

Capital Flows to Emerging Market Economies

June 7, 2012

- Private flows to emerging economies set to fall by \$118 billion in 2012 to \$912 billion
- This is an upward revision relative to the January 2012 Capital Flows Report
- Emerging Europe and Emerging Asia account for most of the decline
- A recovery in capital flows to just under \$1 trillion projected for 2013
- Euro Area crisis is both a current restraint on flows and the largest downside risk
- In addition, some EM-specific factors are holding down flows in 2012

Net private capital flows to emerging market economies remain quite volatile and subject to disturbance from the Euro Area crisis. They fell in 2011 relative to 2010 (to \$1,030 billion from \$1,088 billion) and are likely to be lower again in 2012 (\$912 billion), even though the macroeconomic performance of emerging market economies (and thus the return on investments there) remains substantially better than that of mature economies (Chart 1 and Table 1, next page). Rapid mood swings are also apt to make market-based and banking-related flows quite volatile. Indeed, improved global market conditions following the apparent stabilizing success of the ECB's massive 3-year repurchase operations at the turn of the year helped lift net flows to emerging economies early in 2012. This included a moderation in the pace of bank deleveraging. This improvement has prompted us to raise our estimate for net private flows to emerging markets in 2012 from the very subdued forecast of \$746 billion

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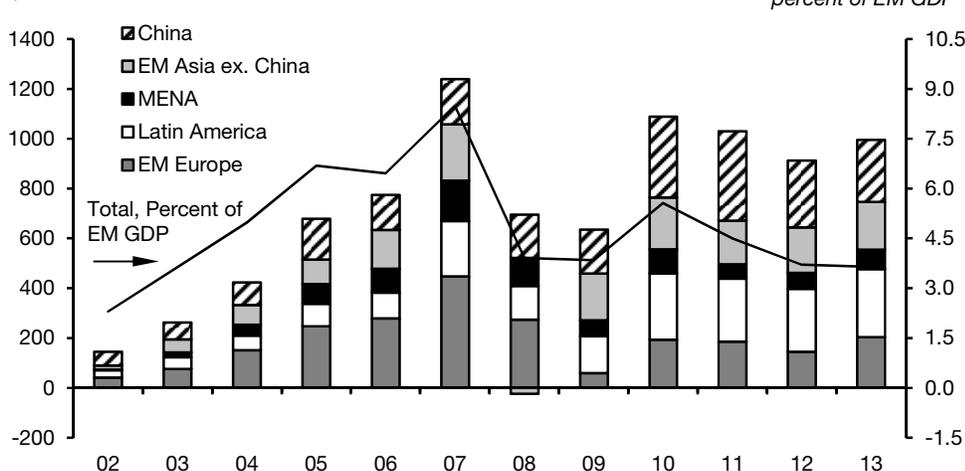
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Chart 1
Emerging Market Private Capital Inflows, Net
\$ billion



Capital Flows to Emerging Market Economies

Table 1
Emerging Market Economies: Capital Flows

\$ billion

	2010	2011e	2012f	2013f
Capital Inflows				
<i>Total Inflows, Net:</i>	<u>1157</u>	<u>1093</u>	<u>959</u>	<u>1045</u>
Private Inflows, Net	1088	1030	912	994
Equity Investment, Net	607	545	560	577
Direct Investment, Net	459	524	499	481
Portfolio Investment, Net	148	21	61	96
Private Creditors, Net	481	485	353	417
Commercial Banks, Net	159	143	73	123
Nonbanks, Net	322	342	279	294
Official Inflows, Net	69	63	46	51
International Financial Institutions	31	25	15	17
Bilateral Creditors	38	39	31	34
Capital Outflows				
<i>Total Outflows, Net</i>	<u>-1514</u>	<u>-1431</u>	<u>-1293</u>	<u>-1200</u>
Private Outflows, Net	-607	-715	-663	-707
Equity Investment Abroad, Net	-270	-226	-251	-311
Resident Lending/Other, Net	-337	-489	-411	-396
Reserves (- = Increase)	-802	-669	-630	-493
<i>Memo:</i>				
<i>Net Errors and Omissions</i>	<u>-104</u>	<u>-47</u>	<u>0</u>	<u>0</u>
<i>Current Account Balance</i>	<u>357</u>	<u>338</u>	<u>334</u>	<u>155</u>

made in January (see Box 1, next page). Moreover, inflows in 2013 are projected to accelerate to \$994 billion. Despite the upward revision to our 2012 estimates, however, the outlook for capital flows to emerging economies for 2012-13 remains quite subdued relative both to recent history and GDP in emerging economies (see Chart 3, page 4). They are also subject to unusually large downside risks. For example, global financial tensions would undoubtedly intensify in the context of a Euro Area member abandoning (or being forced to abandon) the common currency, and this would no doubt have severe repercussions for capital flows to emerging markets.

It should be noted that the moderation in flows in 2011 and 2012 is not solely the result of risk factors emanating from mature economies. There are also EM-specific factors that have dampened flows. Among these are:

- Growing perceptions that China's currency may have appreciated sufficiently in real terms. This is dampening speculative capital inflows into China, and the now much appreciated real value of the RMB is making China less attractive to foreign direct investors. Moreover, Chinese financial and non-financial companies are increasingly eager to invest abroad. The changing dynamic of China's balance of payments is investigated in more detail on pages 11-19. Flows to India have also moderated as some

The outlook for capital flows to emerging economies for 2012-13 remains quite subdued relative both to recent history and EM GDP

Capital Flows to Emerging Market Economies

BOX 1: REVISIONS TO IIF FORECASTS

Since our January 2012 report, we have made substantial net upward revisions to our capital flows estimates. Net private capital inflows to emerging markets were higher in 2010 and 2011 than previously estimated and are also projected to be higher in 2012 and 2013 than previously forecast (Table 2). The upward revisions are almost exclusively in Emerging Asia, especially China, which has seen a large degree of volatility in recent capital flows (Chart 2). Chinese balance of payments data through 2012Q1 suggest that the impact on capital inflows has been smaller than we expected, especially due to continued strong FDI inflows. By contrast, spillovers to Emerging Europe from the Euro Area crisis are large and broadly in line with our projections earlier this year. Therefore, only small further reductions were made to the projections for this year and next, led by Poland and Turkey.

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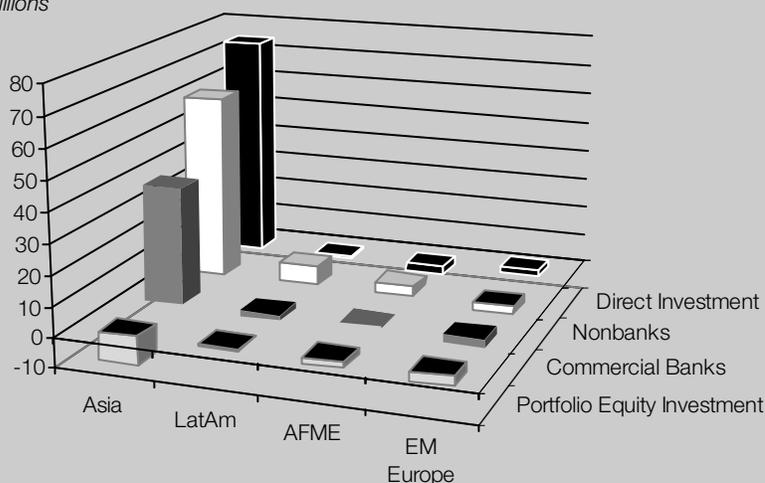
Table 2
Revisions to IIF Net Private Capital Inflows

\$ billion

	2010	2011e	2012f	2013f
IIF Capital Flows				
Current	1,088	1,030	912	994
January 2012 Report	1,040	910	746	893
Difference	48	120	166	101
Revisions by Region				
Latin America	5.1	-4.2	3.7	0.6
Emerging Europe	-8.7	-23.3	-1.3	-14.0
Africa/Middle East	6.8	-14.9	-1.3	-1.2
Emerging Asia	44.4	162.0	165.1	116.1

Chart 2
Revisions to 2012 Forecasts for Net Private Capital Inflows

\$ billions



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concerns have developed about government policies (see Box 7, pages 25-27).

- The political turmoil in parts of the Middle East associated with the “Arab Spring” led to a sharp drop off in flows in 2011, especially to Egypt (see page 33).
- Two factors have restrained what remain relatively buoyant flows to Latin America. A number of countries that have been very attractive to investors — most notably Brazil — have taken measures to discourage flows, either by cutting interest rates to dampen carry-trade related flows or by imposing (limited) restrictions on inflows. More worryingly, Argentina’s virtual appropriation of Repsol’s FDI assets has made the investment climate there extremely unfriendly.
- Although flows to Emerging Europe remain dominated by conditions in the Euro Area (especially in the banking sector), a number of investor-unfriendly actions taken by Hungary have dampened flows there. Worries about political conditions and have weakened flows in Russia.

High-frequency market data highlight some of the volatility in private flows to emerging economies in recent quarters (Chart 4). Most of this volatility has occurred in portfolio equity flows, which were quite strong early in 2012, but which slipped back during Q2. By contrast, net fixed income flows have remained quite steady through recent months, which reflects wide interest differentials. Credit-worthy sovereigns and corporates in emerging economies are taking opportunities to borrow at historically low rates in mature bond markets.

High-frequency market data highlight some of the volatility in private flows to emerging economies in recent quarters

STRONG FLOWS PROMOTED BY THE UNDERLYING GLOBAL BUSINESS CYCLE

The global outlook continues to be characterized by divergence between solid growth in emerging markets and quite subdued growth in mature economies (Table 3, next page). Fundamentally, this should support net capital inflows to emerging economies. Not only do such relative growth conditions make investors in mature economies more likely to invest in

Chart 3
Private Capital Inflows and EM Real GDP Growth
net private capital inflows, percent of GDP, 1991-2012

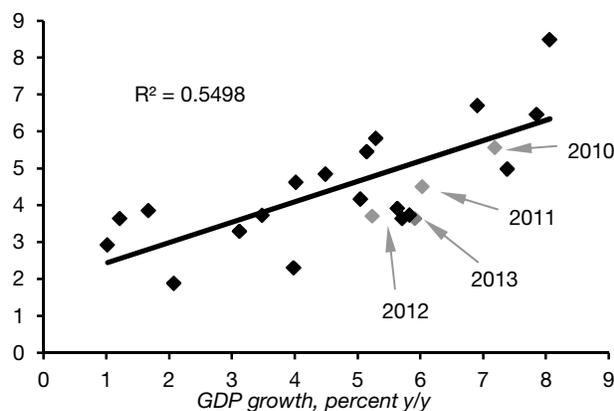
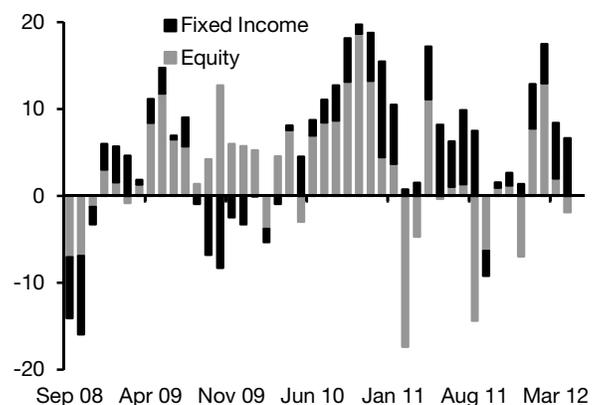


Chart 4
Emerging Market Funds: Debt and Equity Net Flows
\$ billion



Capital Flows to Emerging Market Economies

Table 3
Global Output Growth
percent change over previous year

	2010	2011e	2012f	2013f
Mature Economies	2.8	1.3	1.4	1.7
United States	3.0	1.7	2.4	2.5
Euro Area	1.9	1.5	-0.2	0.9
Japan	4.5	-0.7	2.6	1.5
Other Mature Economies	2.8	1.6	0.9	2.1
Emerging Economies	7.2	6.0	5.2	6.0
Latin America	6.2	4.0	3.3	4.4
Argentina	9.2	6.5	2.0	2.0
Brazil	7.5	2.7	2.7	5.2
Mexico	5.5	3.9	3.6	4.0
Emerging Europe	4.6	4.8	2.8	3.6
Russia	4.3	4.3	3.5	4.0
Turkey	9.2	8.5	3.2	4.0
Asia/Pacific	9.1	7.5	7.0	7.6
China	10.4	9.2	8.0	8.7
India	8.4	6.5	6.5	7.0
Africa/Middle East	4.1	4.8	4.0	4.1
South Africa	2.9	3.1	2.9	3.7
World	4.4	3.2	3.0	3.6

emerging economies, but they also make emerging market investors (both government and private sector) more inclined to invest in other emerging economies.

