

## THREATS TO MACROECONOMIC STABILITY UNDER THE IMPACT OF INTERNATIONAL CAPITAL MOVEMENT

*Victoria IORDACHI<sup>1</sup>, PhD, Associate Professor,  
National Institute for Economic Research, Republic of Moldova  
Stela CIOBU<sup>2</sup>, PhD, Associate Professor,  
Academy of Economic Studies of Moldova  
Dorina CLICHICI<sup>3</sup>, PhD, Senior Researcher II,  
Institute for World Economy, Romania*

*One of the most interesting issues that provoke controversial disputes is the impact of financial flows on the evolution of the states as a whole and economic growth of developing economies. The process of capital movement between countries cannot be stopped and it must be managed efficiently in order to obtain economic benefits and minimize the risks related to macroeconomic stability.*

*The purpose of this study is to identify and analyze the effects of capital inflows on the macroeconomic stability of the Republic of Moldova. The research was based on the following methods: analysis and synthesis, induction and deduction, graphical and tabular methods, methods inherent in economic disciplines – observation, reasoning, comparison, classification, grouping; systemic methods and static analysis. As a result of the research, it is concluded that imprudently regulated capital inflows, in spite of their obvious advantages, could pose a serious threat to macroeconomic stability and external competitiveness, generating overheating of the economy, if their volume exceeds its ability to absorb them. However, the analysis depicts that remittances inflows have positively influenced so far, the economic development of the Republic of Moldova.*

**Keywords:** *financial flows, macroeconomic stability, monetary policy, remittances, capital volatility, shadow economy.*

*Una dintre cele mai interesante probleme, ce stârnește dispute controversate, constă în impactul fluxurilor financiare asupra evoluției statelor per ansamblu și creșterii economice a economiilor în dezvoltare. Procesul mișcării capitalului între țări nu poate fi oprit, iar acesta trebuie dirijat chibzuit în scopul obținerii beneficiilor economice și minimizării riscurilor asupra stabilității macroeconomice.*

*Scopul acestui studiu constă în analiza efectelor ce pot fi induse de fluxurile de capital asupra stabilității macroeconomice a Republicii Moldova. Cercetarea s-a bazat pe următoarele metode: analiza și sinteza, inducția și deducția, metodele grafice și tabelare, metodele inerente disciplinelor economice – observația, raționamentul, comparația, clasificarea, gruparea; metodele sistemice și ale analizei statice. În urma cercetării, s-a constatat că intrările de capital, reglementate nechibzuit, în pofida avantajelor evidente, pot reprezenta o amenințare serioasă pentru stabilitatea macroeconomică și competitivitatea externă, generând o supraîncălzire a economiei, în cazul în care volumul lor depășește capacitatea acesteia de a le absorbi. Cu toate acestea, analiza arată că intrările remiterilor au influențat pozitiv dezvoltarea economică de până acum a Republicii Moldova.*

**Cuvinte-cheie:** *fluxuri financiare, stabilitate macroeconomică, politică monetară, remiteri, volatilitatea capitalului, economie tenebră.*

*Одной из наиболее интересных проблем, вызывающих противоречивые споры, является влияние финансовых потоков на эволюцию государств в целом и экономический рост развивающихся стран. Движение капитала между странами не может быть остановлено и этот процесс должен эффективно управляться для получения экономических выгод и минимизации рисков макроэкономической стабильности.*

*Целью данного исследования является анализ негативного влияния потоков капитала на макроэкономическую устойчивость Республики Молдова. Исследование основано на следующих*

<sup>1</sup> © Victoria IORDACHI, timush\_v@yahoo.co.uk

<sup>2</sup> © Stela CIOBU, stela.ciobu@gmail.com

<sup>3</sup> © Dorina CLICHICI, dorina.clichici@iem.ro

методах: анализ и синтез, индукция и дедукция, графические и табличные методы, методы, присущие экономическим дисциплинам – наблюдение, рассуждение, сравнение, классификация, группировка; системные методы и статистический анализ. Результаты проведенного исследования подтверждают, что приток капитала, неосмотрительно регулируемый, несмотря на очевидные преимущества, может представлять серьезную угрозу для макроэкономической стабильности и внешней конкурентоспособности, порождая перегрев экономики, если их объем превышает ее способность поглощать их. Тем не менее, анализ показывает, что приток денежных переводов до сих пор положительно влияет на экономическое развитие Республики Молдова.

