

The Impact of Foreign Capital Inflows on Financial Stability in Emerging Markets

Siyu Chen

*International Development, King's College London, London, UK
K24059434@kcl.ac.uk*

Abstract. Most emerging market economies are facing the problem of domestic capital shortage. The introduction of foreign capital has become an important way to promote economic growth. However, capital flows are a "double-edged sword": on the one hand, it can enhance market liquidity and promote financial development; on the other hand, it can lead to excessive credit expansion and sudden cessation of credit, thereby triggering major crises and economic instability. This article explains the positive role of foreign capital and the negative risks it poses from the perspective of global financial cycles and the "trilemma". It also analyzes through three mechanisms how foreign capital makes an important contribution to the stability of the financial market. By comparing Turkey and India, it is found that due to external shocks and insufficient domestic policy responses, Turkey suffered from severe inflation and a currency crisis, and experienced a significant depreciation of the exchange rate; while India had sufficient foreign exchange reserves, proactive monetary policy regulation, and effective measures for capital flow management. In conclusion, capital inflows are not the key factor determining economic stability. It is necessary to strengthen domestic risk management capabilities and institutional construction, and reduce the risks brought by fluctuations.

Keywords: Capital flows, sudden stop, global financial cycle

1. Introduction

Emerging markets often face the problem of domestic capital shortage, making the attraction of foreign capital crucial for bridging the gap between investment and savings. With the continuous deepening of global finance, these capital inflows have become increasingly important for economic development. However, capital flows are a "double-edged sword": while they provide liquidity, they also bring volatility, which may threaten the resilience of the economy. This study discusses the dual effects of foreign capital and argues that its impact is transmitted through three key mechanisms: the credit channel, the exchange rate channel, and the risk of sudden stops. The study employs a comparative analysis of Turkey and India. It indicates that the impact of capital flows largely depends on the quality of domestic risk management in the face of the inherent risks of global financial integration.

2. Literature review

2.1. Positive effects

For some countries, the inflow of foreign capital is regarded as beneficial. Firstly, in terms of increasing the supply of funds, it makes it easier for enterprises to obtain financing. Alimov shows that debt inflows would boost consumption, investment, and GDP growth in the short term [1]. Therefore, it can be seen that an increase in foreign capital inflow will expand the scale of funds in the economy. Thus, both enterprises and the government will have the necessary funds for investment and consumption. In other words, the additional funds available support investments and consumption for both governments and enterprises to promote the flow of money in the economy. Second, foreign investment will be introduced to increase the funds available in the market. Rey believes that the influx of funds is associated with a higher rise in bank loans [2]. Therefore, there is an increase in the liquidity of the banking system due to an increase in foreign capital inflow. After an increase in foreign capital, banks have raised more funds for loans and are lending out these funds at a faster pace; thus, the velocity of money in the market has risen. Foreign capital has thus increased the scale of the market. Thirdly, in terms of the development of finance, foreign capital has promoted the construction of financial institutions and expanded the scale of the stock market and banking system. Akpilic highlights the importance of institutional quality in attracting foreign direct investment (FDI) [3]. This indicates that foreign capital not only brings in funds but also fosters a more stable financial environment. This is of great significance in financial development, as it makes the management of local industries, banks and the stock market more effective .

2.2. Negative effects

Foreign capital inflows carry inherent risks. Firstly, from the perspective of credit expansion, Calvo shows that during a capital inflow episode, there is a sharp and sustained increase in capital inflows [4]. This shows that a large amount of foreign capital has flooded in, leading to a surge in bank liquidity. As a result, enterprises and the government have begun to borrow heavily, leading to the phenomenon of excessive borrowing. Secondly, the emergence of crisis risks enables foreign capital to withdraw instantly, causing a sudden stop in capital flows and triggering a financial crisis. Calvo notes the mechanism by which a sudden stop in international credit flows might trigger financial and balance of payments crises [4]. This suggests that the sudden withdrawal of foreign capital inflow on the opposite side was the direct cause of the financial crisis. At the same time, he also shows that even without questioning the country's solvency, pessimistic speculation might turn into a self-fulfilling prophecy. In other words, the withdrawal of foreign capital is unstable. This collapse of confidence leads to the sudden withdrawal of foreign capital, directly knocking down the economy. Thirdly, the triggering of asset bubbles is particularly reflected in the real estate sector. Calvo suggests that loans provided to non-trading sectors (such as real estate) might turn into non-performing loans [4]. This explains, for instance, asset bubbles like those in the real estate sector. When foreign capital flows in, a large amount of money flows into the real estate industry, causing rapid growth in housing prices. When a crisis strikes, these loans cannot be recovered and turn into bad debts. This has led to a seriously inefficient allocation of resources brought about by foreign capital.