While mature-emerging growth differences should be expected as emerging economies catch up to higher income levels, the current divergence is also driven by some key factors that are holding growth in mature economies below their potential:

- Weakness in bank credit growth in mature economies as banks tighten credit standards in an environment of increased regulatory pressures. Even though some of the deterioration in credit conditions has spilled over to emerging economies, the overall loan supply and demand situation is much more favorable in the emerging world.
- Differences in fiscal policy. The dramatic increases in government debt in the mature economies demonstrate the need for consolidation over the medium term in order to safeguard debt sustainability. This phenomenon is not confined to a number of Euro Area countries but also includes the U.S., where fiscal consolidation will likely dampen growth in 2013, although the size of the eventual reduction in the government deficit is uncertain. By contrast, debt levels have remained broadly stable in the emerging world and fiscal consolidation is not a factor hampering growth.

The 2012 growth outlook for the mature economies has actually been raised somewhat since the last Capital Flows Report in January. This reflects an upward revision for Japan as

The current divergence in growth prospects is also driven by some key factors that are holding growth in mature economies

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reconstruction spending combined with solid private consumption growth has boosted the first quarter GDP results. We also raised our forecast for annual Euro Area growth slightly, mainly due to the better-than-expected growth outcome for Q1. By contrast, we lowered our growth profile for the Euro Area for the remainder of this year and this took down our annual 2013 projection to below 1%, as we now expect a more drawn out recession and more moderate recovery. Overall, growth in the mature economies is a bit lower for 2013 compared to the January Capital Flows Report. For the EM economies, the growth outlook remained broadly unchanged and the forecast is for GDP growth of 5.2% this year and 6% next. The working assumption is that the Euro Area crisis does not escalate further as such a scenario would have more severe ripple effects throughout the emerging economies as well.

ALL EYES ARE FOCUSED ON EUROPE

Economic and political developments in Europe currently exert a dominant influence on global capital flows, and this seems unlikely to change for a while. Inflows to emerging markets are affected by Euro Area difficulties via two channels. First, financial stability risks in the Euro Area are at the forefront of investors' concerns and changes in risk perceptions have triggered significant swings in global investment and lending patterns over the past two years. Second, European investors and lenders themselves have historically been important suppliers of capital to emerging markets. During the years 2000-2008, the Euro Area has been the dominant source of private capital in the world (Chart 5). Since 2009, however, flows have been very subdued in net terms and quite volatile on a monthly basis (Chart 6). There was a dramatic fall in net outflows from the Euro Area in the middle of 2011 which was the counterpart to extreme weakness in capital flows to emerging economies. Through 2012Q1, however, Euro Area capital exports had regained their previous pace.

Most recently, however, developments in Europe have taken a turn for the worse. The recent bout in risk aversion is likely to be reflected in weak flows from Europe in the second

During the years 2000-2008, the Euro Area has been the dominant source of private capital in the world

Chart 5
Net Private Capital Outflows
\$ billion, net private flows by residency of investors & lenders

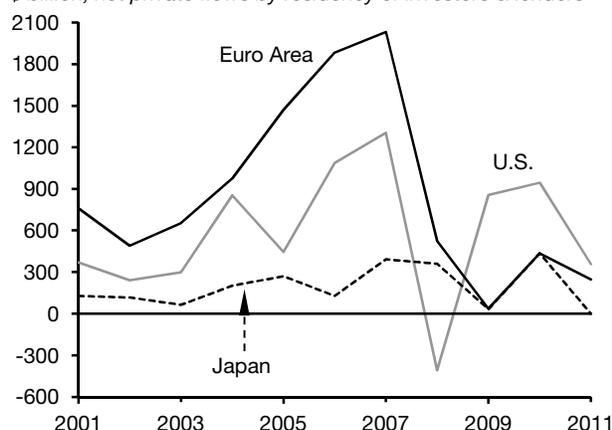
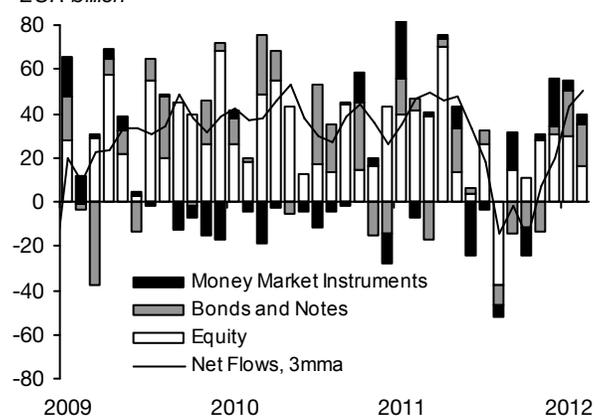


Chart 6
Euro Area: Net Private Capital Outflows
EUR billion



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quarter of this year. More importantly, recent discussions of Greece exiting the Euro Area introduce a very tangible possibility of financial turmoil in the near term. Such an event would likely have severe repercussions in global financial markets. The ripples of a disorderly exit would likely be transmitted via sharp reversals in capital flows away from emerging markets and towards perceived safer economies. This would weigh on asset prices, undermine confidence and impair financing conditions in the emerging world. A range of emerging economies could face funding constraints, especially those that are more dependent upon external finance, notably in Emerging Europe (see pages 28-30).

FOREIGN DIRECT INVESTMENT FLOWS: DOMINANT BUT MODERATING

Foreign direct investment in emerging markets – which accounts for around one-half of all net private inflows – reached \$524 billion in 2011, mainly driven by investments in the services sector (see Box 2, pages 8-9). Looking ahead, however, overall FDI inflows to emerging markets are projected to fall slightly this year to \$499 billion and further to \$481 billion in 2013, led by an expected sharp decline in FDI flows to China.

Overall FDI inflows to Emerging Asia continued to surge in 2011, marking the second consecutive year of solid gains. Notably, FDI inflows to China increased by \$35 billion (19%), reflecting continued gains in manufacturing and services sectors. Although China will remain the top destination for FDI among emerging economies in 2012 and 2013, ongoing rapid wage growth is expected to moderate flows from higher-income economies sharply (see page 14). In India, the rise in FDI inflows continued to be driven by investments in services, especially in the communication sector. In addition, in recent years multinational companies have become more interested in India's primary sector as high oil prices continued to favor energy-related investment. Last year, BP made one of the largest foreign direct investments in India to explore deep-water oil and gas. Looking ahead, however, the introduction of controversial tax measures on foreign investment may dampen investment and, indeed, has already started to adversely affect the country's investment climate (see Box 7, pages 25-27).

Notwithstanding the ongoing financial crisis in the Euro Area, FDI flows to Emerging Europe increased slightly in 2011. Russia and Turkey were the main FDI recipients in the region. In particular, FDI flows to Turkey surged by 83% in 2011—led by investments in financial services—and are expected to stabilize at this level in the next two years. In contrast, FDI flows to the Czech Republic declined slightly as flows from Western countries continued to decline.

In the Middle East, foreign direct investment declined sharply in 2011 as a result of political turmoil. In particular, FDI inflows to Egypt fell by 68%, on top of the 17% drop registered in 2010. Inflows to Saudi Arabia have also declined sharply as foreign investors became more cautious about their energy-related investment in the country. However, some countries in the region also enjoyed further increases in FDI flows. For example, FDI flows to Morocco picked up as the French car company Renault opened the region's biggest car factory.

China will remain the top destination for FDI among emerging economies in 2012 and 2013

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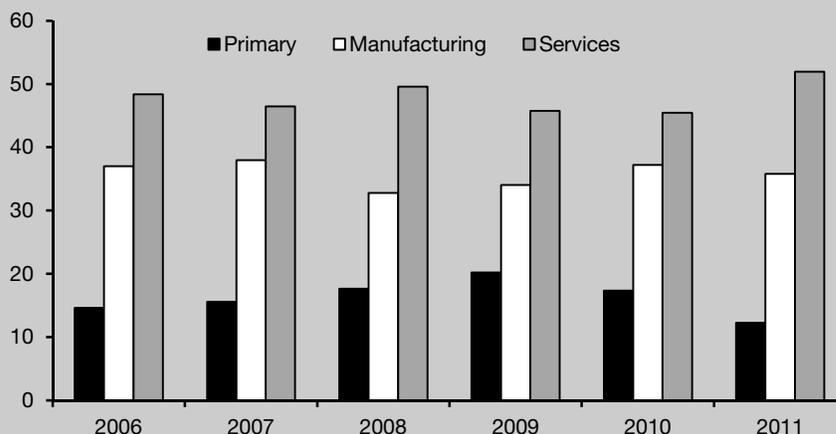
BOX 2: SECTORAL BREAKDOWN OF FDI FLOWS

Over the past few decades, FDI inflows to emerging economies have increased remarkably across sectors, but there have also been changes in the sectoral composition. In most emerging economies, but especially in Europe, FDI flows in services surged significantly during the second half of the 1990s, outpacing the flows to the manufacturing sector. Different countries have experienced this structural change at different times, with China being the most recent example (Chart 7). China's export-oriented manufacturing industry has always been an attractive destination for FDI. With the growing middle class of China, however, China's services sector – mostly non-tradable – seems to have become one of the most promising industries in the emerging world over the past few years (Chart 8).

Although the overall distribution of FDI inflows by sector to emerging economies has not changed notably since the second half of the 2000s (Chart 9), the sectoral composition of FDI flows continues to be very different between emerging regions and also countries:

- In Emerging Europe, the main destination of FDI flows continues to be the services sector, which accounts for around 80% of all FDI (Chart 10, left panel). Restrictions on foreign ownership in the oil and gas industry, particularly in Russia, are the main barriers against FDI inflows to the region's primary sector.
- In Emerging Asia, FDI flows in services increased notably during the second half of the last decade, mainly driven by FDI flows to China (Chart 10, right panel). The pattern of distribution by sector, however, differs significantly from one country to another. In Thailand, Malaysia and the Philippines, for example, the main destination of FDI flows is still the manufacturing sector.

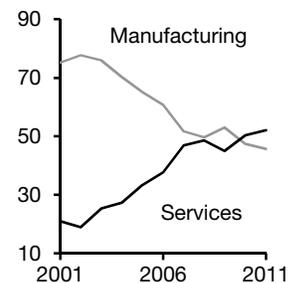
Chart 9
Sectoral Decomposition of FDI Inflows to Emerging Markets
percent



Source: National BOP Statistics, OECD, ECLAC, CEIC, and IIF Staff Estimates

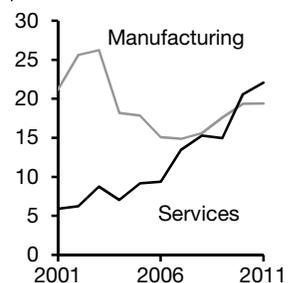
The composition of FDI has shifted toward services in China

Chart 7
China: Sectoral FDI Flows
percent of total FDI in China



Source: CEIC

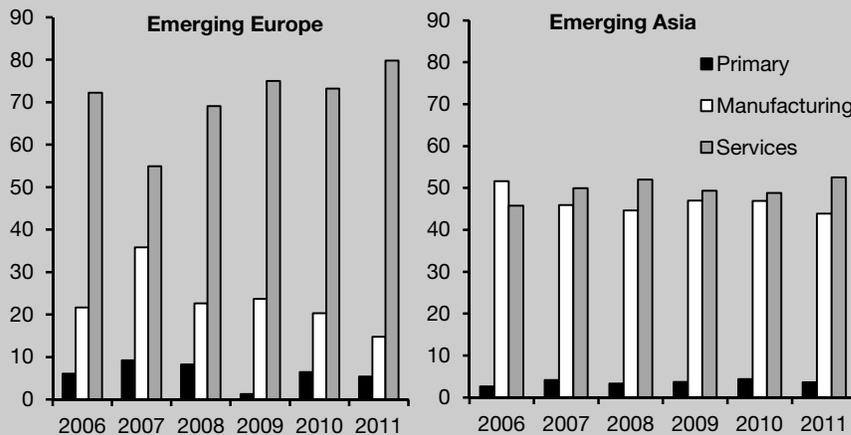
Chart 8
China: Sectoral FDI Flows
percent of total FDI in EM