**Ключевые слова:** финансовые потоки, макроэкономическая стабильность, денежно-кредитная политика, денежные переводы, волатильность капитала, теневая экономика.

**JEL Classification:** E44, E60, F21, F32.

**UDC:** 330.101.541:336.74

### Introduction

Although foreign capital generates a wealth of benefits to recipient countries through its positive impact on the efficient use of investments, however, practice shows that the international financial market is subjected to instability, volatility in the movement of capital flows, as well as financial and currency crisis. In addition, the increase in financial flows to developing countries raises doubts about the ability of these states to use them rationally, especially in the case of large current account deficits.

Also, the financial crises that affected many countries such as Thailand, Indonesia, North Korea in the second half of 1997, Russia and Brazil during 1998-1999 attested the contagion phenomenon when the crisis, triggered in one country, is emanating to other countries within a union of economies, which usually are interdependent from financial or commercial point of view. At the same time, the benefits invoked in economic theories about the positive impact of capital inflows in a certain sector of the economy as a result of promoting financial liberalization do not necessarily increase the efficiency of the functioning of the financial market. Relevant in this respect are the events of 1982, namely the international debt crisis, the crisis of the European exchange rate mechanism from 1994-1995, the Asian financial crisis at the end of the 20th century, the consequences of which have strongly altered the economic potential of the Republic of Moldova, but also the international financial crisis of 2008-2009, propagated all over the world.

The actuality of the research theme is conditioned by the need for a scientific approach to the phenomenon of capital flow circulation across countries in order to capitalize the benefits of capital flows and reduce the risks to the national economy by their efficient management.

### Literature review and empirical evidence

Considering the fact that the phenomenon of financial globalization boosted in the XXth century, and the most devastating crisis occurred during the last decades, most of the theories that analyze the problems induced by capital circulation are relatively modern, inspired by monetarist schools. Thus, within the process of this paper elaboration, we were guided by the ideas promoted by economists from universities and research centres from the USA, EU, as well as theories promoted by the Nobel Prize winners in the field of international foreign-financial relations, experts from the international financial organizations, in particular the International Monetary Fund, which is the institution responsible for the insurance of stability in the functioning of the international financial system. Also of great value for our research were work papers elaborated by the most important centres of international excellence in economic and financial research, like the World Bank, UNCTAD, the Organization for Economic Co-operation and Development, the International Settlement Bank, etc.

Some studies find evidence that FDI are the least volatile among financial flows in general and, particularly, during episodes of sudden stops in crises in developing and emerging economies (Wei, 2001, Albuquerque, 2003, Levchenko and Mauro, 2007, Sula and Willett, 2009). But other studies show that FDI flows are as volatile as other flows, and may not always be stabilizing (Claessens, Dooley and Warner, 1995; Bird and Rajan, 2002; Fernandez-Arias and Hausmann, 2000).

FDI flows might pass through a particular country to reduce corporate tax liabilities or are used to obtain other funds holding physical assets as collateral. These aspects make these flows similar to portfolio debt flows that can fluctuate in the short term (Blanchard and Acalin 2016). Hence, countries have to be cautious about expanding their share of these flows without a deeper understanding of their interaction with other flows and the effects on stability (Lehmann, Sayek and Kang, 2004; Wu, 2009; Brukoff and Rother, 2007).

