private inflows also increased to 28% and 23% in 2006 and 2007, respectively, almost reaching the same level of significance as FDI (Figure 2). Much of the portfolio investment was undertaken by institutional investors. The main causes of the rising international investments by institutional investors are four folds: first, since the 1980s debt crisis in Latin American EMEs, macroeconomic conditions in EMEs were greatly stabilized and improved, which boosted the confidence of international investors. Second, capital liberalization in EMEs, coupled with technological invocations in telecommunications, provided the possibility of large scale cross-border investments. Third, declining returns in OECD mature markets drove institutional investors to look into EMEs, seeking for higher returns by taking more risks. And finally, as managed assets keep growing, it is increasingly difficult to diversify within the mature markets. It is thus important for institutional investors to invest internationally.

<Table 1 here>

<Figure 2 here>

International investments by institutional investors have a significant bearing on the EMEs, even though these investments may account for still only a small proportion of funds managed by institutional investors[5]. There is scant comprehensive data on foreign institutional ownership in EMEs, but based on a reasonable estimate (Frenkel and Menkhoff 2004), the share of assets managed by foreign institutional investors in EMEs was about 26 per cent of the total assets, as shown in Figure 3. This suggests that institutional investors have established significant presence in the EMEs.

<Figure 3 here>

III. Institutional Investors, Portfolio Flows and Financial Development in EMEs

Addressing institutional changes in EMEs, mainstream economists argue that the large entry of foreign institutional investors produces significant benefits to financial development: first, pension funds and insurance companies typically pull together large amounts of long-term funds and hence facilitate large-scale and long-term undertakings in EMEs; second, because of their large size, it is much more cost-effective for institutional investors than individual investors to

[5] The limited scope of international diversification and investments is due to two main factors: first, some institutional investors are subject to quantitative limits on foreign investments (in most OECD countries with regard to pension funds except the US and UK where the "prudent man" rule applies). Second, there is evidence that home bias greatly limits foreign investment by institutional investors (Reisen and Fischer 2000).

gather and process information when making investment decisions. With the superior professional knowledge and techniques, institutional investors enhance the efficiency of capital allocation. Third and finally, through institutional investors' investment diversification and active trading, risks are reduced and liquidity amplified, which helps to stabilize financial markets in EMEs.

Unfortunately, these claims fail to meet both theoretical and empirical tests. Institutional investors have been found to play an important role in creating the 1992 EMU crisis, the 1994 Mexican peso crisis, the 1998 Asian Financial Crisis (Harmes 2001) and the current global financial crisis (Lo 2008). Some important features and behaviors of institutional investors render them a source of instability and inefficiency in the financial markets.

Short-termism in Institutional Investment

It is often claimed that investment by pension funds and life insurance companies is based on a long-term horizon. This is because they have a long-term liability structure and low risks of premature withdrawal of funds, which allow them to follow a buy-and-hold strategy rather than a trading strategy (Davis 2000). However, it is important to note that institutional investors are in general short-term oriented, especially mutual and hedge funds, to which pension funds increasingly delegate asset management. For example, in the United States, 30% of mutual funds are held by other financial institutions, notably pension funds (Davis and Steil 2001, 17). In the United Kingdom, pension funds significantly increased their allocation to hedge funds in 2004 (Pazarbasioglu, Goswami and Ree 2007). Therefore, even if the assets managed by pension and insurance funds are long-term, the management of these assets may be based on a short-term horizon.

There has been a growing literature documenting the short-termism of institutional investors. Some authors emphasize the incentive structures and competitive pressures faced by the fund managers. Fund managers are usually evaluated based on short-term performance, typically quarterly or even shorter. As Menkhoff 2(002, 913) points out, "[E]ven if customers receive detailed reports only on a quarterly or half-yearly basis, responsible fund managers and their superiors are informed about the running performance on a daily basis". Bad performance relative to other managers or the benchmark would mean redemption or the threat of redemption. Therefore, competitive pressures force fund managers to focus on the short run. Moreover, remunerations of mutual and hedge fund managers are usually based on the amounts of assets managed. Boosting short-term performance and attracting inflows of funds would mean more handsome returns. Although many authors attribute the short-termism to the principal-agent problem, that is, the owners of the funds are long-term oriented but the managers are short-term leaning; it is an overstatement that owners of funds do not care about short-term performance. This is because owners' costs of investment are reduced if superb short-term performances of funds attract new inflows and hence enlarges the size of the funds. After all, it is these owners of funds who evaluate relative performances of fund managers and pose redemption threats that lead to short-termism of the fund managers.