Source: CEIC

Capital Flows to Emerging Market Economies

Chart 10
Sectoral Decomposition of FDI Inflows to Emerging Europe and Asia
percent

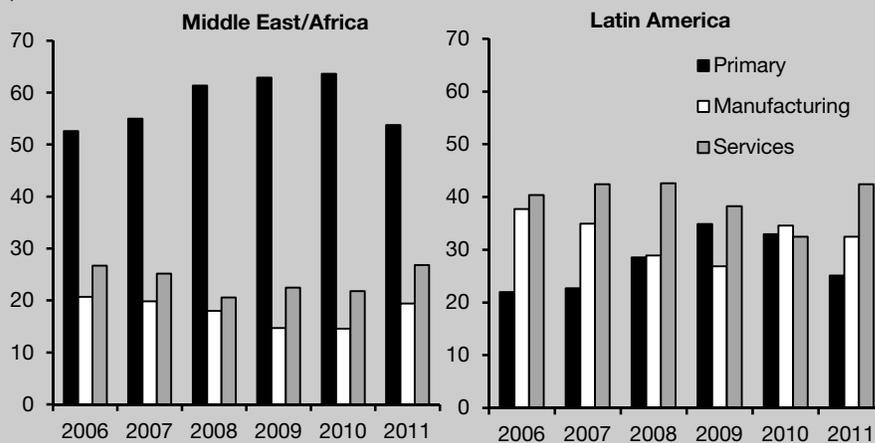


Source: National BOP Statistics, OECD, CEIC and IIF Staff Estimates

- In Middle East/Africa, FDI flows in the primary sector still account for almost 60% of all FDI flows (Chart 11, left panel). In 2011, however, the share has declined slightly, mainly reflecting the drop in FDI inflows to Saudi Arabia's primary sector.
- In Latin America, the sectoral distribution of FDI flows has historically been very volatile, owing to large structural differences among countries (Chart 11, right panel). That said, in 2011, FDI flows in services increased markedly in all countries. Additionally, in Brazil FDI flows in manufacturing continue to be larger than primary and services.

The sectoral composition of FDI inflows to Latin America continues to fluctuate

Chart 11
Sectoral Decomposition of FDI Inflows to Middle East/Africa and Latin America
percent



Source: National BOP Statistics, OECD, ECLAC, and IIF Staff Estimates

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Looking ahead, we now project a slight recovery in FDI inflows to the region, assuming that the adverse impact of the political uncertainty on FDI will diminish in 2012.

Economic conditions over the past few years have favored FDI flows to Latin America. High commodity prices, improved credit ratings, and the region's strong growth momentum have played an important role in attracting foreign investors to the region. As a result of these factors, overall FDI flows to Latin America reached a new all-time record in 2011 and are projected to continue to increase in the near-term. That said, however, foreign direct investment in Argentina is likely to decline sharply in 2012 as the nationalization of the country's biggest oil-company – which used to be owned by the Spanish energy firm Repsol – deteriorated the investment climate for multinational companies (see page 30).

OTHER FLOWS: PORTFOLIO EQUITY VOLATILE; BANK FLOWS WEAK; NON-BANK DEBT FLOWS RESILIENT

Among the three other categories of net private capital flows that we track, there are three different stories. Portfolio equity flows should show some improvement in 2012, but are apt to remain quite volatile and subject to shifting global conditions. Net bank flows will remain weak, as large, global banks continue to de-lever (especially from Europe) and other banks remain cautious about filling the hole. The most buoyancy is likely in portfolio debt flows, which is the category which benefits from large and sustained interest rate and bond yield differentials.

Portfolio equity investment flows are projected to increase markedly in 2012 and 2013, despite the expected volatile market environment. However, net inflows are starting from very low levels in 2011 when they amounted to just \$20 billion (against an average of \$56 billion in the first decade of the century). They are projected to rise to around \$100 billion in 2013, but even at this level they will still remain around 30% below their 2009-10 peak. Further support is coming from equity valuations: price-earnings ratios in emerging markets are well in line with historical averages.

Portfolio equity investment flows are projected to increase markedly in 2012 and 2013

By contrast, **commercial bank flows** to emerging markets are projected to decline substantially this year by around half, to \$73 billion. This reflects continued efforts to de-lever banks' balance sheets, notably in Europe. The ECB's two 3-year LTROs eased European banks' funding challenges temporarily in the early months of 2012, and this effect was evident in the significant improvement in the IIF Emerging Market Bank Lending Survey in 2012Q1. However, by the beginning of the second quarter of this year, the positive effects were wearing off already and our forecasts assume a prolonged period of adjustment in banking markets. The tightening in regulatory requirements is adding to these tensions, including the measures taken by the EBA to accelerate the increase in European banks' capital ratios. The regions that have been most affected by this bank deleveraging are Emerging Europe and Asia. Even though a very slight rise in net bank exposure is projected for 2013, it will be well below that seen in 2010-11, and far below the peak of 2006-07.

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Net debt flows from other private creditors are projected to fall back in 2012 to \$279 billion after having reached an all-time high of \$342 billion in 2011. These flows account for around one-third of all net private capital inflows and include, for example, flows of non-bank sources into bond markets and deposits into local banks by nonresidents other than banks. In general, however, the distinction to commercial bank lending is becoming increasingly blurred. Despite a decline in 2012, which is envisaged to be partly reversed in 2013, inflows from other private creditors remain at very high levels.

Despite a decline in 2012, inflows from other private creditors remain at very high levels

The continued high interest rate differential between mature and emerging economies in an environment of very accommodative financial conditions in the G3 regions is the key driver of these inflows. As these differentials are expected to persist for some time – and given that these inflows are less volatile in nature than portfolio equity flows – they will remain a relatively stable source of capital for emerging markets. Inflows to China, however, are expected to remain at a somewhat lower level going forward. This is partly due to more dampened expectations of further RMB appreciation curtailing investor demand.

Official flows to emerging markets, which are not part of the IIF measure of net private capital inflows, are expected to fall to around \$50 billion in both 2012 and 2013 from over \$60 billion in the previous years. Against this background, and in contrast to earlier periods, the increase in the availability of IMF resources is primarily targeted at the mature peripheral countries in the Euro Area (see Box 3, next page).

CHINA'S NEW BALANCE OF PAYMENTS DYNAMICS

The rapid ascent and integration of the Chinese economy with the rest of the world has made its balance of payments increasingly sensitive to changes both at home and abroad (Chart 12). An expanding domestic economy and a slackening in external demand helped foster adjustment of the current account balance, while the sharp increase in capital flows during the past several years underscores the move toward currency convertibility and the

Chart 12
China: Balance of Payments Flows
\$ billion

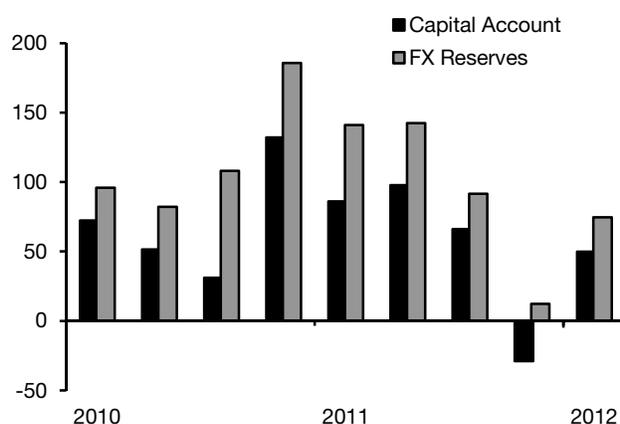
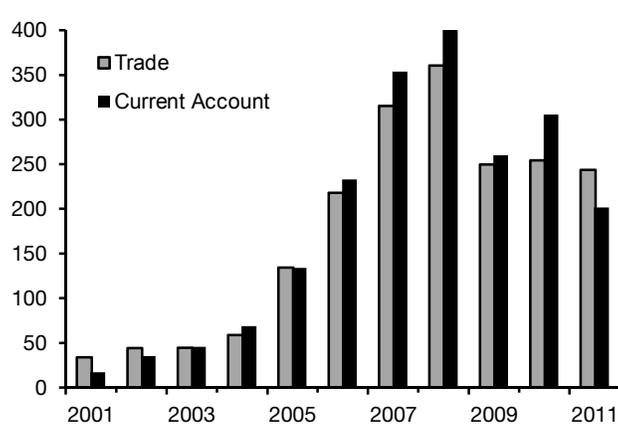


Chart 13
China: Current Account and Trade Surplus
\$ billion



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BOX 3: USE OF IMF CREDIT

The use of IMF credit has increased dramatically since the start of the 2008/2009 global financial crises, reaching \$154.5 billion in April 2012. Unlike previous crises, this time developed countries, namely Greece, Ireland and Portugal, have significantly contributed to this sharp increase (Chart 14, left panel).

In the aftermath of the 2008/2009 financial crisis, the outstanding IMF credit reached historic high levels in both developed and least-developed countries, but the use of IMF credit by emerging countries was relatively limited compared to previous crisis periods. That said, however, there was an uneven pattern between emerging regions and also between countries:

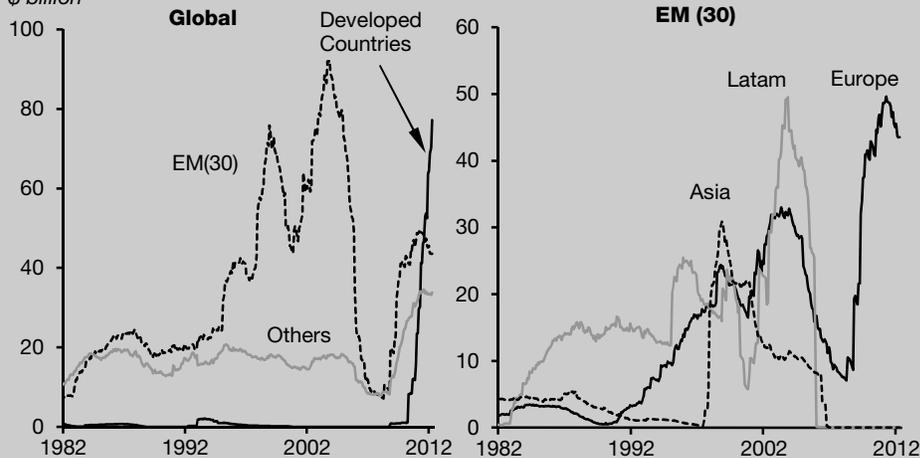
- In our sample of EM(30), none of the countries from Latin America and Emerging Asia have borrowed from the IMF since the onset of the global financial crisis in 2008 (Chart 14, right panel),
- Emerging Europe stood out as the region where the use of the IMF credit surged to record high levels, with Romania leading the way (Table 4),
- In Africa/Middle East, the outstanding IMF credit increased slightly as Lebanon borrowed from the IMF for the first time in its history.

Table 4
Outstanding IMF Credit
\$ billion (as of April 2012)

Countries	Amount
Greece	29.37
Ireland	21.45
Portugal	24.73
Romania	16.39
Ukraine	13.76
Hungary	11.03
Turkey	2.34
Lebanon	0.03

Chart 14
IMF Lending

\$ billion



*IIF CFR Sample (30)

growing openness of the economy (Chart 13, previous page). Although the offshore market for the RMB is in its infancy, China's large external footprint means that it will increasingly be influencing global economic and financial conditions. For most of the past decade, China has garnered a significant proportion of net private capital flows to emerging economies, and the further opening up of the capital account and internationalization of the RMB could promote such a trend. On the other hand, there is now interest to promote foreign

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investment by Chinese companies, in part to diversify China's overseas assets away from official reserves, which are typically invested in low yielding mature markets.

Export-led growth has underpinned the rapid development of the economy and of the balance of payments. In addition to promoting growth, the spectacular expansion of China's external trade sector has dramatically altered international commerce. China's merchandise exports and imports rose from less than 4% of the global total in 2000 before its WTO entry to 10% in 2011, making it the world's second largest trading nation after the U.S.

