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PORTFOLIO INVESTMENT IN THE TWENTY FIRST CENTURY – A LITERATURE REVIEW AND ANALYSIS OF FLOW DIRECTIONS

INWESTYCJE PORTFELOWE W XXI WIEKU – PRZEGLĄD LITERATURY I ANALIZA KIERUNKÓW PRZEPLÝWU

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Abstract: The subject of portfolio investment seems particularly significant given that the current fluctuations on international financial markets make it necessary to perform an analysis of their causes and effects. It seems reasonable to make considerations regarding the direction of the flow of portfolio investment in the twentieth and twenty-first century. This article presents theoretical considerations concerning the characteristics and effects of the flow of portfolio investment in the global economy and an analysis of flow directions in the years 1960-2015. These considerations are based on data of the International Monetary Fund and the World Bank, which collate net inflows of the portfolio investment to particular countries in the indicated period. Our considerations show the links between the financial markets of countries and regions, together with the general tendencies of movements of capital at the time of crisis and the stabilization periods of global financial markets. The article shows the link between the financial markets of individual countries, together with the general trend of movement of capital in the period of crisis and the stabilization of financial markets.

Keywords: portfolio investment, capital flows, financial crisis.

Streszczenie: Zagadnienie inwestycji portfelowych staje się istotnym przedmiotem analizy w dobie współczesnych fluktuacji na międzynarodowych rynkach finansowych. Z tego powodu konieczne jest podtrzymywanie rozważań na temat ich przyczyn i wywołanych przez nie efektów. W tym zakresie zasadne wydaje się podjęcie rozważań dotyczących kierunków przepływu inwestycji portfelowych w XX i XXI wieku. W niniejszym artykule przedstawiono rozważania teoretyczne dotyczące specyfiki i skutków przepływu inwestycji portfelowych w gospodarce światowej oraz analizę kierunków przepływu w latach 1960-2015. Rozważania zostały oparte na danych Międzynarodowego Funduszu Walutowego i Banku Światowego, zestawiających wpływy netto z tytułu inwestycji portfelowych do poszczególnych krajów we wskazanym okresie. Rozważania ukazują powiązania pomiędzy rynkami finansowymi poszczególnych państw wraz z ogólnymi tendencjami ruchów kapitałów w okresach kryzysów i stabilizacji na rynkach finansowych.

Słowa kluczowe: inwestycje portfelowe, przepływy kapitału, kryzysy finansowe.

1. Introduction

The subject of portfolio investment seems particularly significant given that the current fluctuations on international financial markets make it necessary to perform an analysis of their causes and effects. Undoubtedly, one of the factors causing instability is the speculative capital flowing into national capital markets in the form of portfolio investments. It is also affected by endogenous and exogenous development factors which determine a market's ability to adopt standards from the better-developed economies.

Both the development and unfavourable fluctuations of capital markets largely result from the processes of globalisation and liberalisation of the financial sector which have led to a great influx of foreign capital (including portfolio capital) to the developing countries. In the face of a looming financial crisis, it seems particularly important to conduct analyses regarding the connections between local and international financial markets [Claessens 1993, p. 10].

The theses of these considerations are based on the statements that portfolio investments influence the structure, instruments and institutions of a capital market and that the direction of the flow of portfolio investments determines the location of new world's financial centres [Coordinated Portfolio Investment 2002, p. 49].

2. Portfolio investment – a theoretical framework

Different definitions of portfolio investments, which can be found in the literature differ in the emphasis that they put on various aspects of making and implementing financial flows. The majority of definitions of portfolio investments describe them as “investments of capital in foreign securities, mostly equities and bonds. Despite being, by and large, short-term investments, they can also be long-term in nature (e.g. purchase of several-year-long bonds issued by a foreign government)” [Budnikowski 2006, p. 108]. The difference between portfolio investments and direct foreign investments lies in the fact that the former are made in order to obtain a rate of return on the invested capital higher than the rate available in the home country and to diversify the portfolio in terms of risk minimisation – not to exercise effective control over a company [Foreman-Peck 1995, p. 138].

According to the definition of the World Bank, portfolio equity can be seen as “net inflows from equity securities other than those recorded as direct investment and including shares, stocks, depository receipts (American or global), and direct purchases of shares in local stock markets by foreign investors” [World Bank].