In addition to perverse incentive structures, the high leverage (that is, investing with borrowed funds worth a multiple of own funds) of mutual and pension funds also forces the fund managers to focus on the short-term performance (Harmes 1998). Even if fund managers believe that their investments are sound in the long run, they are obliged to sell positions if short-term bad

performance devaluates assets that are bought with borrowed money and triggers margin calls (that is, lenders call in credits when the price of collateral falls below a specified level). Furthermore, institutional investors must pay their creditors (usually banks) 'per period' fees when they borrow money or securities to enter a position. The costs of leverage can become prohibitive if assets are carried over the long term. Therefore, "the structure of transaction costs […] induces a strong bias toward short horizons" (Shleifer and Summers, 1990: 21, quoted in Harmes 1998, 104).

Institutional Investors and Information Quality in EMEs

Short-termism not only undermines the often claimed benefits of "patient" investment by institutional investors but also reduces the incentives of institutional investors to collect, process and utilize private information regarding the long-term performances of investment projects. As reported by Menkhoff (2002), a survey of 45 fund managers indicates that the "endurance horizon" (how long a position is held) is short as compared to the anticipation horizon (how far in the future news regarding economic "fundamentals" is considered). This suggests that even if institutional investors have private information that would allow them to reap high returns over the long run, they have trouble utilizing the information if the markets behave differently in the short run. As Menkhoff puts it (2002, 914), "[I]nvestments have to justify their investment decisions so frequently that they run into problems trying to follow any private information if the markets do not share their view at a given time".

In addition to the short-termism, there are at least two other factors that undermine the efficiency in using information by institutional investors, despite the often alleged benefits of their economies of scale in information processing. One factor has to do with the peculiar feature of information in EMEs. As Frenkel and Menkhoff (2004) rightly argue, information in EMEs is often non-anonymous and based on personal experience. This is different from the publicly available, reliable information institutional investors are accustomed to. Because of the significance of local knowledge, local investors have an advantage over foreign institutional investors in compiling and analyzing information, even though the latter have better technologies in processing information. As a result, the entry of foreign institutional investors would in fact lower the overall quality of information in EMEs.

Another factor concerns the fact that institutional investors often take emerging markets as one separate asset class. Investors would first determine the share of the portfolio to allocate to EMEs as a whole then allocate it to individual countries within the asset group. Fund managers are usually general experts in emerging markets who are usually uninformed about individual countries or seek to differentiate them. The reason to use general experts is due to the difficulties in evaluating and comparing the performance of the narrowly defined specialists (Davis and Steil 2001). Therefore, it is dubious that foreign institutional investors have informational advantages or they help to improve information quality in the EMEs.

Institutional Investors and Market Volatility

It is often argued that institutional investors undertake sound risk managements (through hedging, diversifying and insuring) and hence help to spread and reduce risks in the financial markets. But it is important to note that on the one hand, many institutional investors tend to take on excessive risks and on the other hand, ironically, risk management techniques that reduce risks for

institutional investors may in fact increase systemic risks. Excessive risk taking may be contained for some institutional investors such as defined-benefit pension funds, where minimum funding or solvency requirements are imposed. However, competitive pressures and tactical asset allocation techniques encourage institutional investors to take on more risks. Because fund owners tend to favor the best-performing funds with new inflows while funds do not flow out from under-performing funds as much (the so-called "uphill" bias) (Brown et al 1996), there are incentives for mutual fund managers to take more risks when their investment performance is poor (Bogle 1998; Menkhoff 2001).