On the contrary, portfolio and banking flows are considered relatively destabilizing, but some country-specific examples find that these foreign investments have had a positive effect on stability when supported by appropriate macroeconomic policies (Pruski and Szpunar 2008).

Mixed evidence in the literature, often with differing country experiences, demonstrates that stability effects of a particular component of capital flow in one country may not be the same for another.

While analyzing various literature we observe differences in conceptual approach of financial flows in various regions. Thus, in the CIS countries, including the Republic of Moldova, the influence of financial flows on financial stability began to be studied at the beginning of the XXIst century, during the intensification of integrationist processes among countries. But most of the theories formulated by eastern economists, including the Moldovan researchers were directed towards the mechanism of attracting investment flows in national economy, in conditions of a poorly liberalized capital account.

***We greatly appreciate the contribution of local and foreign researchers, but it is important not to just estimate the quantity of capital inflows and outflows, but to determine the efficiency of capital movement for economic development and financial stability.***

#### **Methods and information**

The objective of this study is the analysis of the impact of capital inflows on national economy from the perspective of risks on financial stability. For this the major source of capital inflows in most of developing countries are analyzed – remittances, which is also actual for the Republic of Moldova. Capital inflows regulated inefficiently represent a huge problem for central banks within the process of the objectives' realization of monetary policy. At the same time, in Moldova, remittances inflows fuel the real and financial sectors' development and constitute the main source of population wealth.

The methodology of research was based on the following methods: analysis of remittances inflows in the Republic of Moldova, synthesis, induction and deduction, graphic and tabular methods, methods inherent in economic disciplines – observation, reasoning, comparison, classification, grouping; method of survey, systemic methods and static analysis. Data on financial flows in the national economy of the Republic of Moldova was taken from the database of the National Bank of Moldova, and the National Bureau of Statistics, while the statistics on international flows was taken from World Bank report papers and online database.

#### **Scientific results obtained**

The so much desired capital inflows may pose a serious threat to macroeconomic stability and external competitiveness, if they are inefficiently regulated, thus contributing to the economy's overheating, if their volume exceeds its ability to absorb. At the same time, suspicious financial flows from foreign jurisdictions will boost the development of illegal transactions in the country's economy, thus increasing corruption, crime and the development of the shadow economy.

Capital movement denotes huge difficulties, which have been emphasized over the last decades. In our opinion, two major forces contribute to endangering the stability of national economies and hence of the international financial system. *First of all*, as a result of the country's economic and financial interdependencies, economic shocks are rapidly transmitted from regional level to international level and vice-versa, the phenomenon being called „the contagion effect”.

*Secondly*, capital volatility threatens the financial system stability by generating the following<sup>1</sup>:

- 1) Short-term capital movement intensification;
- 2) Shadow economy development;
- 3) National economy vulnerability;
- 4) National economy overheating;
- 5) Speculative funds growth.