At the turn of the 19th and 20th century it was common to invest in foreign bonds. This tendency changed after World War II, moving in favour of equity purchases. Nowadays this is still the dominating form of portfolio investments. The funds mainly flow from countries with stable economies and financial surpluses (the United States) or from economies without strong internal capital markets. Owing

to technological advancement, the information on the market situation of given companies and their share prices has become available.

The motive behind making portfolio investments described in the literature on the subject is the desire to achieve the necessary investment risk level. This phenomenon is explained by the above mentioned modern portfolio theory. "A portfolio should be balanced in a way so that a decrease in the rate of return on a portion of equities is accompanied by an increase in the rate of return of the remaining equities" [Tietje 2011, p. 81; Budnikowski 2006, p. 109]. This ideal scenario can be achieved by searching for investment targets on foreign markets since the domestic securities market is fairly limited in terms of available options. Moreover, domestic companies are linked with their foreign environment in a similar way, which limits the investor's possibility to create a diverse investment portfolio.

"Portfolio investments are purchases of equities and other securities of foreign manufacturing and service companies in order to obtain income, which is then transferred to the home country in the form of interest and dividends" [OECD 1996, p. XXX; Weresa 2007, p. 336]. In this case the essence of such investment is not to gain control over a company or to establish a strong position on a foreign market (namely the main characteristics of direct investments), but to make a profitable capital investment. These types of investments are usually made by small-capital investors. Investments on foreign markets are associated with an inherent risk. Investors deciding to invest their funds overseas are not only interested in obtaining an appropriate level of profitability, but also an adequate level of capital liquidity which should be as high as possible. "Ultimately we are dealing with the following trilemma: rate of interest on capital – security of investment – capital liquidity, all on an international scale" [Weresa 2007, p. 337].

In the literature one can also find an approach emphasizing the differences between direct investments in the country and portfolio investment, which do not stem from the size of the invested funds, time horizon or motives for making cash flow for investors. An important factor distinguishing portfolio investments from the rest is the degree of legal protection for investors. It is assumed that the risk in this case lies with the investor (as opposed to FDI, where the risk of project failure is charged both to the investor and in some aspects also the host country) [Sornarajah 2010, p. 8].

The basic method of using foreign capital to achieve one's own purposes is issuing securities on a foreign market (where the securities are issued by non-residents) or an international market (the securities are issued in a different currency than the national currency of the respective country).

Even though it is important to develop the perspective of global investing, we also have to be aware of the necessity to understand and familiarise ourselves with new notions, financial instruments (e.g. Eurobonds – international bonds that are not denominated in the home currency of the country in which they are issued [Reilly,

Brown 2001, p. 129] or Euroequities) and institutions (e.g. bond and foreign equity markets) which are present on foreign and international markets.

3. Movement of capital on international financial markets

The reasons for the international movement of capital are sometimes identical to those which determine such flows within a given market (supply and demand of money). There are also reasons exclusive to international movements. Depending on the level of political stability or the possibility to obtain a higher rate of return, certain markets may seem more attractive than others. Those reasons also include speculative factors, differences in the interest rates on money and capital markets as well as improvement with regard to the structure of capital investments [Bożyk, Misala, Puławski 2002, p. 115].

As a consequence of globalisation, it has become easy to purchase equities of companies from any capital market in the world. There are various reasons for such an expansion of opportunities with regard to investing. First of all, the establishment and development of numerous foreign financial markets, e.g. in Japan, Great Britain and Germany, have made them available to investors from all over the world. The expansion of foreign market investments, aided by the development of telecommunications technologies, has made it possible for financial markets from all corners of the world to communicate with each other [VanDuzer, Simons, Mayeda 2013, p. 57]. Since greater possibilities of investing funds result in a wide choice with regard to the desired risk-return ratio, it may seem reasonable to determine the value of foreign securities when selecting investments or building one's portfolio. A higher return on foreign assets may be explained by higher economic growth rates in the countries from which they come from. Moreover, the low correlation between returns on assets is a major reason for diversification, i.e. creating a portfolio so as to either minimise the investment risk or maximise the returns (according to Markowitz's theory [Reilly, Brown 2011, p. 355]). Individual economies are connected with each other based on their geographic proximity, similar economic policy or strong trade relations. It can be demonstrated that the process of diversification which includes foreign securities enables the investor to better limit the risk with regard to portfolio investments. Nowadays, investors who ignore foreign markets simply limit their possibilities when it comes to the selection of investments. On the other hand, capital markets which are not attractive for foreign capital lose their chance for dynamic development.