More importantly, the ways by which institutional investors manage their risks involve heavy uses of derivatives. Derivatives developed in the 1980s were mainly to meet the needs of international banking (instruments such as swaps, forward rate agreements, interest rate options and short-term interest rate futures); but increasingly, derivatives are oriented toward the needs of institutional investors (instruments such as program trading and index options and futures). Institutional investors from advanced countries also tend to press foreign markets to adopt innovations they use at home, including the uses of derivatives (Davis and Steil 2001, 241)[6]. However, the use of derivatives may in fact intensify risk levels in the economy. This is so because of three related reasons: first, derivatives make separate markets much more tightly connected than otherwise would have been. When a mutual fund manager purchases a currency forward contract to hedge her investment in the foreign bond market, she helps to connect these two markets whereby disturbances in one market would be significantly transmitted to the other. Second, it is well documented that derivatives are often used to mask risks involved in an investment so as to evade regulations. As Chew (1996, 57; quoted in Kregel 1998, 679) puts it, "structured notes are the epitome of how investment technology helped and continues to help money managers circumvent guidelines that were framed to protect the interest of small, unsophisticated investors…" Third, the use of derivatives typically improves the capacity of investors to increase leverage because capital adequacy requirements do not reach off-balance sheet derivatives. That is, derivatives allow investors to commit little of their own capital but take large positions. As a result, return over equity is multiplied when investors gain, but losses can also be large enough to overwhelm the capacity of the investors to absorb with their own capital. All this means that systemic risks are elevated even if risk managements help to reduce idiosyncratic risks faced by individual institutional investors.

It is argued that trading by institutional investors provides liquidity to the fledging emerging markets and hence stabilizes and accelerates the development of financial markets. Although institutional investors do not offer liquid liabilities like banks do, they demand liquidity and help to generate it through their own arbitrage, trading and diversification. Moreover, it is argued that institutional investors possess the countervailing power and press for more transparent public disclosure systems, market-oriented accounting, reliable clearing and settlement facilities and deregulation, all of which encourages more efficient trading and reduces price volatility (Davis 2000). However, the large amount of trading by institutional investors is not always based on investors' private information or rational reallocation of portfolio; rather, frequent trading could be because most of funds are actively managed and simply cannot be held unchanged for a long time. In addition, institutional investors have an incentive to generate high turnover simply to

[6] For example, when carrying out tactical asset allocation, it is desirable for institutional investors to buy or sell index futures without any transactions in the underlying assets, which helps to avoid disturbances of long-term portfolio holdings.

show their superior management skills (Menkhoff 2001) and to earn exorbitant fees for managing the reallocation of portfolio. Therefore, trading by institutional investors may in fact worsen volatility. As Sias (1996) shows, there was a positive contemporaneous relation between institutional ownership and securities market volatility after controlling for capitalization.

Two other notable trading strategies adopted by institutional investors intensify market volatility. The first strategy is dubbed momentum trading. Presumably, if financial markets are efficient and asset prices should reflect the "fundamentals" (or the long-term capacity of the asset to generate income flows), then institutional investors who trade based on fundamentals rather than market whims should buy undervalued assets and sell overvalued assets, the so-called contrarian trading, whereby stabilizing asset prices. However, institutional investors are found to engage in momentum trading (Borensztein and Gelos 2003; Kaminsky, Lyons and Schmukler 2004), that is, they buy past winners and sell assets that performed poorly in the recent past. Momentum trading creates the potential for market overreaction and price overshooting because prices of assets may further deviate from its "fundamentals" because of the strong demand from institutional investors. Moreover, because of the sizeable trading, institutional investors may help to generate "reflexive" bubble (Soros 1987) or "displacement" (Minsky 1982), where the "fundamentals" are affected and reshaped by the trading itself. It is possible that momentum trading is justified by a rational analysis of the "fundamentals", but it is equally likely that it is a deliberate decision of ignoring "fundamentals". Knowing their influences, institutional investors may shape investors' expectations through their own trading. Therefore, instead of arbitraging against noise traders to move asset prices towards the "center of gravity", institutional investors can in fact manipulate noise traders to create a rising trend of asset prices and unexpectedly sell out their positions at the high point before the bubble collapses.