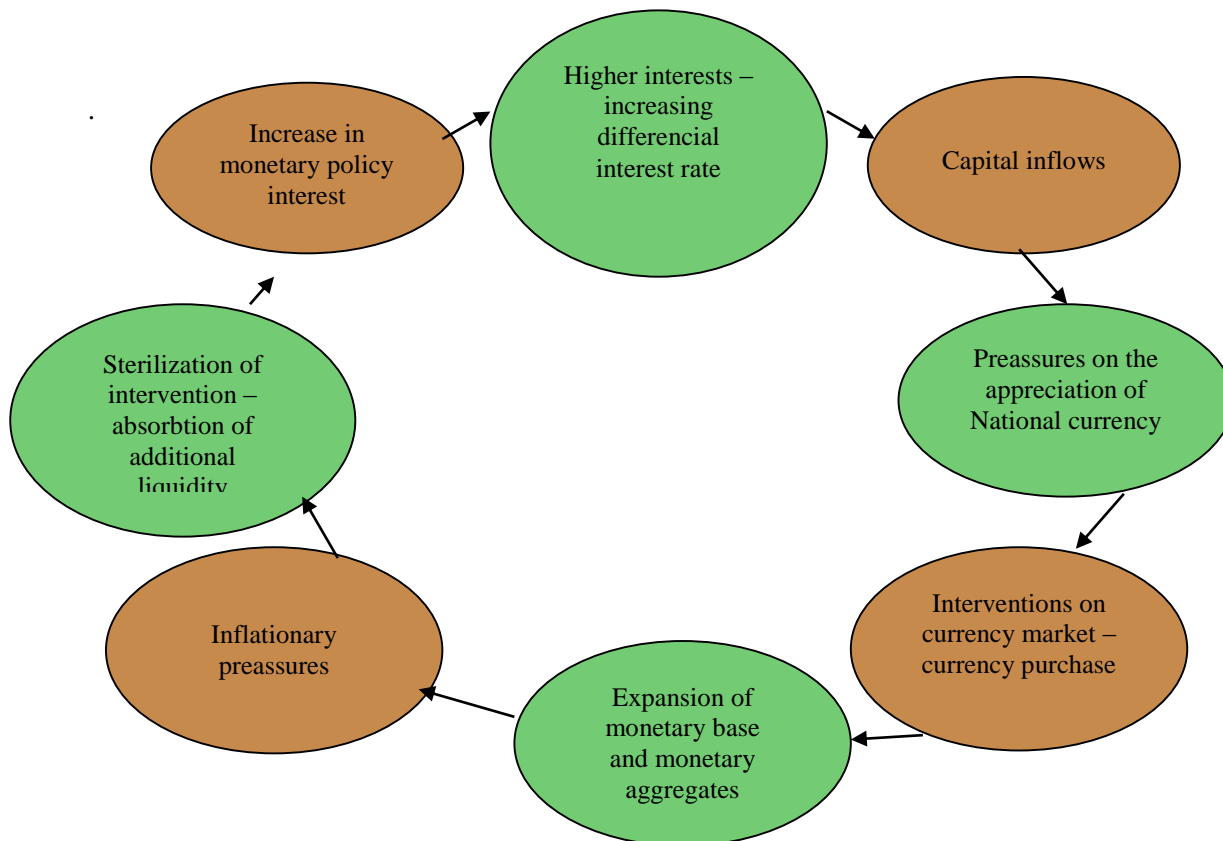
For the monetary authorities, capital inflows also represent a big dilemma. On the one hand, they stimulate the development of the economy, thus supporting real convergence. They also contribute to reducing short-term inflationary pressures by the effects on exchange rate appreciation and by orienting consumption to marketable goods. On the other hand, due to the effects on exchange rate appreciation,

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<sup>1</sup> *Timuș V., Timuș A. Reflecții asupra surselor de vulnerabilitate ai economiei mondiale sub incidența mișcării internaționale a capitalului. In: Revista Economică. 2008, nr. 1 (38), p. 49-53.*

capital inflows can erode the external competitiveness of the economy, amplifying external imbalances, which leads to depreciation of the currency and, ultimately, to higher inflation. Figure 1 presents a possible vicious circle of monetary policy generated by massive capital inflows.

*Monetary policy attempts to alleviate the pressures of the sudden appreciation of the national currency are doomed to failure because of the impossibility of a triangle of independent monetary policy, the free movement of capital, and a fixed exchange rate.*