The hallmark of the Chinese balance of payments has been massive accumulation of reserves. From less than \$168 billion at the end of 2000, official foreign exchange reserves exceeded \$3.3 trillion in March 2012. A sovereign wealth fund was also established in 2007 and currently has about \$0.5 trillion under management. While total external debt has grown from \$160 billion at the end of 2000 to almost \$700 billion at the end of 2011, the large reserve holdings have put China in the unusual position of being a low-income net creditor country.

The global financial crisis and the ongoing Euro Area crisis have had considerable impact on China's balance of payments. Most notable has been the volatility that these external events have imparted to both current and capital account transactions. Going forward, China's large external footprint means that it will increasingly be influencing global economic and financial conditions. In addition to shifts in portfolio allocation of its large reserve holdings,

BOX 4: CHINA – RMB INTERNATIONALIZATION

China's large and rising presence in the global economy provides the basis for its currency to be used for settling trade and investment transactions, but foreign exchange restrictions and capital controls had prevented the international use of the RMB. The dismantling of these impediments has initialized the internationalization of the RMB, which is being supported by swap agreements for RMB1.65 trillion (\$260 billion) that China has signed with 17 economies, including Hong Kong SAR.

July 2009: Pilot program for RMB cross-border trade settlement for exports in five cities.

June 2010: Trade settlement expanded to 20 provinces and municipalities.

January 2011: Pilot program for RMB cross-border settlement of overseas direct investment transactions.

August 2011: Trade settlement expanded nationally and to imports.

October 2011: Foreigners were permitted to conduct foreign direct investment transactions in China with RMB obtained offshore.

March 2012: Trade settlement expanded from companies specifically enlisted in the program to all China-based importers and exporters.

China's large and rising presence in the global economy provides the basis for its currency to be used for settling trade and investment transactions

Capital Flows to Emerging Market Economies

BOX 5: CHINA – THE NASCENT OFFSHORE RMB BOND MARKET

A key part of the government's policy to promote RMB internationalization includes the development of the offshore "dim sum" bond market. The market was initiated in Hong Kong SAR in 2007, when the government allowed Chinese financial companies to issue offshore RMB bonds, but market activity expanded rapidly in 2011, when the government allowed all Chinese companies to issue offshore RMB bonds. By the end of March 2012, 148 offshore bonds issued in Hong Kong SAR raised RMB206 billion (US\$33 billion).

2007: China Development Bank issues the first RMB offshore bond.

2009: The government of China issues the first offshore RMB sovereign bond.

2010: McDonald's Corporation is the first foreign company to issue an offshore RMB bond.

2011: Baosteel is the first nonfinancial Chinese company to issue an offshore RMB bond.

2012: HSBC issues the first offshore RMB bond in London.

the government's "going global" policy is spurring large capital outflows of Chinese direct investment.

Importantly, recurrent global financial turmoil has not stopped the government from advancing reforms aimed at further opening and liberalizing the balance of payments. Many of these measures are aimed at promoting the internationalization of the RMB, which are a natural consequence of China's expanding external transaction but may be inspired to buttress uncertain global conditions (see Chart 15 and Box 4). The pilot program of RMB trade settlement has been expanded nationally and made applicable to exports and imports, while recent steps are opening the window for foreign investment in China (Chart 16). The government has also widened the daily trading band for permissible exchange rate fluctuations and broadened the offshore market for the RMB. The offshore RMB bond market in Hong Kong has also developed rapidly (see Box 5).

Recurrent global financial turmoil has not stopped the Chinese government from advancing reforms

SIGNIFICANT CURRENT ACCOUNT ADJUSTMENT

The global financial crisis accelerated the adjustment that was starting to take place in China's external performance. An expanding domestic economy and a slackening in external demand helped reduce the current account surplus from a peak of 10% of GDP in 2007 to less than 3% in 2011. The current account surplus contracted by more than 50% between 2008 and 2011 to \$201 billion, and fell slightly to \$25 billion in the first quarter of 2012 from \$29 billion in the same period a year earlier.

Capital Flows to Emerging Market Economies

Chart 15
China: RMB Deposits in Hong Kong

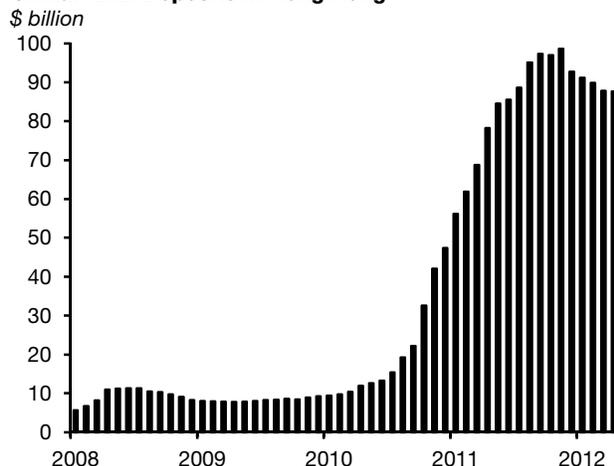
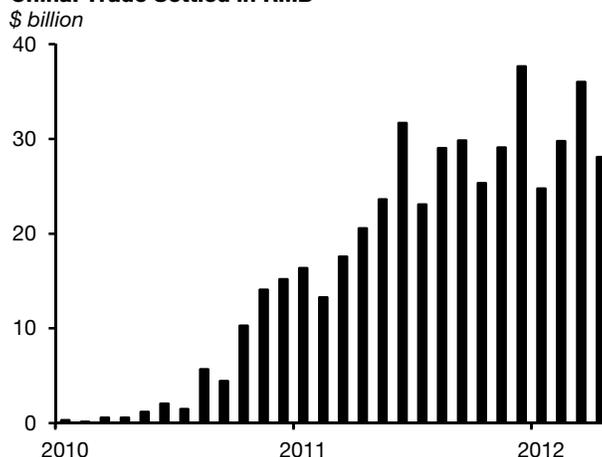


Chart 16
China: Trade Settled in RMB



Current account transactions have been dominated by exports, but the rapid expansion of the domestic economy has bolstered the demand for imports beyond that of inputs for exports. Diminishing market share gains have also progressively made exports more susceptible to changing external demand conditions. Moreover, China's favorable competitive position has also been eroded by rising wages, labor shortages in key industries and a stronger exchange rate. While the renminbi in mid-May was close to the level at the end of 2011, it has appreciated by 22% against the dollar since mid-2005.

The sustained strong growth in trade was interrupted by the global financial crisis. Total merchandise exports rose an average of 29% a year between 2001 and 2007, but growth slowed to 17% in 2008 and exports contracted by 16% in 2009. After rebounding by 31% in 2010, export growth moderated to 20% in 2011 and to less than 7% in the first four months of 2012.

Most of the recent weakness reflects the softening in demand in the mature economies. Not surprisingly, shipments were the worst to the EU, which accounts for 18% of total exports. Exports to the EU were 2% lower in the first four months of 2012 than a year earlier following growth of 6.5% in the fourth quarter of 2011. In contrast, exports have held up well this year with the U.S., which accounts for 17% of the total. Exports to the U.S. were 12% greater in the first four months of 2012 than a year earlier compared with growth of 14% in the fourth quarter of 2011.

While exports to Japan, which account for 8% of the total, were 9% greater in the first four months of 2012 than a year earlier, this is down from growth of 17% in the fourth quarter of 2011. The recent weakness also extended to the rest of Asia, which accounts for about 40% of total exports. Part of these exports are ultimately destined to the slower-growing mature economies, which helps explain why their growth moderated from 14% in the fourth quarter of 2011 to 7% in the first four months of this year.

The heavy dependence of exports on imported inputs means that the import performance

Most of the recent weakness in Chinese exports reflects the softening in demand in the mature economies

Capital Flows to Emerging Market Economies

has been similar to exports, although the rapid expansion of the domestic economy is progressively driving import growth. In addition to the slowdown in exports, the slowdown in the domestic economy played a role in lowering growth in imports to 5% in the first four months of 2012 from 25% for 2011 as a whole. Real GDP in China was 8.1% greater in the first quarter of 2012 than a year earlier, down from 8.9% in the fourth quarter of 2011 and 9.1% in the third quarter.

Weaker import growth raised slightly the trade surplus in the first four months of this year to \$50 billion from \$49 billion in the same period a year earlier, but the underlying quickening pace of import growth reduced the trade surplus from a peak of \$361 billion in 2008 to \$244 billion in 2011. The reduction in the trade surplus was also accompanied by a sharp reversal in the balance on services, income and transfers.

After reaching a surplus of almost \$52 billion in 2008, the balance on net invisibles shifted to a deficit of \$42 billion. Transportation costs have risen sharply with the volume of

BOX 6: CHINA – THE “Q” PROGRAMS

The government has set up a series of special programs specifically designed to give foreign investors access to local financial markets and foster outward portfolio investment by residents. These programs apply to institutions that are "qualified" because the investor must gain government approval to participate. Each investor is allocated a permissible amount to invest, although the programs for foreign investment in China are also subject to an overall quota or limit. While the three programs initiated to date are small, they represent important steps opening and liberalizing the financial sector.

QFII: The Qualified Foreign Institutional Investor program is a window for foreign portfolio investment in China. The program was established in 2002 with an overall quota of \$10 billion, but was raised to \$30 billion in 2007 and to \$80 billion this year. As of May 2012, \$42 billion of the quota had been utilized by 167 qualified institutional investors, with 76% held in equities, 14% in bonds and 10% in bank deposits.

QDII: The Qualified Domestic Institutional Investor program is a window for residents to make portfolio investments abroad. The program was established in 2004, but, unlike the QFII, the QDII does not have an overall quota or limit. As of May 2012, \$75 billion was invested abroad by 96 qualified institutional investors.

RQFII: The RMB Qualified Foreign Institutional Investor program allows qualified Hong Kong SAR subsidiaries of foreign institutional investors to use the RMB funds raised in Hong Kong SAR to invest in domestic markets. The program was established in December 2011 with an initial quota of RMB20 billion (US\$3.2 billion) and was raised to RMB70 billion (US\$11 billion) in April 2012, with 80% to be allocated to fixed-income securities and 20% to equities.

While the three programs initiated to date are small, they represent important steps opening and liberalizing the financial sector

Capital Flows to Emerging Market Economies

merchandise trade, but rising incomes and an easing in travel restrictions led to a doubling in tourism payments since 2008 to \$73 billion in 2011. Nevertheless, the shift in the balance services, income and transfers from a surplus to a deficit largely reflects large profit and dividend payments on foreign direct investment, which the government estimates is 11-12% on a stock of \$1.8 trillion at the end of 2011.

BURGEONING AND VOLATILE (TWO-WAY) CAPITAL FLOWS

Despite administrative controls and a cumbersome approval process required by the government on a wide range of foreign exchange transactions, the sharp increase in capital flows during the past several years underscores the move toward currency convertibility and the growing openness of the economy. Capital flows have also become more responsive to changing economic and financial conditions in China and the rest of the world. In contrast to the current account, the divergence in domestic and external conditions after the global financial crisis triggered a surge in capital inflows. Net private capital inflows jumped from \$176 billion in 2009 to a record \$359 billion in 2011. These flows will have been encouraged by the government's qualified investor schemes (see Box 6, previous page).

Foreign direct investment has remained the dominant component of the capital account and demonstrated considerable resilience to volatile global conditions. Although gross inflows dipped during the global financial crisis from \$175 billion in 2008 to \$114 billion in 2009, they quickly rebounded to \$185 billion in 2010 and to a record \$220 billion in 2011. The government does not publish a breakdown of the components of foreign direct investment, but a growing share of the upward momentum is likely to reflect the reinvestment of retained earnings by multinational companies expanding their operations to tap the domestic market.

Chinese foreign direct investment abroad has also grown in importance, although this activity is much less established and consistent than inward investment. After rebounding from almost \$44 billion in 2009 to a record \$60 billion in 2010, gross outflows of foreign direct investment slipped to less than \$50 billion in 2011. Last year's setback is most likely to have been temporary given the rising prominence and sophistication of the Chinese corporate sector. Outward investment is also being encouraged by the government's "going global" policy, which has been more recently supported by reforms allowing local currency to be used for such transactions.

In contrast, the underperforming domestic stock market has tended to discourage inflows of portfolio equity, but debt-creating inflows have grown in importance during the past several years. While a large share of these inflows is intercompany financing associated with foreign direct investment, debt-creating inflows have contributed to capital account volatility. Compared with net repayments of \$12 billion at the onset of the global financial crisis in 2008, net debt-creating inflows steadily rose to a record \$145 billion in 2011.