Another trading strategy – herding- refers to "a group of investors trading in the same direction over a period of time" (Nofsinger and Sias 1999, 2263 quoted in Menkhoff 2002, 922). A stable market is one where a large number of investors hold diverse expectations. Herding increases volatility because the market is heavily tilted towards either the buying or the selling side, causing large swings in asset prices. It is possible to perceive that institutional investors are less likely to engage in herding than individual investors due to their superior knowledge, it should be noted that the impacts of herding by institutional investors are much more destructive. This is because on the one hand, the large size of selling and buying by institutional investors may easily overwhelm the available liquidity in a market, which may lead to price discontinuities and cascading sales (or purchases), a phenomena known as "market crashes". On the other hand, institutional investors are often considered market-savvy and their investment strategies and behaviors are often the object of imitation. This means that there would be little counterbalancing actions by other market participants to dampen a one-way street trading. Some well-known examples of institutional trading causing market volatility include the 1987 stock market crash in the US, where institutional investors' portfolio insurance and index arbitrage were to be blamed. The 1997 Asian financial crisis was also partly attributable to the sudden stop of portfolio equity flows as institutional investors unwound their positions. The recent global financial crisis also witnessed the large unwinding of highly leveraged hedge funds, aggravating the liquidity crisis (more on this later).

Herding behavior is due partly to perverse incentives of fund managers. As pointed out above, because of the short-term performance evaluation, fund managers are obligated to focus on short-

term performance of the portfolio. Even if the long-term prospect of an asset is sound, fund managers may be under the selling pressure if it performs poorly in the short run. Likewise, even if fund managers believe that certain assets are overpriced, they are reluctant to take a short position and risk failing to generate short-term gains, like others do. Moreover, because performance evaluation is done on the relative basis, fund managers would follow other managers' decisions "in order to show clients that they know what they are doing. If they follow other fund managers' decisions and investment turns out to be unprofitable, they are more likely to be thought of as unlucky than as unskilled, since other fund managers will have made the same mistake". (World Bank 1997, 126; quoted in Harmes 2001, 405). This again reminds us of what Keynes said eloquently more than 70 years ago, "Worldly wisdom teaches that it is better for reputation to fail conventionally than to succeed unconventionally" (Keynes 1936, 158).

Furthermore, herding seems to be an inevitable outcome of institutional investors' trading strategies. Because of institutional mandates, such as minimum funding or solvency criterions imposed on pension funds, fund managers must adopt "stop-loss" strategies where selling occurs automatically when losses reach a certain threshold level. Such programmed trading strategies are designed to reduce individual risk but they indeed heightened systemic risk. In addition, the heavy uses of derivatives contribute to herding. As mentioned above, derivatives allow for large leveraged positions, which have to be liquidated when falling asset prices trigger margin calls. The 2007-2009 global financial crisis provided the best example of how the house of cards of financial derivatives can be violently destroyed. As Figure 4 shows, hedge funds have increased their leverage significantly over time and become increasingly fragile. The first half of 2007 witnessed the failure of multi-billion-dollar hedge funds that were deeply involved in mortgage-backed securities and credit-related strategies, which caused large selling in the long/short equity market-neutral funds. These are two completely unrelated parts of the hedge fund industry; the significant dislocation in the latter was not due to any changes in "fundamentals" but rather than because of desperate investors to reduce risk and obtain cash to meet margin calls (Lo 2008).

<Figure 4 here>

Finally, herding by institutional investors often leads to contagion across EMEs. Contagion occurs when the selling pressure in one market is transmitted to another market whose internal economic situations have not changed fundamentally. Contagion may happen if two countries are connected through trade or other economic activities. For example, currency depreciation in one country reduces the trade competitiveness of the other, thus generating external imbalances in the latter. However, in the case of financial turmoil, the transmission is usually through the loss of confidence or the need of liquidating. Institutional investors contribute to contagion not only because their leveraged positions often require them to liquid assets in unrelated markets but also because emerging markets are often grouped into one asset class and hence the selling pressure in one country may entail the overall reduction in this group of assets. This is because risk control systems employed by many institutional investors operate on the basis of international variance-covariance matrices, which automatically revise upward credit and market risks in correlated countries when one country experiences market volatility. This revision triggers automatic margin calls and tightens credit lines. Worse still, prudential regulations in many OECD countries require that institutional investors hold only investment grade securities. As a result, the downgrading of a country's credit rating leads to immediate sell-offs of the affected assets and cut off the new funding (Davis and Steil 2001). According to a study of

inflows and outflows of custodial funds over 1994-9 in 46 countries (Froot et al 1999), it is found that in- and out-flows of funds are highly correlated across international investors and occurred in response to global trends such as inflation and exchange rate expectations rather than changes in local conditions in the country concerned. Pointing to the Asian financial crisis, Davis and Steil (2001, 277) state, "the severe consequences of financial stability in the region showed again how, given the size of institutional portfolios, combined one-way shifts of this nature could lead to sharp adjustments or even dysfunction of the market price mechanism. Moreover, it was seen that in the late 1997, mutual fund investors also began to sell Latin American funds, thus generating contagion across emerging markets in a way that was less present in 1994".