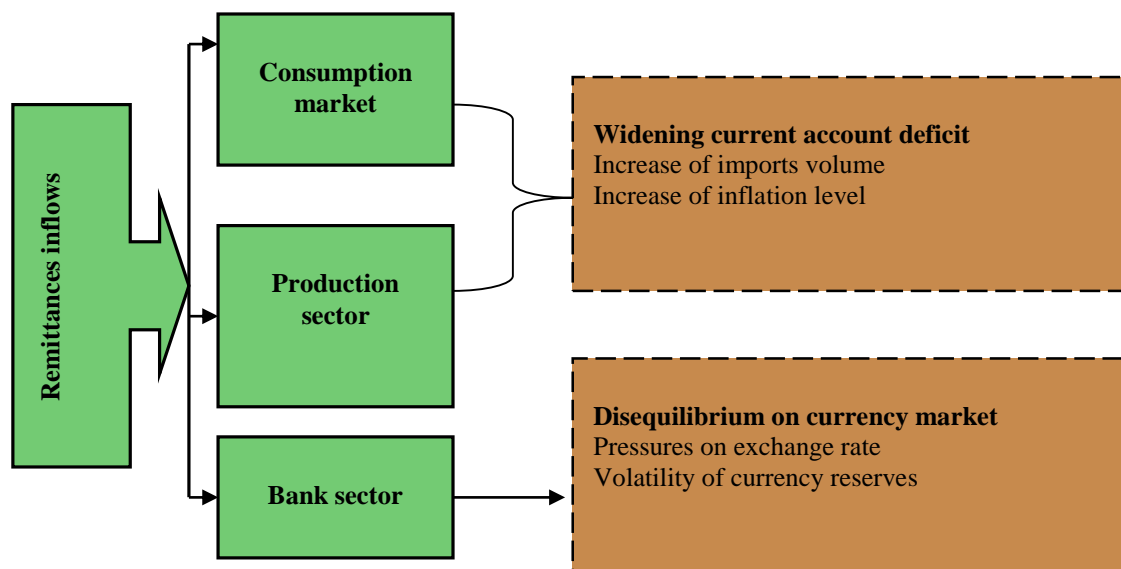
**Figure 1. Monetary policy vicious circle as a result of massive capital inflows**

Source: V. Timuș. *Integrarea Republicii Moldova în fluxurile financiare internaționale*, teza de doctor în economie, ASEM, Chișinău, 2010. CZU: 339.7272 (478) (043).

*Another problem attested on the financial international market is created as a result of the massive expansion of remittances flows and destabilizing effects they produce on recipient countries* (figure 2). The remittances flows get enormous proportions, especially in developing countries, which, according to statistics, exceed FDI flows, thus becoming the main source of financing for the needs of the country.

The banking sector, the consumer market and the real sector of the economy are strongly dependent on the remittances flows. In fact, the consumer market and the real sector are in close interdependence as a result of the produced effects. Money gained by residents working abroad serves primarily to increase consumption in the country, which in turn is fed by the production sector. Faced with excessive demand, domestic producers are exhausting their production capacity by resorting to imports, as production costs are very high.

Manufacturing companies also have to deal with price competition, which are more advantageous on imported goods. This creates a stagnation on the one hand of domestic companies and the prosperity of importing companies. On the other hand, the construction market enjoys prosperity as a result of increasing demand for the purchase of apartments by individuals, which, thanks to increased interest, contributes to higher prices. The rise in asset prices, supported by foreign exchange inflows, contributes to the increase of inflation in the economy, which brings the already mentioned by us challenges to monetary policy.



**Figure 2. Influence of remittances flows in the creation of the financial crisis**

Source: Elaborated by authors.

*Central banks also face the problem in dealing with remittance inflows within the objective of stability maintenance on the domestic foreign exchange market, due to high intervention costs they have to bear for the sterilization of foreign currency on the market and the maintenance of the exchange rate.*

A critical situation is created when the potential of the domestic foreign exchange market can not cover the excessive supply of foreign currency and the increase of exchange rate of the national currency contributes to the deepening of the current account, complicating the burden for the domestic exporters and producers.

Another destabilizing effect may arise when the volume of remittances is decreasing or these transfers are stopped. First, the price bubble will break on the credit market, causing damage to construction companies, investment funds, and the overall effects may be similar to those of the last US mortgage crisis. It should be noted that most developing countries, which are based on remittance inflows, do not have a well-developed capital market, so the effect of spreading the internal crisis at the international level is excluded. Some international risk funds may have to suffer as a result of significant investments in the construction sector.