2.3. Conditional effects

However, capital flows themselves are not the main cause of the crisis; rather, it depends on the global financial cycle, domestic policy systems, and the choices made by countries in the "trilemma". Firstly, in terms of inflow types and volatility, short-term capital is more volatile than long-term capital and is sensitive to global sentiment. Rey shows that credit flows are the most volatile and procyclical components among all flows, experiencing particularly sharp surges during the prosperous period before the crisis and equally severe collapses during the crisis [2]. This indicates that not all foreign capital is good. Compared with long-term capital such as FDI, short-term credit flows have extremely high volatility. This means that when global sentiment fluctuates, such funds will withdraw instantly, causing a huge impact on the domestic economy. Secondly, global shocks are external causes, but domestic policies determine the transmission mechanism. Rey suggests that an increase in the Chicago Board Option Exchange Volatility Index (VIX), a measure of market uncertainty and risk aversion, leads to a decline in the leverage ratio of European banks and a reduction in global domestic credit over the subsequent four quarters [2]. This indicates that the global financial cycle, or global sentiment, determines the tightness or looseness of capital. When global panic occurs, the outflow of foreign capital leads to a contraction in domestic credit. Obstfeld also notes the results of domestic policy decisions [5]. This shows that the "trilemma" is largely borne out by history, confirming the constraints implied by it. This further indicates that although capital flows exist, it is the policy choices of a country that determine whether it can have an independent monetary policy. In other words, national management is the fundamental reason that determines whether a country will be hit by a crisis. Thirdly, institutional and market supervision is of great significance. Akpilic shows that in emerging and middle-income economies, financial development has intensified the negative impact of uncertainty on FDI inflows [3]. Furthermore, a strong system will alleviate this impact. It has been proved that if a country has a strong regulatory system, it can offset the negative impact brought by foreign investment. At the same time, he also mentioned that the quality of the system has enhanced the FDI of low-income economies by promoting stability and investor confidence. This is clearly the conditional effect. Only when good institutional conditions are in place will foreign capital come and bring benefits.

3. Transmission mechanism

3.1. Credit channel

The channels of capital inflow are numerous, but the credit channel is by far the largest. First of all, from the standpoint of foreign capital in the banking system, the influx of foreign capital to banks has boosted bank liquidity. Le and others have proposed that an increase in the inflow of Other investment (OI) is associated with an increase in loanable funds and thus expanded bank credit supply [6]. Capital inflow is the basic force that increases the bank's funds for lending through the conversion of foreign funds into loanable funds. Secondly, from the standpoint of an increase in bank loans. Le and others have shown that higher capital inflows are associated with an expansion of bank credit [6]. Clearly, the capital inflow promotes credit expansion. In other words, due to an increase in liquidity, banks extended more credit. At the same time, with an increase in loanable funds, the lending rate will fall; thus, the company will improve its financial conditions and borrowing capacity. It can be seen that due to extended credit, an increase in funds, and a lower-interest-rate environment, it is now more convenient for enterprises to obtain loans. Thirdly, there is a problem of financial instability. Although credit expansion is expected to have a risk accumulation.

Le and others have shown that capital inflows are correlated with a lower credit risk [6]. The scale of the impact on the banks differs, so some small and medium-sized banks have been more inclined to increase credit supply rapidly in their pursuit of market share, while large banks have seen a relatively small change in credit quality.

3.2. Exchange rate channel

The Exchange Rate Channel is also a way in which this is realised. First, Changes in global interest rates will have an impact on capital flows. Pagliari and others have demonstrated that, in addition to the amount of the flow, the three reasons for changes in capital flows are generally US interest rates, global risk aversion, and domestic real GDP [7]. Capital flows are not sudden and do not directly reflect changes in the economy abroad. Second, the domestic currency will be higher after the capital injection. Rey believes that under the influence of the global financial cycle, the traditional "trilemma" has become a "dilemma", and national monetary policy independence cannot be achieved in any exchange-rate system [2]. Therefore, the world-driven capital flow volatility is directly responsible for the exchange rate fluctuation. At the same time, there will be capital outflows and a fall in the currency. Pagliari and others [7] have found that fluctuations in the US economy, such as changes in the US shadow rate and economic activity, are also reasons for changes in capital flows to emerging economies. A stronger US economy will boost the flow of capital out of other countries, thus raising the currency values in those countries. That is to say, there will be a sudden change in the flow of funds from abroad for emerging countries.