All in all, despite the assertions that institutional investors provide long term financing and improve financial market liquidity, stability and efficiency, evidence abounds that due to their short-term investment horizon, the lack of incentives to extract information regarding long-term "fundamentals" and the tendencies to herd, institutional investors in fact tend to increase price volatility and market instability in the EMEs. Higher volatility raises the cost of capital and reduces investor confidence in face of greater uncertainty. Individual financial institutions may constantly face liquidity constraint and suffer financial losses; and non financial corporations and government may face higher borrowing costs. All this has a dire impact on long term growth prospect in the EMEs.

IV. Institutional Investors and the Loss of Policy Space in EMEs

Disciplining government is deemed anther desirable "collateral benefit" of free capital flows. It is true that free capital flows impose policy constraints; however, whether such constraints are beneficial is highly controversial. In the mainstream theory, there have been three generations of currency crisis models. Despite the differences in explaining the causes of crisis in EMEs; all three generations highlight the perverse role of the government. In the first generation model, government is directly responsible for the currency crisis because their monetization of fiscal deficit clashes with the pegged exchange rate. In the second generation, self-fulfilling speculative attacks on the pegging exchange rate are the direct culprit but governments create conditions vulnerable and conducive to attacks (for example, by setting up the pegged system and meanwhile accommodating inflation or depreciation expectations) (Obstfeld 1996). And finally, in the third generation of model where currency crises are accompanied by banking crises, governments are again to be blamed for (explicitly or implicitly) guaranteeing bank lending whereby encouraging excessive external borrowing. This leads to currency and maturity mismatches and sows the seed for future crisis. Therefore, tying up the hands of the government is the best solution to currency and banking crises.[7] By liberalizing capital flows, as the argument goes, government would have to discipline itself in order to avoid capital flight. The disciplining effect is verified by empirical studies, for example, Kim (2003) finds that capital account liberalization helps to reduce fiscal deficits. Similar findings are also presented by Garrett and Mitchell (2001). On the other hand, Tytell and Wei (2004) report that countries with higher levels of financial opening tend to have better monetary policy outcomes in terms of lower inflation.

[7] Note that there are some exceptions in the third generation of modeling. For example, Krugman (1998) puts great weight on the perverse effects of pro-cyclical capital flows and calls for government's actions to curtail capital flight.

By contrast, non-mainstream economists deem the loss of policy autonomy and the distorted policy mix as a "collateral damage" of free capital flows (Priewe 2008, 28). As Grabel (1996) argues, compromised policy autonomy due to financial liberalization is manifested at both ex-ante and ex-post levels. At the ex-ante level, governments in EMEs tend to adopt restrictive fiscal and monetary policies to attract portfolio inflows and to avoid portfolio reallocation. At the ex-post level, during and post financial crises, governments may have to increase interest rate drastically to stamp capital outflows and accept conditionalities imposed by multilateral institutions or foreign governments.

It is often argued that pegged exchange rate is the root of the "impossible trinity" problem, that is, with the pegged exchange rate and open capital account, it is impossible for monetary policy makers to autonomously set interest rates. Moreover, strong speculative attacks amid sudden stops of inflows make it very difficult for governments to defend the exchange rate target. These valid concerns notwithstanding, abandoning the peg for a flexible exchange rate system is still not a panacea (Ocampo and Vos 2008). On the one hand, it is desirable for EMEs to maintain a stable nominal exchange to provide a general price anchor and to reduce volatility in the terms of trade. On the other hand, flexible exchange rate does not stave off currency crisis; because currency can still be overvalued due to the surge in capital inflows and undershooting when capital flows out, which may still lead to massive depreciation of the currency and debt crisis[8]. Therefore, it is more of the pro-cyclical capital flows that produce pro-cyclical macroeconomic policies than of the inappropriate exchange rate system. When capital inflows surge, borrowing costs are reduced and expected returns are increased; both encourage higher borrowing by the private sector and the government. Debt level rises as a result. On the other hand, exchange rate appreciates, reducing the capacity to generate foreign exchanges to meet debt obligations. Once an internal or external shock triggers reversal of capital flows, the government finds itself with no option but to raise interest rate and cut spending, attempting to assuage position unwinding (although such efforts often end up in vain).