"Flows of capital on a global scale become the driving force of economic development" [Żabińska (red.) 2002, p. 11]. The new role of financial markets involves the movement of resources concentrated in the United States, Europe and Japan to markets in need of financing, mostly those in Asia and Eastern Europe, where the demand surpasses the level of savings. Consequently, we are now witnessing the next stage of evolution of financial markets, in which "national financial markets are

subject to the process of unification into a single global market” [Brushko, Hashimoto 2014, p. 18; Żabińska (red.) 2002, p. 11]. After the end of financial crisis of 1997-98 which affected the markets in Asia, Russia and Latin America, the global economy is now in the phase of putting globalisation processes in order [Allen 2004, p. 232]. Although the first major changes in the structure of capital movements flowing to the developing countries took place as early as in the first half of the 1990s, this process was largely disrupted in 1997. However, it can be predicted that it will once again become noticeable and significant since “there is a rapid increase in the size of capital inflow into this group of countries in the form of portfolio investments focused on short-term profit, which is associated with the development of capital markets in these countries” [Budnikowski 2006, p. 445].

The statistical data presented in this article are based on the sixth edition of the International Monetary Fund’s Balance of Payments Manual. It gives a chance to recognize not only the size of flows, but above all their directions during breakdowns of global financial markets. The major novelty of the following considerations is the attempt to emphasize the link between the financial markets of individual countries, together with the general trend of movement of capital in a period of crisis and stabilization of the financial markets.

4. Historical appearance of global portfolio investment

The history of the world’s portfolio investment flows has changed rapidly since 1960 – as we can see in the chart below (see Chart 1). Since that time, especially starting from the last two decades of the twentieth century, the size of capital flows between financial markets has significantly enlarged, also the rate of change between the scale of the financial flows during the financial crisis and the stabilization of global economic growth has increased [Uzan 2003, p. 40].

The globalization of financial markets, appearing primarily by facilitating the flow of information about the issuers of securities and the abolition of the technical and legal barriers, make investments outside the home market of investors easier and cheaper, which has influenced the growing importance of portfolio investment for the development of markets and companies [Schenk 2011, p. 112].

Before the 1990s of the twentieth century, we can see small growth, especially compared with the investments through foreign direct investments (FDI) whose dynamic growth in the world economy can be observed especially in the period 1985-2000 [Goldstein, Razin 2005, p. 7]. In the case of portfolio investment, the biggest interest of investors and traders in this way of transferring surplus funds to domestic and foreign entities has fallen since 1995. Growth can be linked to deepening the phenomenon of globalization in the financial markets, which is manifested, among others, through the:

- development of links and relationships between the different markets in the economic, financial and legal meaning, like creating economic and trade unions;

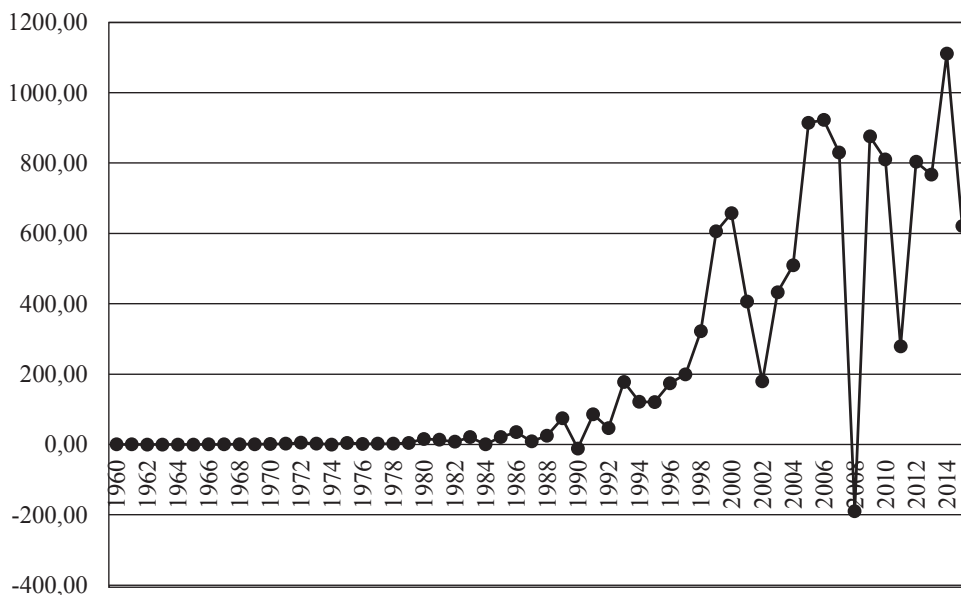


Chart 1. The historical appearance of portfolio investment 1960-2015 (in bln USD)

Source: own study based on [World Bank] data.