Capital flows have become more responsive to changing economic and financial conditions in China and the rest of the world

Chinese foreign direct investment abroad has also grown in importance

Capital Flows to Emerging Market Economies

The increase in external borrowing raised total external debt to \$695 billion at the end of 2011 from \$390 billion at the end of 2008. Since about 85% of total external debt is denominated in U.S. dollars, including 8% in Hong Kong dollars, the valuation effect from fluctuations in the dollar accounted for only about 6% of the increase during the past three years. Denomination of the remaining 15% of external debt is roughly split between the euro and yen.

Part of the increase in external debt reflects the growing access of Chinese borrowers, including the government, to international bond markets. Gross new issues of these bonds jumped from \$3.1 billion in 2008 to \$19 billion in 2011, a level maintained so far this year with \$9.5 billion issued in the first five months. Nevertheless, most of the increase in external debt has been in short-term obligations. Medium- and long-term debt rose by \$31 billion between 2008 and 2011 to \$194 billion, but short-term debt more than doubled during the same period to \$501 billion by the end of 2011 to account for 72% of total external debt.

The increase in the volume of cross-border transactions has been accompanied by greater volatility. The capital account surplus rose from \$86 billion in the first quarter of 2011 to \$98 billion in the second quarter, but fell to \$66 billion in the third quarter and shifted into a deficit of \$29 billion in the fourth quarter. The unusual event of net capital outflows during the fourth quarter of 2011 demonstrates China's growing global integration by becoming a source for dollar liquidity like most of the rest of Asia.

The turnaround in the capital account that generated a \$50 billion surplus in the first quarter of 2012 largely reflects improved global liquidity conditions following the ECB's LTRO. The accumulation of official foreign exchange reserves, which slipped from \$92 billion in the third quarter of 2011 to \$12 billion in the fourth quarter, rebounded to \$75 billion in the first quarter of 2012 to bring the total to more than \$3.3 trillion in March. In addition, domestic banks raised their external assets from \$296 billion at the end of 2010 to \$385 billion at the end of 2011 and \$442 billion in March 2012.

Part of the recent volatility in capital inflows also reflects the changing outlook for the Chinese economy. The shift to an accommodative monetary stance, prospects for slower growth and the adjustment in the current account balance tempered market sentiment for an appreciation of the exchange rate in late 2011. The change was reinforced by renewed constancy in the exchange rate against the dollar as the authorities sought to combat the export slowdown. The gradual 7% appreciation of the exchange rate against the dollar since the authorities abandoned the de facto peg in June 2010, slowed toward the end of last year and the RMB depreciated slightly during the first five months in 2012.

Additional confirmation of the change in market sentiment is provided by the 12-month NDF market, which calls for the exchange rate to depreciate to RMB6.39/\$1 from RMB6.33/\$1 as of mid-May 2012. Some loss of exuberance for the RMB has also occurred in the nascent offshore market. RMB deposits in Hong Kong banks rose sharply since mid-2010 to a peak of \$99 billion in November 2011 before slipping to \$88 billion in March 2012. The value of RMB cross-border trade settlement has also remained below the peak of almost \$37 billion reached at the end of 2011.

Part of the increase in external debt reflects the growing access of Chinese borrowers to international bond markets

Capital Flows to Emerging Market Economies

CHINA'S NEAR-TERM CAPITAL FLOW PROSPECTS

While the increase in volatility for both trade and capital flows, accompanied by heightened uncertainty about the global prospects, complicate the task of projecting the near-term outlook, the fundamentals suggest that China's large balance of payments surplus will be sustained. Export growth may only slowly and partially recover from the current slowdown, but the outlook for import growth to remain subdued with slower growth in the domestic economy should help keep the trade surplus at around \$275 billion this year and next. After falling from 10.4% in 2010 to 9.2% in 2011, real GDP growth is set to slip to 8% this year before picking up in response to greater policy stimulus to 8.7% in 2013.

The moderation in external trade and slower growth in the domestic economy may also limit the increase in the deficit on services, income and transfers. In addition to some easing in the past rapid growth in tourism payments, less robust domestic market conditions in China and weak export growth should dampen profit and dividend payments over the near term. These developments mean that the current account surplus should remain around \$225 billion, less than 3% of GDP, this year and next.

The recent surge in net private capital inflows appears to have run its course. After reaching a record \$311 billion in 2011, net private capital inflows are set to moderate to \$199 billion in 2012 and \$152 billion. Despite a further opening to foreign investors, capital account transactions should be tempered by slower growth at home and abroad. While foreign direct investment will remain the largest source of external financing, preliminary reports suggest that net inflows will diminish as inward investment falls and outward investment rises. The outlook for weaker profit and dividend payments in the current account also acts as a restraint on investment inflows arising from retained earnings in the capital account.

While new bond issues are sustaining last year's pace, net debt-creating inflows are likely to recede from \$135 billion in 2011 to \$76 billion this year before picking up to \$87 billion in 2013. In addition to diminished need for funds due to a decline in inward investment, lingering global financial uncertainty should constrain the cross-border exposure of foreign banks. Nevertheless, the large balance of payments surplus should raise official foreign exchange reserves from \$3.3 trillion in March 2012 to \$3.8 trillion by the end of 2013.

The outlook for a balance of payments surplus to be sustained over the near term imparts an upward bias to the exchange rate, suggesting that the recent change in market sentiment favoring a depreciation is at odds with the fundamentals. The sustained positive flow of official foreign exchange reserves also implies that the authorities are intervening in the market. The strengthening in the dollar and sluggish growth in the global economy also suggest that the government will continue to favor a weaker exchange rate with the renminbi slipping below the current RMB6.36/\$1 before strengthening with export growth later next year.

The recent surge in net private capital inflows appears to have run its course

Capital Flows to Emerging Market Economies

EUROPE'S PERIPHERY OFFERS LESSONS FOR EMERGING MARKETS

International capital flows bring important economic benefits to recipient and sending countries alike. However, under particular circumstances foreign capital inflows can also be associated with important risks to financial and macroeconomic stability. Generally speaking, these risks relate to the possibility of a sudden stop in the supply of international capital. The resulting reversal of foreign inflows can bring domestic agents into payment difficulties, reduce credit supply, and weigh on asset prices. The harsh consequences of such reversals were experienced in numerous emerging market crises in the 1980s and 90s, as well as in a number of economies in the European periphery today.

Changes in the supply of foreign capital can come about due to developments in the recipient country, the source country, or global factors. These factors interact in complex ways, which makes it difficult to predict if and when a particular country will experience a crisis. Nonetheless, analyzing the characteristics of a country's external assets and liabilities helps to identify those countries that may be vulnerable to sudden reversals in foreign capital inflows.

Developments in Greece and other Euro Area periphery countries over the past few years provide an instructive example of how the build-up of vulnerabilities is reflected in a country's external accounts. While there are important cross-country differences, all five GIIPS countries shared a common trend in their external positions: they were running persistent current account deficits during the years preceding the global financial crisis of 2008, financed by net inflows of foreign capital. This means the countries' net foreign assets were falling and they were building up a large negative net international investment position (IIP). The net IIP indicates the *level* of net external assets, while the current account balance indicates the *change* in net external assets (excluding valuation effects). Hence, Chart 17 shows the trajectory from a strong to a weak external position as a move from the top-right to the bottom-left corner in the years 2000-2008. Once a critical level of net external liabilities

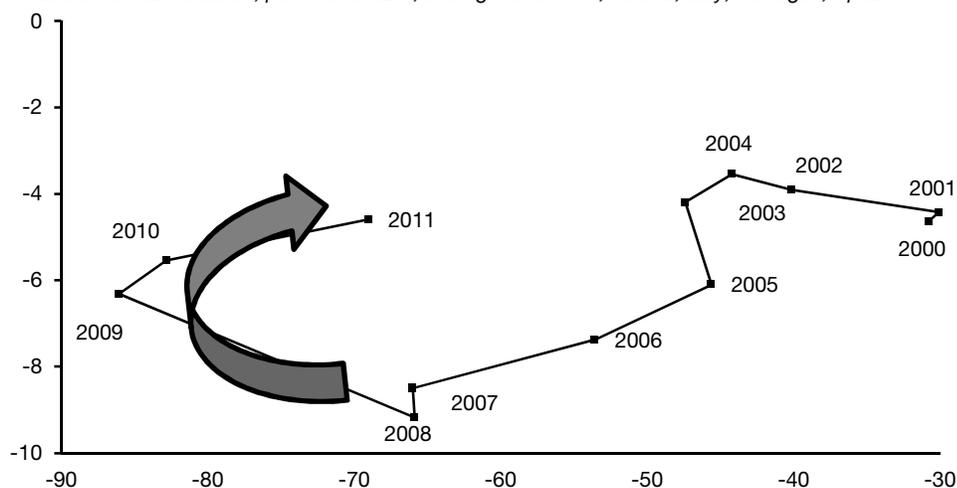
Under particular circumstances foreign capital inflows can also be associated with important risks

European periphery countries were running persistent current account deficits during the years preceding the global financial crisis of 2008

Chart 17

GIIPS: Net International Investment Position and Current Account Balance

current account balance, percent of GDP, average of Greece, Ireland, Italy, Portugal, Spain

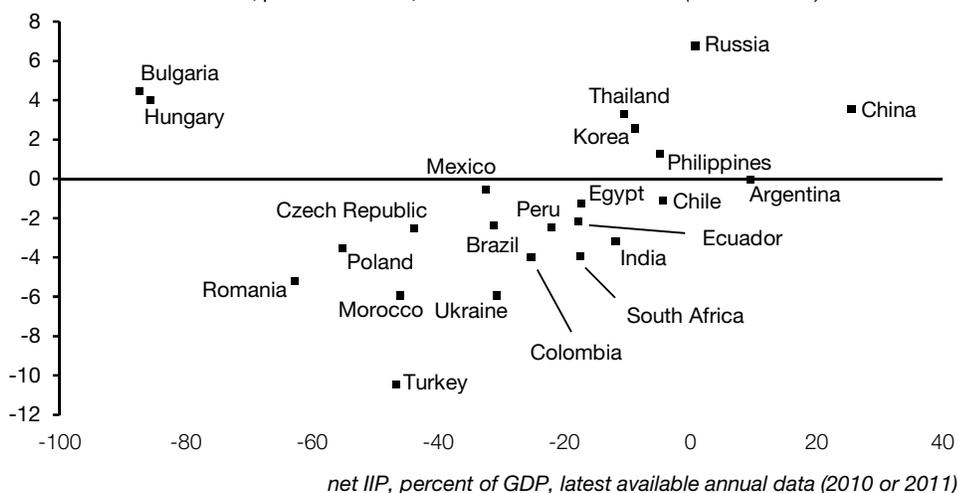


Capital Flows to Emerging Market Economies

Chart 18

Net International Investment Position and Current Account Balance

current account balance, percent of GDP, latest available annual data (2010 or 2011)



was reached, private investors and lenders lost confidence in the ability of some countries to repay their external liabilities, resulting in a sharp drop in the supply of external finance. As a result, countries were forced to reduce their consumption and investment sharply, resulting in an improvement in the current account balance.