It is worth noting that the loss of policy autonomy in EMEs is aggravated by the rise in institutional investors and their international portfolio allocation. First, the rise of institutional investors centralizes investment decisions and strengthens the bargaining power of finance capital. Unlike what is often argued within the mainstream economics where financial markets represent the interests and decisions of "unconnected market players" (Sinclair 1994), financial markets are in fact controlled by a handful of money managers whose demands are neither democratic nor "rational". The concentration of finance capital and investment decisions means that collective outflows would be a great threat to EMEs during hard times; and hence, governments in EMEs would have to listen to and accommodate the demands from the institutional investors. These demands are typically in accordance with the Washington Consensus policy prescriptions (restrictive monetary and fiscal policies), which protect the interests of international investors at the expense of domestic economies. In addition, because institutional investors "facilitates the diffusion and use of similar economic models for

[8] Without the official pegging, international investors may have factored exchange risk into their lending decisions and hence prevent over-lending. However, during boom periods, international investors and home borrowers may both downplay the risks of lending and borrowing. As a result, balance sheet may still be overstretched and debt over accumulated, sowing the seeds for future debt crises. Furthermore, as some economists insist, it is rather inevitable to develop currency mismatches for countries that have difficulties of borrowing in their own currencies (Eichengree and Hausmann 1999).

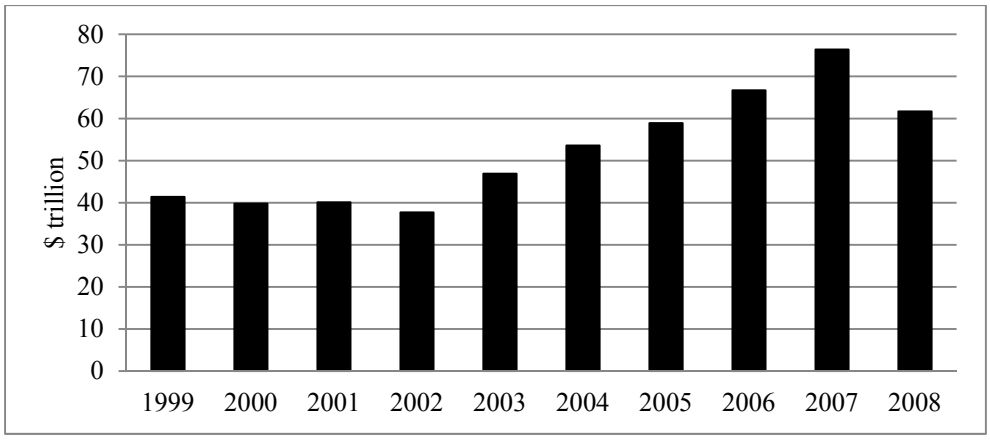
evaluating fundamentals" (Harmes 1998, 104), the demands for institutional investors are often supported by other investors and the actions of institutional investors are often closely followed by other investors. This makes the demands of institutional investors even more insurmountable.

Not only may institutional investors make macroeconomic policies more pro-cyclical, but they may further constrain governments' policy maneuver by pressing for more financial liberalization and deregulation to reduce the barriers to their global portfolio allocation. Robertson (2007) provides a fascinating account of how the US government, representing the interests of investment banks and private equity funds, pressured the governments of Korea and Thailand to further liberalize their financial markets. As he reports, "From negotiating sales of Korean firms to foreigners to advising the Korean government on banking privatization to acquiring and managing distressed assets, Morgan Stanley [and the like] participated in many of the central reform issues that faced Korea in the 1997-2002 period". In sum, "[E]conomic policy in the typical 'emerging market' [is held] hostage to the whims and fancies of two dozen or so thirty-something country analysts in London, Frankfurt, and New York. A finance minister whose top priority is to keep foreign investors happy will the one who pays less attention to developmental goals" (Rodrik 1998, 65). Increasing financial liberalization enables more portfolio flows by institutional investors, which reduces policy space and causes more instability, which in turn gives the opportunity for institutional investors to push for more liberalization. This vicious cycle continues, undermining the long term development of EMEs. Indeed, capital account liberalization has strong forecasting power for financial crises (Kaminsky and Schmukler 2001). It seems that to break the vicious cycle, restoring capital control and hence policy space is required.