- diversification of direct and portfolio investment throughout the whole rld,
- increase of the degree of dependence and correlation between financial markets,
- the use of economies of scale, actioned by offering the same financial services on different markets,
- sharing large capital operators and government administrations on an international scale,
- finding partners for cooperation regardless of nationality,
- stimulating the flow of information at international level.

Achieving the level of strong informational efficiency of international financial markets through including in the prices of securities all available information about economic entities, can be considered as one of its most important growth factors of the portfolio investment at the beginning of the twenty-first century.

In an attempt to find characteristics of the investment portfolio over time, one cannot overlook the fact that with the enlargement of cash flows in the form of the global economy, their direction of flow has changed, in terms of both exporters and importers of capital.

Data aggregated by the International Monetary Fund since 1960 show a large variation in the direction of flow of portfolio investment over the various decades [International Monetary Fund]:

- In the 1960s, the main beneficiary of flows in the form of portfolio investments was Colombia and the exporter of capital in the form of portfolio investments was Canada, Israel and the Netherlands;
- In the 1970s, portfolio investment flows were mainly directed to: Saudi Arabia, Switzerland, Italy, Kuwait, Mexico, Libya, Uruguay, Zimbabwe and Spain. The group of the largest exporters of capital in the form of portfolio investments usually included: the United States, Canada, the United Kingdom, Norway, Germany, the Netherlands, Sweden, Israel, France, Finland and Denmark. We can see the process of the gradual expansion of the group of countries that have carried out investments abroad. Most of the countries with a negative balance of portfolio investment were highly developed countries with large capital resources available, in which the knowledge of making investments and access to information at the time was the largest in the world.
- In the 1980s, the biggest net inflows of portfolio investment were reported still in Switzerland, Saudi Arabia, Italy, Libya and Kuwait, but also in Germany (third position in the world's ranking of portfolio investment inflows). Exporters of capital in the form of portfolio investment were still the United States, Canada, France, Norway, Finland, the Netherlands and also Spain and Australia. After this period, higher changeability can be seen not only in the sizes of portfolio investment flows, but also in the directions of seeking the best opportunities for capital investment by investors. The OECD countries were at that time the biggest beneficiary of capital flows in this form, while many countries of this group have also become a source of cash flows to developing countries. This tendency of variability flows has remained longer in the world economy due to the process of the development of capital markets in various regions and increasingly better access to information about the countries and entities [Demirguc-Kunt, Huizinga 1992, p. 15].
- The directions of flow of portfolio investment in the 1990 has changed, for certain countries, so far as in the category of the main donors for the system of international finance. The main importers of capital in the form of portfolio investments during this period were: Switzerland, France, the Netherlands, Singapore, Sweden, Japan, the United Kingdom and Norway. Among exporters of capital there can be specified: the United States, Germany, Italy, Brazil, Australia, Canada, Mexico, Republic of Korea. The most important fact is that in this decade the interest of investors directing their funds to securities on other than their native stock markets began to grow rapidly.

Analyzing the dynamic changes that have occurred in the world economy since 2000, there has also been an increase of the dynamics of the changes taking place in the flows of portfolio investments in the period 2000-2015 (see Chart 1 and Tables 1 and 2). The growth process started in 1996, continued despite the decline in the stock markets of Southeast Asia during the crisis in 1997 (capital moved towards more stable economies), reached its peak in 2000, and the size of portfolio investments (net inflows) of the world reached 657.27 billion USD.

The decrease in the size of the investment portfolio in 2000-2002 was associated with an increase unrelated with the fundamental factors in the share prices of IT companies, which led to cracks in the “Internet bubble”. Venture capital companies, seeking interesting investment opportunities around the world, transmitted the capital to them through portfolio investment, but they were not always confident about the level of investment risk. These actions resulted in the collapse of primarily the US stock markets, followed by a domino effect reactions on other stock exchanges worldwide. The crisis has caused a loss of confidence in investments in securities, primarily equity, and the withdrawal of funds by investors from the capital markets. The biggest beneficiaries of portfolio investment inflows were Germany, the United Kingdom, Japan, Hong Kong, Canada and Switzerland.