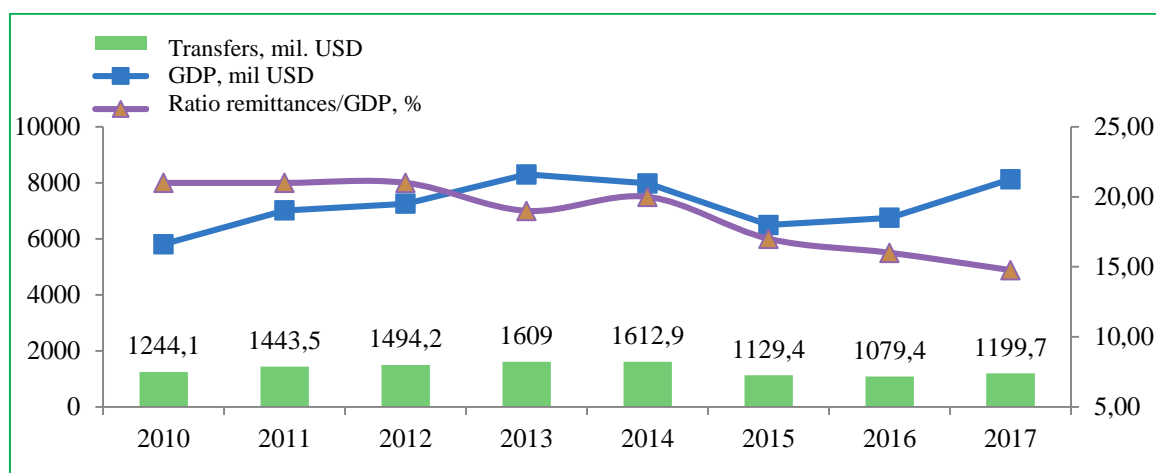
The banking sector is also exposed to risk as a result of the resuted crisis, as deposits opened by individuals are fuelled by residents working abroad and banks are involved in over-granting credits to sectors in which losses have occurred.

In Republic of Moldova, remittances flows represent an important source of currency inflows in national economy, which in 2017 registered 1199.97 million USD (figure 2). Compared to 2016, the volume of transfers from abroad increased by 11.2%, as a result of the appreciation of Euro and Ruble against the Dollar. Although it is the highest level registered during the last three years, the remittances volume in national economy remains about a third less compared to 2013-2014, before bank robbery and the 2015 crisis. Sure is the fact that remittances remain one of the main sources of income for Moldovan citizens and a key factor in the evolution of the economy, accounting for about 15% of GDP<sup>1</sup>.

At the same time, the total volume of remittances in 2017 formed a half of the total volume of inflows from exports, while the total volume of currency inflows generated by exports plus remittances covered only 75% of the total volume of currency outflows generated by imports. It is to mention that we didn't include in our calculations inflows generated by FDI, as during the last years their volume remains very slow (in 2017 the total volume of inflows generated by FDI registered only 324 million USD).

<sup>1</sup> *Tendințe în economia Moldovei, Nr. 28 (trim. IV) 2017, INCE, Chișinău, p.64, ISSN: 1857-3126*





**Figure 3. Evolution of remittances flows through the bank system in the Republic of Moldova**

Source: *Tendințe în economia Moldovei, Nr. 28 (trim. IV) 2017, INCE, Chișinău, p.64, ISSN: 1857-3126*

Estimating the evolution of the inflows in the economy of our country, as regarding the remittances, compared to the CIS countries, the Republic of Moldova in the context of capital circulation is a net receiver (inflows significantly exceed outflows), and population welfare is basically dependent on these financial means. Analyzing the statistical data presented by the World Bank, in 2017, according to the preliminary data the CIS countries ranked as follows:

1. Russian Federation – 7279 mil. USD
2. Uzbekistan – 2695 mil. USD
3. Kyrgyzstan – 2541 mil. USD
4. Tajikistan – 2031 mil. USD
5. Armenia – 1489 mil. USD
6. Azerbaijan – 1489 mil. USD
7. Belarus – 1216 mil. USD
8. Republic of Moldova – 1199 mil. USD
9. Kazakhstan – 297 mil. USD
10. Turkmenistan – 10 mil. USD<sup>1</sup>.