V. Conclusion

The mainstream economists contend that free capital flows bring about collateral benefits to EMEs. On the one hand, portfolio flows, dominated by institutional investments, foster desirable institutional changes in the financial markets in these economies by enhancing long-term financing and by improving market liquidity and stability. On the other hand, institutional investors help to discipline governments and hence reduce the vulnerability of the economies. However, the so-called collateral benefits are neither theoretically plausible nor empirically verified. The rising presence and power of institutional investors in EMEs in fact reduce the efficiency of the financial system due to the short-termism of investment horizon, reduced efficiency in collecting and processing information, and increased market volatility through herding. Furthermore, the concentration of finance power and centralization of investment decisions enhance the bargaining power of the institutional investors vis-à-vis governments in EMEs and hence further reduce the policy space of the latter. Understanding the drawbacks of free portfolio flows does not mean that it is desirable or feasible to eradicate institutional investors or capital flows all together. However, in light of the perverse consequences, or the "collateral damages" of free capital flows, capital controls and more rigorous regulations on institutional investors are called for.

Figure 1: Global Fund Management of Conventional Assets (Pension, Mutual and Insurance Funds)



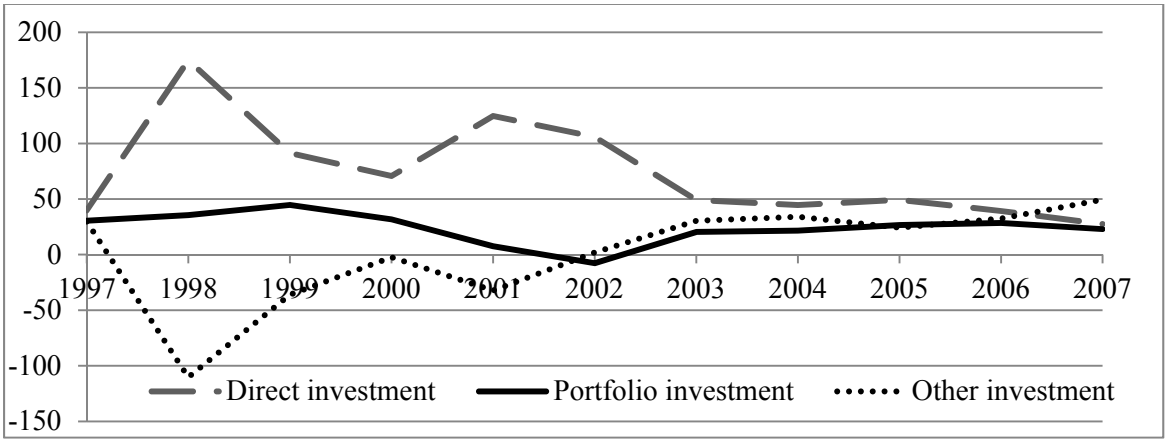
Source: International Financial Services (2009)

Table 1 Global Capital Inflows to Emerging Market Economies 1997-2007 (in billions of US dollar)

	1997	1998	1999	2000	2001	2002	2003	2004	2005	2006	2007
Direct investment	191.4	186.7	212	212	227.9	190.1	203.8	276.4	374.2	464	532.5
Portfolio investment	146.3	37.9	103.9	94.9	13.7	-13.9	84.8	133.3	201.3	336.6	441.8
Other investment	142.9	-117.9	-83.7	-7.3	-59	3.4	126.4	211.1	184.6	383.8	955.1
Reserve assets	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.