The period 2003-2006 was a time of renewed increases in the global stock markets and greater interest in portfolio investments. The biggest importers of portfolio investment inflows were: Japan, France, Switzerland, Spain, Norway and the Netherlands. However, strong increases in prices of securities again brought no improvement in business operation and financial performance, but a speculative bubble and of large-scale lending to investors. US banks granted mortgages and other loans secured by mortgages to people with inadequate financial possibilities. These loans became collateral to the securities sold to investment and pension funds. After the collapse of the real estate market in the United States, all stock markets in the world recorded huge declines. Investors once again started to withdraw their funds in the form of portfolio investments, which achieved their lowest level in history in 2008. Capital flows in the form of portfolio investment were mainly directed to Japan, Germany and Norway. However, in 2009-2010 the volume of portfolio investments peaked again, almost equaling the sizes in 2004-2005.

In the period 2000-2008 and in 2010 the largest exporter of capital in the form of portfolio investment (country reporting the lowest negative net inflows of portfolio investment) was the United States. In 2011-2015 the United States was in the group of the five largest exporters of capital, just in 2009 in 9th place among importers of capital. This demonstrates the international flow of capital to the markets of most developed countries after a period of financial crisis and seeking stable investments, but also rebuilding the financial markets of the world.

The slowdown in the development of the strongest economies in the world, the growing debt of the United States and the euro zone’s fiscal problems became the cause of declines in the US stock markets and Europe in 2011. This translated well into the interest of portfolio investment, also into debt instruments. In 2010-2011, there was a noticeable decline in the volume of portfolio investments in the world, but already in 2012 we can see another increase the tendency to look for investment purposes beyond national markets. In 2011 the biggest beneficiaries of portfolio investment inflows were Spain, Norway and Greece, and in 2012 the United Kingdom, Greece and Singapore.

Table 1. Countries rankings with highest net inflow of portfolio investment from 2000 to 2007. Data in current bln U.S. dollars

Rank	2000	Net inflow*	2001	Net inflow	2002	Net inflow	2003	Net inflow	2004	Net inflow	2005	Net inflow	2006	Net inflow	2007	Net inflow
1	Germany	150.66	United Kingdom	68.99	Japan	105.97	Japan	95.11	France	66.18	Switzerland	47.63	France	134.15	France	168.50
2	Japan	35.98	Japan	46.29	Hong Kong SAR, China	38.80	Spain	46.22	Switzerland	39.55	Belgium	44.71	Norway	76.99	Netherlands	115.23
3	Canada	32.06	Hong Kong SAR, China	41.30	Switzerland	21.68	Switzerland	34.57	Hong Kong SAR, China	38.90	Germany	35.67	China	68.42	Canada	70.50
4	Italy	23.24	Switzerland	41.19	Norway	18.31	Hong Kong SAR, China	33.98	Netherlands	38.66	Canada	33.76	Switzerland	43.75	Singapore	47.45
5	Singapore	21.06	Norway	27.08	Netherlands	14.52	Singapore	19.97	Belgium	30.49	Hong Kong SAR, China	31.04	Canada	41.91	Belgium	43.02
6	Denmark	17.80	Singapore	22.68	Singapore	13.69	Saudi Arabia	18.74	Norway	28.68	France	18.39	Kuwait	29.13	Kuwait	34.90
7	Norway	15.30	China	19.41	Sweden	12.43	Denmark	15.92	Saudi Arabia	26.65	Malta	14.88	Hong Kong SAR, China	26.18	Switzerland	28.19
8	Switzerland	12.92	Spain	17.02	China	10.34	Kuwait	13.37	Sweden	25.14	Mexico	13.49	Korea, Rep.	23.39	Korea, Rep.	27.08
9	Kuwait	12.67	Sweden	15.12	France	7.90	Sweden	9.54	Singapore	17.80	Austria	13.48	Germany	22.37	Australia	23.45
10	Russian Federation	12.47	Argentina	9.50	Canada	5.43	Argentina	7.76	Denmark	14.71	Japan	13.27	Sweden	21.63	Norway	20.30
11	Netherlands	10.39	Kuwait	8.72	Brazil	5.12	Norway	6.16	Kuwait	13.88	Kuwait	13.13	Denmark	16.85	Chile	16.46
12	Saudi Arabia	9.38	South Africa	8.30	Argentina	4.64	Portugal	5.58	Finland	11.39	Denmark	11.96	Singapore	16.19	Malta	15.44
13	Sweden	4.93	Italy	6.84	Finland	4.44	Russian Federation	4.51	Argentina	9.42	Russian Federation	11.44	Saudi Arabia	11.95	Ireland	10.35
14	China	3.99	Finland	5.61	Bahrain	4.22	Chile	2.65	Brazil	4.75	Norway	8.01	Finland	11.43	Bahrain	8.56
15	Venezuela, RB	3.13	Turkey	4.52	Kuwait	3.23	Bahrain	2.41	Bahrain	3.50	Finland	7.50	Venezuela, RB	9.95	Denmark	7.47