3.3. Capital flow volatility and sudden stop

Foreign capital has the risk of sudden withdrawal and is thus unsuitable. Calvo thinks that one reason for the sudden decline in foreign credit flow is a financial and balance-of-payments crisis [4]. Not many new funds have been raised, but an unexpected outflow has caused a financial crisis. At the same time, the foreign-invested capital has suddenly left the market and reduced liquidity. Calvo believes that if there is a sudden end to foreign capital inflow, some human capital will be diverted from the financial sector, thus lowering both the average and marginal productivities of physical capital [4]. In other words, when foreign capital suddenly withdraws, the company must urgently raise funds to repay debt and is thus unable to invest in production. Therefore, the sudden stop lowers the company's own funds and reduces the extra output per unit of physical capital. All the above reasons lead to financial instability. Pagliari and others believe that volatility in capital flows is still one of the problems for macroeconomic and financial stability in emerging market and developing economies (EMDEs) [7]. Therefore, this fluctuation of the financial market will not be easily resolved.

4. Case study

4.1. Turkey

A reduction in the total money supply across the country has caused various economic problems in many countries, and Turkey is one such country. According to the IMF, inflation was 85% in 2022 year-on-year and had risen significantly from less than 20% in September 2021. A significant depreciation of the exchange rate and a fall in real interest rates for households were the main reasons [8]. Clearly, rapid depreciation of the exchange rate resulted from capital flight and thus

Turkey faced a severe currency crisis in 2021-2022. In light of the above crisis, monetary policy was aggressively tightened; as the IMF has reported, by mid-2023, the repo rate had been raised from 8.5% to 50% by 2024 [8]. Given the scale of the drop, the government of Turkey raised interest rates to stabilise the currency. Inflation has been relatively low for a long time. As indicated by the IMF, the rise in services inflation occurred later and remained relatively high even after the exchange rate was stabilised [8]. It outperformed goods inflation and had a longer duration. Therefore, this division indicates that the cause of the increase in inflation in Turkey is now due to domestic factors rather than an exchange-rate change.

The first reason for the problems in Turkey is a sudden decrease in foreign direct investment. First, a weaker currency will likely lead to imported inflation. Ozkaya and Altun have shown that although the pass-through effect of the exchange rate in Turkey has weakened, it is still relatively large; thus, a 1% fall in the exchange rate will lead to about 1.5% higher prices [9]. It can be seen that, due to a decline in the exchange rate, domestic prices will increase at a higher rate; therefore, the problem of exchange rate volatility for emerging economies in Turkey is quite serious. Second, the cause of this situation is not only foreign capital but also domestic policy problems. Rey believes that due to the impact of global financial cycles, the "trilemma" has become a "dilemma"; that is to say, as long as capital flows freely, one cannot achieve both an exchange rate regime and independent monetary policy in the face of global financial cycles [2]. That is to say, when monetary policy fails to do so, the government will be unable to alleviate the capital flight crisis effectively.

4.2. India

India has also demonstrated the risks brought about by capital inflows, but at the same time, it has emphasized that after experiencing multiple crises, India did not undergo a systemic collapse. Firstly, India has experienced significant capital inflows. Muduli et al. mentioned that foreign direct investment accounted for more than half, and the portfolio investment flow accounted for 30% [10]. This indicates that India has long had large-scale capital inflows and a relatively stable composition. Further confirmation is that before the fluctuations occurred, the capital account in India was open and attractive. Secondly, India has also faced significant volatility in capital outflows. Muduli et al. suggest that the probability of portfolio investment outflows in India was 5%, with a scale of approximately 3.2% of GDP [10]. In extreme risk scenarios, the probability of portfolio investment outflows was 5%, with a scale reaching 7.7% of GDP. This highlights the volatile nature of India's capital flows. Although India's capital has fluctuations, there was no collapse phenomenon. Muduli et al. shows that the capital flow experience flowing into India was different from that in other emerging market economies; India experienced 5 major sudden stops and reversals [10]. Notably, even after the onset of the pandemic, India remained a host for capital inflows throughout 2020 and into 2021. This shows that India not only did not experience a complete collapse in capital flows but also demonstrated the ability to absorb shocks.