For the monetary authority, large inflows of remittances do not pose a serious problem, as the National Bank of Moldova successfully absorbs the freely convertible currency on the currency market and has the possibility to supply the official reserve currency. Thus, the volume of foreign currency purchases in the fourth quarter of 2017 amounted to about 110 million USD, while the volume of official reserve assets by the end of 2017 has increased since the beginning of this year by 597.4 million USD and continues to increase. The balance of official reserve assets at the end of the fourth quarter of 2017 totalled 2.8 billion USD, increasing by 27.1% in comparison to the same period of the previous year<sup>2</sup>.

Generally, remittances inflows positively influence the development of national economy in Moldova. We know that the largest contribution to the formation of the Gross Domestic Product is held by final consumption, which in 2017 constituted 98.3% of GDP, mostly generated by household consumption – 84.5% of total final consumption<sup>3</sup>. Household consumption has increased significantly since 2000, becoming the engine of economic recovery. Neither wages, which are continuing to increase more slowly than consumption, nor consumer credit, which, although rising, remained at a lower level than other countries in the region are unable to explain such a strong increase in consumption. ***In our view, the main source that contributes to consumption formation in national economy is the income of the population,***

<sup>1</sup> World Bank database, <http://www.worldbank.org/en/topic/migrationremittancesdiasporaissues/brief/migration-remittances-data>

<sup>2</sup> *Tendințe în economia Moldovei, Nr. 28 (trim. IV) 2017, INCE, Chișinău, p.34, ISSN: 1857-3126*

<sup>3</sup> National Bureau of Statistics, [www.statistica.md](http://www.statistica.md)

*which is strongly fuelled by aids received from relatives abroad, or remittances. This makes us consider remittances inflows as the main source of economic growth, correlating almost perfectly with consumption growth since 2000. Thus, further reduction of the remittances inflows in the national economy may pose a serious problem for the development of the real and financial sector, which are strongly dependent on them.*

#### Conclusions:

1) The peculiarity of international financial integration of the Republic of Moldova is limited to a precarious composition of capital flows, where the major share is held by the inflows generated by money transfers of residents working abroad (remittances) and foreign currency outflows for paying imports.

2) Republic of Moldova is a net receiver of remittances inflows in the context of international capital movement, while the welfare of population, the development of the financial and the real sector practically depend on the Moldovan residents working abroad. The national public authorities have not implemented adequate politics to motivate migrants invest in the real sector of the economy. Respectively, in the context of a weaker relationship between the high volume of remittances inflows and the growth of the real sector, the negative aspects of these resources could represent a serious problem for economic imbalances.

3) Capital movement across borders positively influenced the development of the national economy of the Republic of Moldova, but not through the investment component, but through the tertiary sector, the provision of services, which does not involve the increase of production activity in the country. Economic growth was achieved through the increase in total final consumption, fuelled by the remittances inflows, which partially substituted FDI sources.

4) For the National Bank of Moldova, remittances inflows do not represent a serious problem, as freely convertible currency on the currency market is successfully absorbed, representing the main source for supplying the official reserve currency.

5) Often within a country, statisticians and authorities that are responsible for promoting monetary-credit policies are only interested in estimating and monitoring the volume of capital inflows and outflows. The objective should be in determining the efficiency of capital movement for economic development and financial stability. National authorities should pay a greater attention to the process of financial integration, know the country's position on the global scale and monitor the process of capital fluctuation, since capital flows uncontrolled can cause imbalances not only within countries, but also launch crises with repercussions over the whole international financial system.

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