* All changes due to credit and debit entries are recorded on a net basis separately for financial assets and liabilities. Financial account balances are calculated as the change in assets minus the change in liabilities; signs are reversed from previous editions [World Bank].

Source: own study based on [International Monetary Fund].

Table 2. Countries rankings with highest net inflow of portfolio investment from 2008 to 2015. Data in current bln U.S. dollars

Rank	2008	Net inflow	2009	Net inflow	2010	Net inflow	2011	Net inflow	2012	Net inflow	2013	Net inflow	2014	Net inflow	2015	Net inflow
1	Japan	282.69	Japan	210.59	Germany	154.11	Spain	44.06	United Kingdom	33670	Germany	212.80	Germany	180.57	Germany	220.34
2	Norway	112.41	Germany	119.24	Japan	144.77	Norway	42.14	Greece	128.31	Singapore	62.48	Netherlands	84.20	Hong Kong SAR, China	141.24
3	Ireland	62.49	Luxembourg	51.69	Italy	57.40	Greece	26.57	Singapore	78.21	Ireland	57.06	Singapore	53.36	Euro area	135.48
4	Hong Kong SAR, China	36.35	Hong Kong SAR, China	40.01	Hong Kong SAR, China	56.97	Belgium	23.14	Netherlands	74.36	Norway	51.83	Kuwait	41.70	Japan	132.70
5	Russian Federation	35.69	Singapore	27.15	Singapore	29.43	Qatar	19.03	Germany	66.85	Hong Kong SAR, China	49.79	Russian Federation	39.94	Italy	106.81
6	Switzerland	32.85	Switzerland	24.82	Belgium	27.36	Malta	16.09	Spain	54.37	Kuwait	21.23	Korea, Rep.	30.61	China	66.47
7	Kuwait	28.13	Saudi Arabia	20.14	Greece	26.87	Saudi Arabia	16.05	Norway	51.57	Qatar	18.31	Bahrain	29.61	Singapore	54.78
8	Sweden	27.44	Mexico	19.25	United Kingdom	23.45	Russian Federation	15.28	Portugal	38.47	Switzerland	17.52	Saudi Arabia	26.78	Switzerland	54.54
9	Malaysia	23.96	United States	18.53	Kuwait	20.52	Switzerland	14.60	Japan	32.21	Netherlands	13.33	Norway	25.10	Korea, Rep.	48.59
10	Cyprus	16.49	Cyprus	14.68	Saudi Arabia	15.15	Italy	14.21	Kuwait	23.92	Macao SAR, China	12.44	Sweden	23.99	Netherlands	46.44
11	India	15.07	Chile	12.40	Norway	14.62	Kazakhstan	12.87	Kazakhstan	17.39	Malta	12.01	Qatar	19.93	France	41.63
12	South Africa	14.30	Austria	11.03	Portugal	14.52	Singapore	12.86	Denmark	16.01	Russian Federation	11.01	Malta	17.96	Norway	37.56
13	Libya	10.96	Finland	9.82	Finland	13.55	United Kingdom	11.82	Malta	12.10	Korea, Rep.	9.34	Austria	16.80	Kuwait	32.67
14	Kazakhstan	9.38	Malta	8.93	Austria	9.94	Egypt, Arab Rep.	10.65	Israel	10.85	Greece	7.66	Denmark	12.28	Russian Federation	26.42
15	Argentina	8.03	Netherlands	8.39	Mauritius	9.82	Israel	8.82	Iraq	5.67	Israel	7.58	Thailand	12.06	Spain	1844

Source: own study based on [International Monetary Fund].