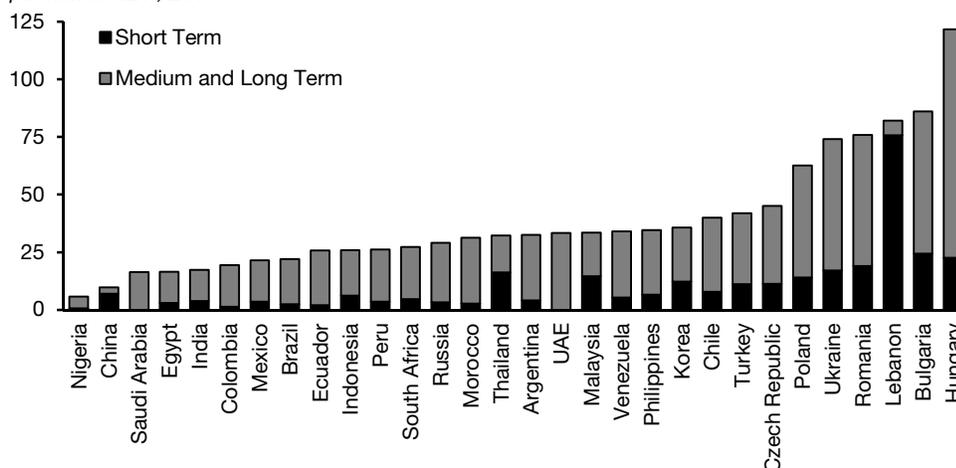
The European periphery's experience serves as a reminder not to lose track of the fundamentals of emerging economies' external positions. The above analysis of current account balances and the IIP can be applied to a cross-section of emerging markets (Chart 18). The bottom left of the chart shows those countries with net external liabilities that are increasing (excluding valuation changes). This particular yardstick would suggest that Turkey, Romania and Morocco are the most dependent on external finance. Of these countries, Romania has already been under an IMF program since 2009, under which it is receiving emergency assistance while undergoing reforms to restore external solvency. By contrast, Turkey's current account deficit widened further to 10% of GDP in 2011 and is projected to be 9.3% this year, a pace of build-up in external liabilities that is unlikely to be sustained (page 29).

Of course, the current account balance and net IIP are but two indicators of external vulnerabilities. Other factors are important when considering risks to the balance of payments. For example, the composition of external liabilities (and assets) is important. For recipient countries some sources of foreign capital are inherently riskier than others. Generally speaking, debt inflows are riskier than equity inflows since equity transfers some of the risk from the recipient to the supplier of capital. This is because returns on equity depend on how an investment performs, whereas debt needs to be serviced and repaid irrespective of an investment's performance. External debt is thus an important indicator of balance of payments risks. This is especially true for short-term debt (i.e. with a remaining maturity of less than a year), since there is a more immediate risk that the debt may not be rolled over.

The composition of external liabilities (and assets) is important for assessing external vulnerabilities

Capital Flows to Emerging Market Economies

Chart 19
Total External Debt
percent of GDP, 2011

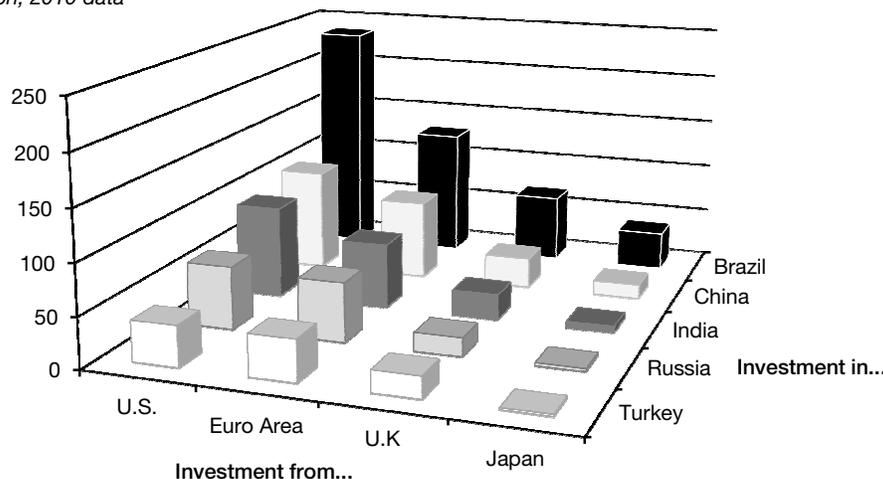


When looking at the same sample of emerging market economies, Hungary stands out as the country with the highest external debt-to-GDP ratio by far (Chart 19). Like Romania, Hungary has already been undergoing an IMF program to restore external solvency since 2010. Notably, the three countries identified previously as having a high dependency on external financing rank quite differently on this metric. Romania is among the countries with the highest external debt burden with external debt at 76% of its GDP, while Turkey's external debt ratio is 42% and Morocco's only 31%.

Another important factor to consider is who holds the claim on a country's external liabilities. The largest suppliers of capital today are the U.S., the Euro Area, the U.K. and Japan (Chart 20). Especially the U.S. and the Euro Area have huge outstanding claims on each of the major emerging market economies. If a particular source country is experiencing economic tensions, this can have direct spillovers to recipient countries of capital flows. Today, given the tensions in the Euro Area, countries that depend heavily on finance from that region are

Another important factor to consider is who holds the claim on a country's external liabilities

Chart 20
Stock of Portfolio Investment from Mature to Emerging Economies
\$ billion, 2010 data



Capital Flows to Emerging Market Economies

likely to be more exposed to shifts in the supply of external finance. Data on outstanding portfolio investment claims show that Turkey and Russia are relatively more exposed to claims from Europe, while India, China and Brazil receive a larger portion of their capital inflows from the United States.

EMERGING ASIA: NAVIGATING GLOBAL TURBULENCE

The recurrent global turmoil brought on by the crisis in the Euro Area is contributing to periodic bouts of risk aversion and pullbacks from regional equity and bond markets. Moreover, deleveraging by European banks remains a drag on capital inflows, along with more stringent global banking regulations. Nevertheless, the relatively strong regional fundamentals, search for yields and liberalization of capital accounts are providing support to capital flows to the region.

Real GDP growth for our seven countries constituting Emerging Asia slowed significantly in 2011 (to 7.6%, from 9.1% in 2010), and will moderate further in 2012, to 7%, before reviving to 7.6% in 2013. These more subdued growth rates continue to outperform the rest of the world, however. Private capital flows to Emerging Asia are likely to be around \$450 billion this year and next, down slightly from around \$530 billion in the previous two

Relatively strong regional fundamentals, search for yields and liberalization of capital accounts are providing support to capital flows to the region

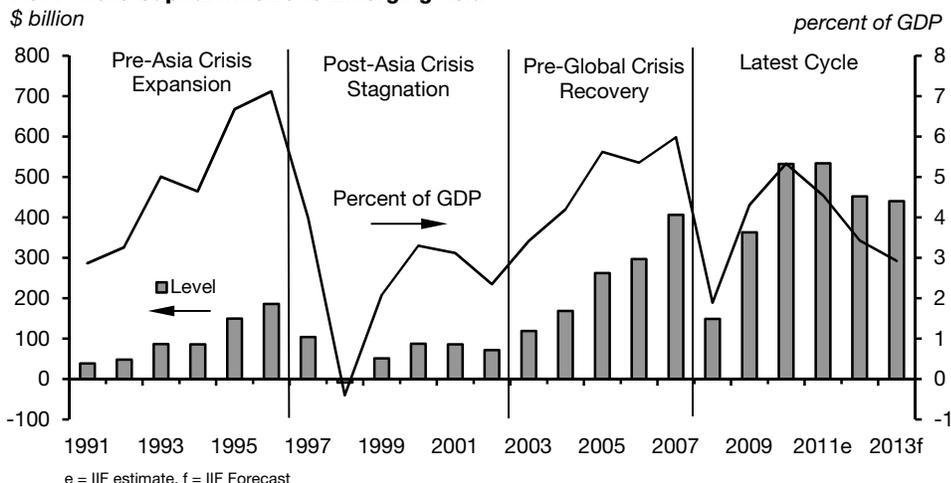
Table 5
Emerging Asia: Capital Flows

\$ billion

	2010	2011	2012f	2013f
Capital Inflows				
<i>Total Inflows, Net:</i>	<u>550.3</u>	<u>551.6</u>	<u>468.6</u>	<u>459.6</u>
Private Inflows, Net	532.1	533.9	452.1	439.7
Equity Investment, Net	330.1	310.7	287.7	270.4
Direct Investment, Net	248.2	298.8	260.8	227.0
Portfolio Investment, Net	81.8	11.9	26.9	43.4
Private Creditors, Net	202.0	223.2	164.4	169.3
Commercial Banks, Net	112.5	119.6	60.4	73.6
Nonbanks, Net	89.5	103.6	104.1	95.7
Official Inflows, Net	18.2	17.7	16.5	19.9
International Financial Institutions	5.5	3.5	3.8	3.7
Bilateral Creditors	12.7	14.2	12.7	16.2
Capital Outflows				
<i>Total Outflows, Net</i>	-894.1	-761.7	-690.0	-668.8
Private Outflows, Net	-232.5	-267.6	-291.7	-337.5
Equity Investment Abroad, Net	-123.3	-99.2	-117.3	-157.1
Resident Lending/Other, Net	-109.1	-168.4	-174.4	-180.4
Reserves (- = Increase)	-595.7	-443.9	-398.4	-331.3
<i>Memo:</i>				
<i>Errors and Omissions</i>	-65.9	<u>-50.2</u>	<u>0.0</u>	<u>0.0</u>
<i>Current Account Balance</i>	<u>343.8</u>	<u>210.1</u>	<u>221.5</u>	<u>209.2</u>

Capital Flows to Emerging Market Economies

Chart 21
Net Private Capital Inflows to Emerging Asia



years (Chart 21 and Table 5). The share of Emerging Asia in total private capital flows to emerging markets is set to edge down from 52% in 2011 to 44.5% in 2013, reflecting a foreign direct investment-led moderation in **China**.

Portfolio equity flows remain quite volatile and subject to global contagion. This depressed foreign purchases of domestic stocks last year, but improving valuations and relatively strong growth should provide support in 2012-13. Foreign portfolio equity inflows slumped from \$82 billion in 2010 to \$12 billion in 2011, but this decline was small relative to the massive outflows of \$54 billion in 2008. So far in 2012, flows have been mixed: there was a revival in the first quarter of 2012, but this was followed by a pullback in the second quarter to date. Nevertheless, foreign portfolio equity purchases should be around \$27 billion in 2012 and \$43 billion in 2013 — absent another major global financial shock.

Deleveraging by foreign banks became more prominent in the fourth quarter of 2011, but the buoyancy earlier in 2011 meant that net new credits extended by them remained around \$120 billion for last year as a whole. While the pace of European bank deleveraging in Asia has slowed somewhat in recent months, and has been offset by inflows from other nationalities of banks — including from within Asia — net bank flows are set to fall to around \$60 billion this year and be around \$74 billion in 2013, which is 35-40% below the level prevailing in 2010 and 2011.

By contrast, net inflows from nonbank private creditors rose from \$90 billion in 2010 to a record \$104 billion in 2011, and are set to remain high at \$100 billion a year over the near term. The global contagion contributed to a sell-off of domestic bonds by foreign investors late last year, but this came after large purchases earlier in the year. There was reduced risk aversion and increased foreign purchases in the first quarter of this year, before another slippage due to renewed uncertainty in Europe. While periodic swings will persist due to volatile global conditions, borrowers from Emerging Asia are taking advantage of relatively low yields to increase issuance of international bonds. **Indonesia** is a case in point, where

Portfolio equity flows remain quite volatile and subject to global contagion

Capital Flows to Emerging Market Economies

BOX 7: INDIA'S BALANCE OF PAYMENTS TRAVAILS

In contrast to the rest of the region, India is the only country running a large current account deficit, which is likely to have jumped to a record high of \$72 billion, 3.9% of GDP, in the fiscal year ending March 2012, from \$46 billion in 2010/11. The widening of the current account deficit resulted from a \$45 billion surge in oil imports to \$140 billion and a \$20 billion increase in gold imports to \$50 billion, both on a fob basis, largely due to higher prices. At the same time, private capital inflows fell from \$81 billion in 2010/11 to \$72 billion in 2011/12 because of the global turmoil as well as an expanding list of negative domestic factors, including fractious politics stymieing structural reforms and governance lapses.

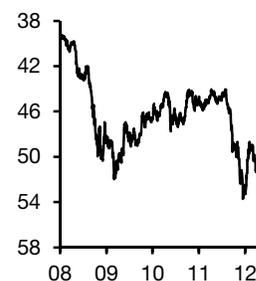
The slippage in private capital inflows in 2011/12 was led by an \$8 billion decline to \$13 billion in foreign portfolio equity inflows along with a \$13 billion slump to \$5.5 billion in net new credits from foreign banks. In contrast, inflows of foreign direct investment rose by \$10 billion to a record high of \$36 billion in 2011/12. In addition, the raising of limits last December on foreign holdings of domestic bonds along with higher interest rates on non-resident Indian (NRI) deposits in domestic banks to shore up the balance of payments boosted inflows from other private creditors by \$2 billion to \$18 billion. Nevertheless, the higher current account deficit and lower private capital inflows weakened the balance of payments and put downward pressure on the rupee.