The reason why capital flows in India did not completely collapse is that there are relevant response mechanisms in place. Firstly, foreign exchange reserves act as a buffer. Muduli et al. note that appropriate measures were formulated to protect the economy from such shocks [10]. The high proportion of foreign exchange reserves in the import ratio indicates that foreign investors choose to invest in countries that are less likely to default on their external debts. This shows that India has enhanced its resilience to shocks by maintaining a high level of foreign exchange reserves. Secondly, it demonstrates the effectiveness of Indian policies. Kumar suggests that the central bank can attract or manage the inflow of foreign capital through monetary policy, but the central bank may face a policy trade-off [11]. This shows that the Indian central bank has the ability to intervene

in capital flows through interest rate measures. As Rey specifically emphasized, whenever capital flows are free, the global financial cycle will limit a country's monetary policy, regardless of the exchange rate regime [2]. It further explains the root cause of instability. Additionally, the government also attempts to strengthen supervision to resist the fluctuations brought about by capital flows. Muduli et al. highlight that the government attempts to resist capital fluctuations rather than reduce them, which prompts emerging market countries to accumulate reserves or restrict access to their financial accounts, including through the adoption of capital controls [10]. This shows the necessity of regulation in India through the implementation of regulatory measures such as capital controls and limited financial accounts. All of these demonstrate that India has chosen to utilize policy tools to break the global cycle.

5. Conclusion

In conclusion, foreign capital inflows are a double-edged sword, bringing both opportunities and risks. Through three key transmission mechanisms- the credit channel, it can enhance liquidity but may also lead to excessive borrowing; the exchange rate channel, which links domestic stability with global financial cycles; and the risk of sudden cessation, which may trigger severe financial crises. Empirical studies of Turkey and India have shown that the scale of capital inflows is less important than its management approach. Ultimately, establishing a robust institutional framework and implementing effective macroprudential policies are crucial for fully reaping the benefits of foreign capital while mitigating its inherent volatility.

References

- [1] Alimov, B. (2022). The dynamic effects of debt and equity inflows: Evidence from emerging and developing countries. *The Journal of Economic Asymmetries*, 26, e00259.
- [2] Rey, H. (2015). Dilemma not trilemma: the global financial cycle and monetary policy independence (No. w21162). *National Bureau of Economic Research*.
- [3] Akpolic, F. (2026). Global uncertainty, institutional quality, financial development, and foreign direct investment inflows. *The Journal of International Trade & Economic Development*, 35(2), 382-408.
- [4] Calvo, G. A. (1998). Capital flows and capital-market crises: the simple economics of sudden stops. *Journal of applied Economics*, 1(1), 35-54.
- [5] Obstfeld, M., Shambaugh, J. C., & Taylor, A. M. (2005). The trilemma in history: tradeoffs among exchange rates, monetary policies, and capital mobility. *Review of economics and statistics*, 87(3), 423-438.
- [6] Le, T. H., Nguyen, N., & Pham, M. (2024). The impacts of capital inflows on bank lending in the ASEAN-6 countries. *International Journal of Emerging Markets*, 19(12), 4364-4382.
- [7] Pagliari, M. S., & Hannan, S. A. (2024). The volatility of capital flows in emerging markets: Measures and determinants. *Journal of International Money and Finance*, 145, 103095.
- [8] Iyer, T., Roitman, A., Walsh, J., & Walsh, M. J. P. (2026). Services inflation and the exchange rate in türkiye. *International Monetary Fund*.
- [9] Ozkaya, A., & Altun, O. (2024). Domestic and global causes for exchange rate volatility: Evidence from Turkey. *Sage Open*, 14(2), 21582440241243200.
- [10] Muduli, S., Behera, H., & Patra, M. D. (2022). Capital flows at risk: India's experience. *RBI Bulletin*, 76(6), 73-88.
- [11] Kumar, V. (2025). Effect of domestic monetary policy on foreign capital flows to India. *Journal of Economic Policy Reform*, 28(3), 371-391.