From that moment until 2014, when the portfolio investments reached a historical high, one can observe an upward trend in this regard. This was caused by the growing trend on most of the global stock markets, particularly in Asia and South America. The more stable stock markets in Europe and North America retained stable quotations, but already in 2015 there were signs of further troubles in the financial markets and the impending recession, resulting in a decrease in the size of the portfolio investment. In 2013-2015 the biggest importers of portfolio investments were still Germany, but also Singapore, Hong Kong and the rest of the Euro zone.

5. Portfolio investments and the investment horizon – the influence on the stability of the financial market

The fact that the classification of a capital market is based on the individual interpretation of certain parameters gives it an arbitrary character. The movement of money funds between economic entities may be seen as twofold. It is different from the perspective of an entity “supplying” the system (investor) and that of the “supplied” entity (debtor). Considering the first approach, we can classify funds into short- and long-term ones, which automatically makes it more difficult to assess the efficiency and timeliness of allocation. In other words, there are some discrepancies between the intended and the ultimately established periods of placement of funds at the debtor’s disposal. This problem disappears if we adopt the approach of a person provided with funds. The period in which the supplied entity has legal tenders at their disposal is important in the division of a market into long- and short-term capital investments. However, if they cannot be reclaimed by the supplying entity (e.g. share capital) or immediately redeemed by the issuer (e.g. financial bonds), this flow occurs within the long-term capital market.

The capabilities regarding the inflow of funds to a capital market depend on the amount of savings, national and foreign resources or propensity to make investments in a given market – in other words, its competitiveness. It is thus very important to gain the trust of market participants and ensure the safety of funds invested in it.

International financial markets expand the possibilities of capital acquisition and the scope of the participants in that market. The motives for foreign allocation or its acquisition on the international markets are varied, including: tendencies towards diversification of capital investments in terms of their risk, the search for cheaper and more accessible capital, the expansion of activity beyond the internal market [Knill 2005, p. 26].

Financial markets are used to make speculative transactions (so-called “hot money”) as well as long-term investments. In extreme cases, speculations may become a significant threat to the stability of the global economy. But also portfolio investment ”differs from other investment in that it provides a direct way to access financial markets, and thus it can provide liquidity and flexibility” [World Bank].

International capital movement is, on one hand, based on the flow of loan capital and, on the other, the flow of productive capital. Loan capital means internationally exchanged (either directly or indirectly – e.g. granting credits) cash contributions or various types of cash contributions (usually bonds), excluding equity purchases [Weresa (red.) 2007, p. 336]. Productive capital in international relations manifests itself in the form of portfolio investments or foreign direct investments.

Long-term capital movement in particular involves the extensive use of capital market instruments – equities and bonds. “Investments in securities may be classified as direct investments if the buyer gains effective control over a foreign company in which he/she allocated the funds or as indirect investments (portfolio investments) if the intention behind the purchase of equities, bonds or other securities is not to gain control over the issuer of securities, but merely to obtain overseas interest or dividends which are higher than those in the home country” [Bożyk, Misala, Puławski 2002, p. 116].

The author [Żabińska (red.) 2002, p. 13] very clearly demonstrates the adverse effects of the influx of short-term portfolio capital. “A decline in the country’s credit rating leads to a currency sell-off, which in turn contributes to the acceleration of its devaluation and the intensification of difficulties with debt repayment”. Even though the activity of market participants during that time, namely selling off financial assets denominated in the weakening currencies, is a substantially reasonable reaction, it results in a further escalation of the crisis. A temporary loss of liquidity prompts the speculative capital to close positions which are also denominated in other currencies. This is how financial crises spread to other markets. Financial innovations (e.g. the development of capital markets with regard to new investment opportunities) as well as the popularization of securities and derivatives also result in the increase in debt and lack of control over credit and investment risk.

Introducing control over short-term capital flows is regarded as the basic means to overcome financial crises. However, it has to be emphasized that developed economies should create conditions to maintain the tendency of the opening of economies and the process of the orderly liberalization of the financial markets. Representatives of the Asian world of finance claim that capital flow should not be liberalized without considering the economic situation in individual countries, basing their opinion on the experience from the financial crisis of 1997-98. Instead, they opt for the careful control of capital and gradual liberalization: the elimination of restrictions on direct foreign investments (long-term capital) and the control of short-term capital [Żabińska 2002, p. 17].

Owing to free capital flow, households, companies and countries are able to borrow capital abroad or allocate their surpluses overseas. “Free capital flows may then enable a more efficient allocation of savings so that the capital will be directed to the most effective enterprises, including overseas ones. Capital mobility may create opportunities for portfolio diversification, risk sharing or inter-period trade” [Grusz-

czyński 2002, p. 20]. Portfolio investments enable entities to diversify the risk associated with disturbances occurring only in their home countries [Razin 2003, p. 40].