While the central bank resorted to some intervention, as evident from the fall in official foreign exchange reserves from \$294 billion in August 2011 to \$262 billion in late-May 2012, the rupee fell from a high of Rs43.8/\$1 in late July to a low of Rs54.3/\$1 in mid-December before reviving to Rs49/\$1 at the end of February (Chart 22). Thereafter, the rupee again came under pressure to fall to \$55.5/\$1 at the beginning of June due to the return of global risk aversion, policy missteps in the mid-March budget and the slew of negative news. While the budget for 2012/13 planned a modest deficit correction, it was dependent on the reduction of fuel and fertilizer subsidies.

Moreover, it contained two controversial tax measures on foreign investment. The first measure, which is being implemented, calls for the government to retroactively tax capital gains from the sale of a company outside India, when the operating assets are in India and no taxes have been paid in another jurisdiction. The move to amend the law was prompted by tax demands of Rs110 billion (\$2.2 billion) from the sale of the Indian telecom business of Hutchison Whampoa to Vodafone in 2007 being struck down by the Supreme Court, due to lack of clarity of the existing law. Several other cases with tax demands totaling Rs350 billion (\$7 billion) are also under litigation. While the passage of the amendment in early May changes the 1962 tax act, the government reaffirmed that the statute of limitation for a tax case will remain at six years in an effort to allay investor concerns that 50 year-old tax cases could be reopened.

The budget also called for the government to impose General Anti-Avoidance Rules (GAAR) to curb the use of shelters for tax evasion, including tougher residency-proving

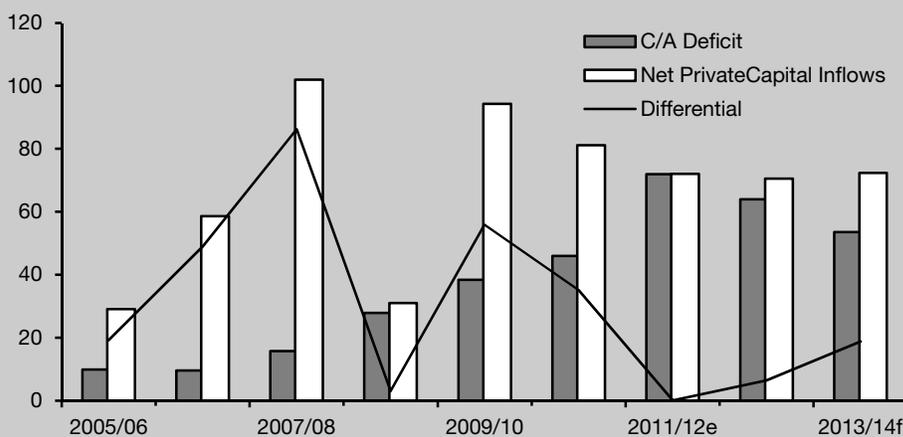
Chart 22
India: Exchange Rate
Rs per \$, inverted scale



Capital Flows to Emerging Market Economies

Chart 23
India: Net Private Capital Inflows and C/A Deficit

\$ billion



e = IIF estimate, f = IIF forecast

requirements for jurisdictions such as Mauritius, with which India has a tax treaty and through which a large part of foreign investment is routed. Concern about the onerous provisions of the GAAR and uncertainty about the changes potentially triggering taxation of short-term capital gains of foreign portfolio equity inflows prompted the government in early May to delay its implementation to April 2013. Moreover, the GAAR is to be revised to make it more investor friendly, including placing the onus of proving a tax violation on the tax authorities.

In an effort to shore up the capital account, the central bank in early May also moved to require exporters to repatriate 50% of their export earnings placed in special accounts, which are around \$5 billion in total. Moreover, the central bank increased the interest rate on foreign currency NRI deposits from 125 basis points to 200 basis points above Libor for up to three-year tenor and to 300 basis points above Libor for three- to five-year tenor. In addition, the authorities resorted to further administrative measures by placing limits on intraday net open positions of foreign exchange dealers to curtail currency speculation.

The weakness in India's external position stems in part from the import-induced surge in the current account deficit over the past year. This unsustainably large deficit should start to moderate from the second half of 2012/13 with the recent fall in elevated global oil prices, decline in gold prices and the imposition of a 4% tariff on gold imports from April. The current account deficit should progressively decline to \$64 billion in 2012/13 and \$54 billion in 2013/14, 2.3% of GDP.

Our base case scenario also calls for private capital inflows to stabilize at around \$72 billion this fiscal year and next. Net inflows of foreign direct investment may slip to \$26 billion in 2012/13 due to the tax controversy, before reviving somewhat to \$30 billion in 2013/14 as some of the concerns dissipate with more positive steps by

The weakness in India's external position stems in part from the import-induced surge in the current account deficit over the past year

Capital Flows to Emerging Market Economies

the government. In addition, foreign purchases of domestic stocks should stabilize at around \$13-16 billion this fiscal year and next with the move to delay as well as revise the GAAR to allay investor concerns. In addition, moderate foreign bank lending, higher limits on foreign holdings of domestic bonds and rising NRI deposits should be positive for the balance of payments.

Before the global crisis, private capital inflows exceeded the current account deficit by a massive \$86 billion in 2007/08. The positive differential fell sharply to \$3 billion in 2008/09 as private capital inflows declined, before rising to \$56 billion in 2009/10 and \$35 billion in 2010/11 with the recovery in the capital account (Chart 23). In 2011/12, it again plunged to only \$0.1 billion with the surge in the current account deficit. Over the near term, the differential should gradually rise to \$6.5 billion in 2012/13 and \$19 billion in 2013/14 as the current account deficit falls and private capital inflows stabilize.

In the meantime, the large holdings of official foreign exchange reserves provide a cushion against global shocks, with the central bank stepping up its intervention coupled with the use of administrative measures. Nevertheless, an improvement in the current account position could take some time to materialize, while the heavy reliance on external financing means continuing vulnerability to recurring bouts of global financial turmoil and unpredictable changes in investor sentiment over the near term.

\$9 billion was raised through international bonds so far this year, up from \$6 billion in all of 2011.

Inflows of foreign direct investment are set to remain another source of strength for the region due to the attraction of regional production and service bases for exports as well as large domestic markets. Inflows remain dominated by China, but FDI into China now seems to be declining thanks to rising wages and some diversification of production bases to reduce concentration risk. Inflows of foreign direct investment into the region as a whole rose from \$250 billion in 2010 to a record \$300 billion in 2011, but may slip somewhat to \$260 billion in 2012 and \$230 billion in 2013. China's share of total regional net inward FDI is projected to fall from 75% in 2010 to 66% in 2013.

The aggregate regional current account surplus is set to stabilize at around \$210 billion a year over the near term. It dropped to that level in 2011 from \$344 billion in 2010 because of the smaller surplus in China. While most countries in Emerging Asia run external surpluses, **India's** current account deficit has widened, and has brought the country's balance of payments back into focus (see Box 7, pages 25-27).

Emerging Asia will remain a major exporter of capital, although there is an interesting shift underway in the composition of outflows. The accumulation of official foreign exchange reserves remains substantial, but has moderated significantly in from 2010. Outflows from private investors in Asia (some into the rest of the region) have picked up significantly,

Inflows of foreign direct investment are set to remain another source of strength for the region

Capital Flows to Emerging Market Economies

however. In 2013, we project net private outflows to exceed net official outflows for the first time in recent history.

Outward foreign direct investment is set to increase from around \$107 billion in 2010 to a record high of \$141 billion in 2013 as corporations move to secure natural resource supplies as well as expand global marketing and production operations. Moreover, loans abroad by residents are set to increase from \$110 billion in 2011 to \$181 billion in 2013, reflecting in large part the expansion of regional banks rather than bond market investments. In contrast, outward portfolio equity investments remain around \$10-16 billion a year over the near term, compared with the previous record high of \$74 billion in 2007, partly reflecting uncertainty about the global outlook.

EMERGING EUROPE: DELEVERAGING, UNCERTAINTY CONSTRAIN INFLOWS

Weakening output growth, bank deleveraging and lingering worries about the Euro Area public debt crisis caused private sector inflows in 2012Q1 to fall by two-thirds from a year earlier, to just \$18 billion, net. Resident capital outflows slowed to a lesser extent, from \$38 billion to \$28 billion. The decline in foreign inflows was centered in bank lending as deleveraging by foreign parents and sluggish demand for credit resulted in accelerated net repayments to foreign parents. Direct equity inflows slowed, as did intercompany lending, in line with the slowdown in Western Europe. Bond issues resumed, but were smaller than a year earlier. Portfolio equity inflows firmed, by contrast, as did foreign purchases of local currency denominated bonds as global risk appetite firmed after the ECB's LTRO.

Foreign capital inflows fell across the region, with the declines being the largest in **Russia, Poland and Hungary**. In Russia, the drop was mainly driven by the heightened uncertainty ahead of the March presidential election, while in Poland it was largely due to the withdrawal of foreign portfolio equity. The shift to large outflows in Hungary reflected accelerated debt repayments to foreign banks following the early repayment by households of some \$6.5 billion in domestic foreign-exchange denominated loans.

Assuming that the Euro Area public debt crisis is contained, private capital inflows should firm later in the year (in 2012Q1, they were tracking at about half the projected annual rate). Reduced political uncertainty should help boost foreign inflows and reduce capital outflows in Russia. Market confidence should be strengthened also by the recent agreement of the Hungarian government to amend several controversial laws that should open the door for negotiating a new program with the IMF and the EU. Net private flows look likely to return to last year's pace as a result, reaching \$145 billion for the year as a whole. This would be 21% less than in 2011. Most of the decline will reflect larger net repayments to foreign banks and smaller trade financing and intercompany lending. Bond issues would be smaller as fiscal deficits narrow and investment remains subdued. Direct equity investment should recover, by contrast, as will portfolio equity inflows and foreign purchases of local currency government bonds.

Assuming further output recovery and progress in addressing the Euro Area crisis, private

Weakening output growth, bank deleveraging and worries about the Euro Area public debt crisis caused private inflows to drop sharply in the first quarter

Capital Flows to Emerging Market Economies

Table 6
Emerging Europe: Capital Flows
\$ billion

	2010	2011e	2012f	2013f
Capital Inflows				
<i>Total Inflows, Net:</i>	<u>216.0</u>	<u>199.0</u>	<u>147.3</u>	<u>203.1</u>
Private Inflows, Net	192.2	184.5	144.9	202.9
Equity Investment, Net	70.5	65.0	80.2	94.0
Direct Investment, Net	64.3	71.8	79.7	84.8
Portfolio Investment, Net	6.2	-6.8	0.6	9.2
Private Creditors, Net	121.7	119.5	64.6	108.9
Commercial Banks, Net	4.2	-2.7	-9.7	13.6
Nonbanks, Net	117.5	122.2	74.3	95.2
Official Inflows, Net	23.8	14.5	2.4	0.2
International Financial Institutions	15.9	10.1	1.7	0.5
Bilateral Creditors	7.9	4.4	0.7	-0.3
Capital Outflows				
<i>Total Outflows, Net</i>	-214.9	-189.8	-134.0	-120.5
Private Outflows, Net	-101.7	-167.0	-127.1	-126.4
Equity Investment Abroad, Net	-48.6	-46.2	-53.1	-63.5
Resident Lending/Other, Net	-53.1	-120.8	-74.0	-62.9
Reserves (- = Increase)	-83.6	-21.3	-7.0	5.9
<i>Memo:</i>				
<i>Errors and Omissions</i>	<u>-29.7</u>	<u>-1.5</u>	<u>0.0</u>	<u>0.0</u>
<i>Current Account Balance</i>	<u>-1.0</u>	<u>-9.2</u>	<u>-13.2</u>	<u>-82.6</u>

capital inflows look set to increase to \$203 billion in 2013, the highest level since 2008 (Table 6). Most of the increment is likely to reflect stepped-up intercompany lending and corporate bond issues. Direct equity and portfolio investment look likely to rise as well. Even so, FDI inflows will remain small relative to the 2006-2008 average. The most dramatic change has occurred in net bank lending, however. Even with some projected increase in 2013, net lending will have been negative in the period 2009-13.