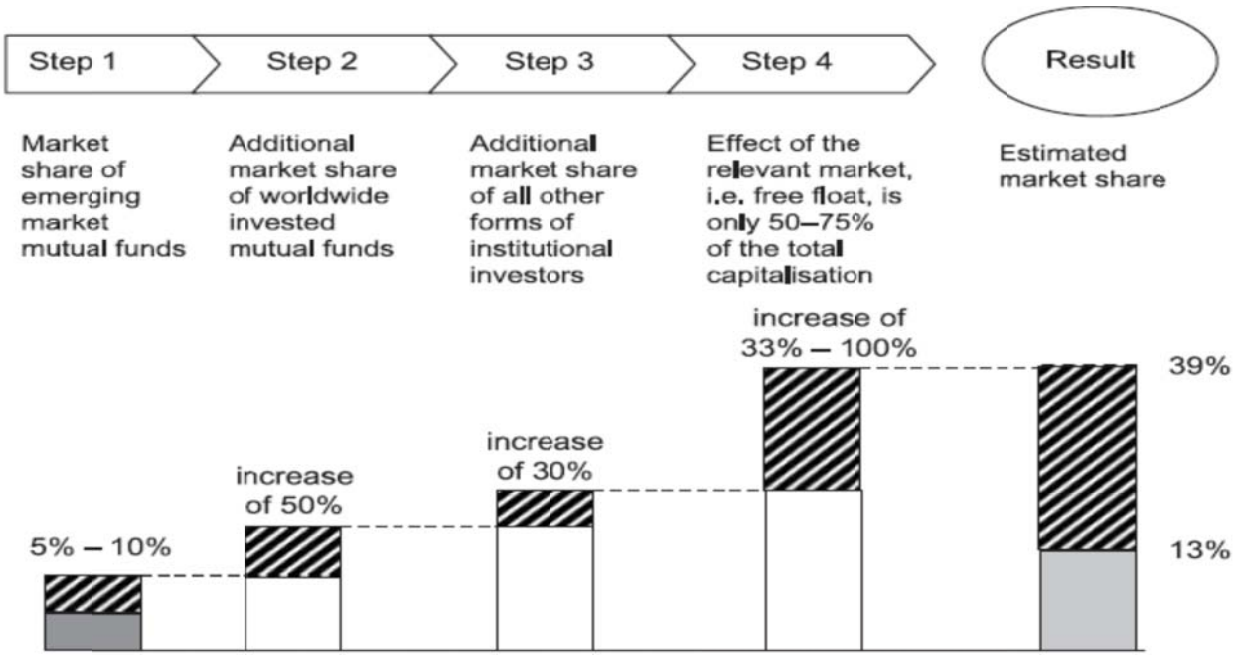
Source: IMF (2009).

Figure 2: Shares of Components of Capital Inflows to Emerging Market Economies 1997-2007



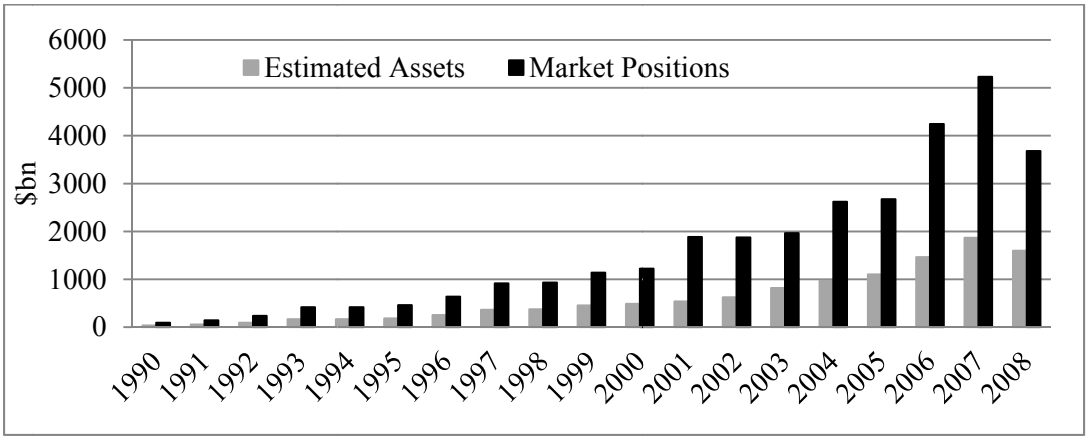
Source: IMF (2009)

Figure 3: Estimate of Market Share of Foreign Institutional Investors in Emerging Markets



Source: Frenkel and Menkhoff (2004, 1277, figure 2).

Figure 4: Growth of Assets and Leverage in the Hedge-Fund Industry, 1990 - 2008



Source: Lo (2008, 10, figure 3).

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