Portfolio investments are also beneficial for the financial system of the supplied country, providing opportunities for its development. Along with foreign investments on the domestic market come foreign financial institutions offering new, increasingly advanced products or services which stimulate competition within that market. The freedom of flow and allocation of reserves, mobilization of savings, the opportunity to assess risk, the increase in financial liquidity – all these factors have a beneficial effect on economic growth. With new technologies and financial instruments the flow of information is becoming increasingly faster. Free capital flow enables the global economy to grow since it allows for specialization in the field of finance and the utilization of the economies of scale. The liberalization of financial flows should result in the improvement of financial discipline, an increase in transparency and the exclusion of inefficient and unofficial markets. It also contributes to lowering the costs of maintaining restrictions since it prompts governments to gradually abolish them. Long-term investments are welcome on financial markets while short-term investments and the influx of capital on securities markets and money markets are limited.

The author [Gruszczyński 2002, p. 27] claims that over the last two decades we have witnessed an increase in international capital flows, both between developed and developing countries. The provided reasons for this state of affairs are as follows:

- liberalization and deregulation of commercial and capital transactions as well as financial markets in those countries,
- political and economic reforms in the developing countries (new attractive opportunities for capital investment),
- privatization of previously state-owned companies,
- multilateralization of international trade which prompts entities to hedge currency and commercial risks.

Nowadays it is claimed that “capital and financial markets are becoming the most open systems of today’s global economy” [Tarczyński, Zwolankowski 1999, p. 11] and their interrelations cause them to almost function as a single entity. However, the configuration of global financial system is changing with the rise of new centers such as those in the BRIC countries (Brazil, Russia, India, China) or the markets of emerging countries – namely countries which have opened to international exchange but struggle with high unemployment, inflation, low savings rate and lack of own capital. That is exactly why they need foreign capital, both in the form of direct investments and the influx of portfolio capital, as well as actions aimed at creating attractive conditions for investors from all over the world.

Owing to the influx of portfolio investments, the market can develop qualities which will make it an increasingly attractive target for making investments, drawing the investors’ attention. The properties which may distinguish certain capital markets from the other ones include: depth (continuity of buy and sell operations), width (a large number of placed orders), flexibility (quick price reaction to changes in supply and demand), efficiency, transparency and reliability.

Analyzing data on the size of the investment portfolio in the history of economic development, we can see the following strong trends:

- the increase of the size of the movement of capital in the form of exports on international financial markets, but also withdrawn in times of crisis,
- the increase of the amplitude of fluctuations between the maximum and minimum values of flows in the form of portfolio investments,
- the decline of the value of the portfolio investment inflows at the time of rebuilding financial markets after crises,
- the reduction of the time between reaching the local maximum and minimum flows of portfolio investment,
- the search for new investment opportunities, even during the financial crisis or just after its completion, in order to exploit opportunistically investment and reconstruction of the securities portfolio,
- the increase the number of countries participating in international capital flows in the form of portfolio investment.

These observations point to the increasingly strong links between financial markets and show the variability of portfolio investments as one of the factors transmitting financial crises in the world. During the time of financial crises capital flows are directed to strong economies like Germany or Japan, and during periods of growth of capital market portfolio investment flow to new opportunities, sometimes short-living, but profitable. This general trend can be a prediction for the next fluctuations on the global financial markets.

6. Conclusions

The growing link between the economies of the countries and their regions, poses an opportunity and also a threat in the form of the transfer of negative phenomena in the economy related to the tightening web cooperation and the global system of flows (especially capital, which is easy to transfer). In particular, it may be disturbing that the transmission of exogenous shocks caused significant fluctuations in the economies participating in the global network system.

Increasing the degree of the relationship between the economies of countries, for example the increasing openness of their economies and economic integration especially made for capital flows and commodity markets and the availability of new forms of communication and equity transactions are the causes of the growing portfolio investment in the global economy in the twentieth century.

Negative effects, like financial crises, have caused the declines of portfolio investment, but also a factor encouraging to search for alternative places to invest capital in order to achieve an optimal level of profit. To create conditions to attract investment portfolio becomes therefore a factor in the development of capital markets in developing countries, which constitute an interesting alternative to global capital flows [Goldstein 1991, p. 41].

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