While capital inflows are likely to decline across the region this year, countries with large macroeconomic imbalances and external borrowing needs are likely to remain most at risk. Of these, the risks for financial disruptions are the highest and rising in **Ukraine**. Risks appear to have risen also in **Romania** amid political turmoil ahead of parliamentary elections scheduled for November, but have eased in **Hungary**. **Turkey**, on the other hand, with a large current account deficit and borrowing needs, could come under pressure, too.

Financing pressures have intensified the most in Ukraine, where terms of trade losses and expansionary policies have left the current account deficit on track to exceed 7% of GDP. With market access lost and IMF lending suspended because of the government's reluctance to adjust domestic energy prices, a deficit of this magnitude is not financeable. Efforts to obtain a discount from Russia on the natural gas import price have failed as well. Unless the authorities obtain such a discount or advance the reforms needed to secure

Financing pressures have intensified the most in Ukraine

Capital Flows to Emerging Market Economies

renewed IMF support, the odds for major financial disruptions will grow later in the year.

Growing political tensions have increased risks perceptions about **Romania**, where structural deficiencies have kept the current account at 4%-5% of GDP despite a weak growth performance. Private sector financing has been difficult to come by, with domestic banks repaying foreign debt and FDI inflows markedly smaller. Risks should be contained by the precautionary IMF agreement, but odds for fiscal slippages have risen. Risks perceptions have eased in **Hungary**, by contrast, with improved prospects for a new IMF program reducing concerns about the refinancing of large repayments due official creditors.

Turkey's large current account deficit remains a source of concern as well. While external financing has been stable thus far, the bulk of it consisted of portfolio equity and debt inflows and unidentified capital, both resident and foreign, all of which would be subject to a quick reversal if risk appetite weakens again. With structural deficiencies likely to keep the current account deficit outsized at 7%-8%GDP through 2013, external financing needs will remain large, leaving Turkey vulnerable to shifts in market sentiment.

LATIN AMERICA: INVESTMENT MAGNET

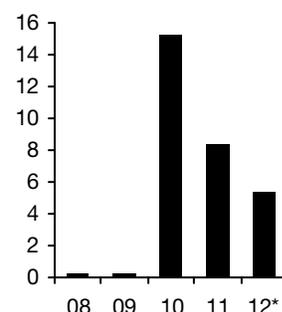
Net private capital inflows to Latin America are projected to remain in the range of \$250 to \$255 billion in 2012, broadly unchanged from last year despite Euro Area uncertainties (Table 7, next page). The overall stability of capital inflows, nonetheless, masks three underlying developments: 1) a moderate decline in net inflows by commercial banks consistent with ongoing deleveraging in Europe; 2) a modest rebound of portfolio equity inflows, and (3) robust net foreign direct investment (FDI). We expect net private capital inflows to strengthen to over \$270 billion in 2013. FDI remains the main driver of private inflows despite worsening investment climates in some countries. We expect net FDI inflows of \$84 billion this year and next, up from \$69 billion in 2011, reflecting relatively stronger growth prospects, abundant commodity export bases and a rising middle class. Amid increased policy resistance to local currency appreciation, we expect international reserves to further increase, albeit at slower pace than in 2011.

China has gained prominence as a major source of investment in Latin America. Chinese FDI inflows to the region rose from virtually nothing to \$15 billion in 2010 and \$8 billion in 2011 (Chart 24). The bulk of this investment (over \$20 billion) has gone toward the acquisition of energy assets in Brazil and Argentina: Sinopec purchased stake in Petrogal Brasil for \$4.8 billion in March after acquiring assets of Repsol in Brazil for \$7.1 billion and Occidental Petroleum in Argentina for \$2.5 billion in prior years. Thus far, Chinese investment has primarily aimed at securing access to natural resources, but it has also involved strategic moves by manufacturers (auto- and steelmakers) to tap into large domestic markets by setting up local plants (Brazil).

Latin America is characterized by three distinct types of countries when it comes to attracting equity investment:

We expect net private capital inflows to strengthen to over \$270 billion in 2013

Chart 24
LatAm: FDI from China
\$ billion



* Through April
Source: ECLAC

Capital Flows to Emerging Market Economies

1. **Large domestic markets:** Despite growing risks of policy slippage, FDI inflows to **Brazil** have continued to grow as investors seek to secure market share in one of the world's largest emerging economies. Discriminatory capital inflow controls that punish nonresident portfolio fixed-income vis-à-vis equity investment (not subject to controls) have amplified equity inflows. Net FDI inflows to Brazil rose to \$42 billion in the year through March, up from \$18 billion a year ago.
2. **Anti-business policies:** Interventionist state policies and legal instability have prevented **Argentina** and **Venezuela** from fully benefiting from abundant oil reserves and global appetite for regional assets. In Argentina, the nationalization of the oil company YPF and steady policy weakening have further eroded business confidence. Policy radicalization is bound to dampen private sector investment (foreign and local), reduce trend real GDP growth and exacerbate underlying price pressures. We forecast FDI inflows to Argentina to decline to \$3.5 billion this year, the lowest level in several decades as a share of total FDI inflows to Latin America (Chart 25, page 33).
3. **Stable pro-market policies:** **Colombia, Chile** and **Peru** are reaping the benefits of sustained policy discipline, stable investment rules and structural reforms. These countries have not only managed to attract significant equity inflows, but have also

Interventionist state policies and legal instability have prevented Argentina and Venezuela from fully benefiting from abundant oil reserves and global appetite for regional assets

Table 7
Latin America: Capital Flows
\$ billion

	2010	2011e	2012f	2013f
Capital Inflows				
<i>Total Inflows, Net:</i>	<u>289.6</u>	<u>283.0</u>	<u>274.1</u>	<u>295.9</u>
Private Inflows, Net	265.6	253.7	252.9	272.7
Equity Investment, Net	138.1	133.5	145.5	156.8
Direct Investment, Net	94.6	115.8	117.9	123.0
Portfolio Investment, Net	43.5	17.6	27.6	33.7
Private Creditors, Net	127.5	120.2	107.4	116.0
Commercial Banks, Net	34.2	25.9	21.2	30.5
Nonbanks, Net	93.3	94.4	86.2	85.5
Official Inflows, Net	24.0	29.3	21.2	23.2
International Financial Institutions	6.0	8.9	5.2	6.4
Bilateral Creditors	18.1	20.4	16.1	16.8
Capital Outflows				
<i>Total Outflows, Net:</i>	-244.7	-233.1	-199.0	-194.9
Private Outflows, Net	-168.0	-137.2	-120.9	-140.6
Equity Investment Abroad, Net	-65.3	-43.5	-41.4	-51.2
Resident Lending/Other, Net	-102.7	-93.7	-79.5	-89.4
Reserves (- = Increase)	-80.2	-98.9	-78.1	-54.3
<i>Memo:</i>				
<i>Errors and Omissions</i>	<u>3.5</u>	<u>3.1</u>	<u>0.0</u>	<u>0.0</u>
<i>Current Account Balance</i>	<u>-44.9</u>	<u>-49.9</u>	<u>-75.1</u>	<u>-101.0</u>

Capital Flows to Emerging Market Economies

become the key players in vibrant intra-regional investment. This is particularly the case of Chile, a major regional capital exporter (Chart 26, next page). Several factors are underpinning intra-regional investment flows (FDI and portfolio equity):

- Growing internationalization of local companies amid sounder corporate governance frameworks;
- Increased stability and openness of some regional economies, which augurs well for medium-term profit growth; and
- In-depth knowledge of regional idiosyncrasies and business practices.

While corporations from Brazil and Mexico have focused their expansion mainly on Europe and the U.S., mid-sized countries have prioritized the Latin American market. Chilean corporates have invested mainly in the retail, pulp, financial and transportation sectors in Colombia, Argentina, Brazil, Uruguay and Peru. Colombian firms, on the other hand, have

Table 8
Latin America: Major Intra-Regional Investments, 2006-2012

	Sector	Value (\$ million)
Argentina:		
2012: Ternium acquires 15% stake in Usiminas (Brazil)	Mining	2,823
2007: Arcos Dorados acquires MacDonald's LatAm operations	Retail	700
2007: Ternium acquires mining company Grupo Imsa (Mexico)	Mining	1,727
Brazil:		
2012: Banco BTG Pactual acquires Celfin Capital (Chile)	Financial	600
2011: Banco do Brasil acquires 50% stake in Banco Patagonia (Arg)	Financial	480
2010: Votorantim acquires controlling stake in miner Milpo (Peru)	Mining	419
2009: Vale do Rio Doce acquires Rio Tinto potash assets (Argentina)	Mining	850
2007: Banco Itaú acquires BankBoston Uruguay	Financial	650
2006: AmBev acquires controlling stake in Quilmes (Argentina)	Consumer	1,200
Chile:		
2011: CorpBanca acquires Santander Colombia (Colombia)	Financial	1,225
2011: Copec enters Montes del Plata pulp mill joint venture	Materials	950*
2010: Censosud acquires grocery chain Bretas (Brazil)	Retail	811
2009: CMPC acquires unit of Aracruz Cellulose (Brazil)	Materials	1,430
Colombia:		
2012: Davivienda acquires Central America operations of HSBC	Financial	801
2011: Grupo SURA acquires Latin American assets of ING	Financial	3,614
2010: Grupo Aval acquires BAC-Credomatic GECF (Panama)	Financial	1,920
Mexico:		
2010: Grupo Casa Saba acquires Farmacias Ahumada (Chile)	Retail	604
2010: Direct TV Latin America acquires Sky (Brazil)	Telecom	605
2006: Telmex buys remaining shares in Embratel (Brazil)	Telecom	786

Capital Flows to Emerging Market Economies

Chart 25

Argentina: FDI Inflows

percent of total FDI to Latin America

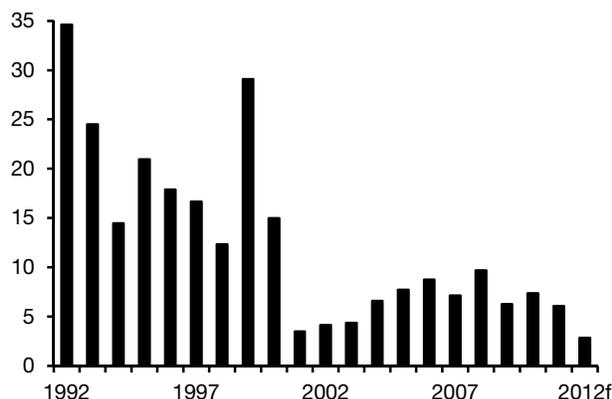
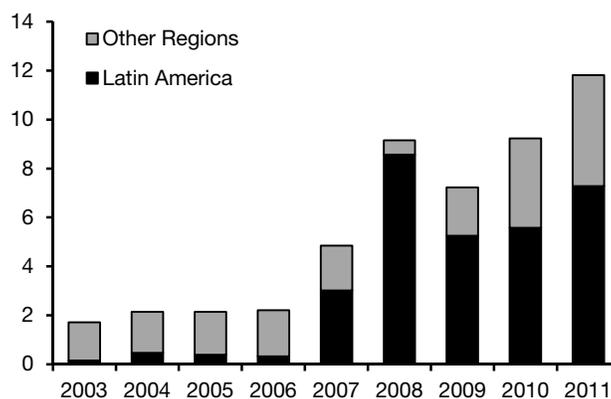


Chart 26

Chile: Outbound FDI

\$ billion



invested in the primary and financial sectors in Central America. In 2011, Colombian investment firm Grupo Sura acquired the pension and life insurance units of Netherlands-based ING in five Latin American countries (including Mexico) for \$3.6 billion, one of the largest operations ever for a Latin American corporate. Investment abroad by Argentinean companies seems to respond to a desire to diversify away from Argentina risk (Table 8, previous page).

AFRICA AND MIDDLE EAST: PRIVATE CAPITAL INFLOWS REMAIN SUBDUED

Net private capital flows for our sample of seven countries constituting Emerging Africa and the Middle East are estimated to have been \$58 billion in 2011, \$41 billion lower than in 2010. This sharp fall is explained by the political turmoil in **Egypt**, which led to a shift from a net capital inflow position of \$21.5 billion in 2010 to a net outflow position of \$3.5 billion in 2011, and the end of the foreign investment cycle in the energy sector in Saudi Arabia (Chart 27). Nonresidents sharply reduced their holdings of Egyptian Treasury bills and equity positions. With the central bank defending the currency, foreign exchange reserves fell from a peak of \$33.6 billion at end-2010 to \$15.2 billion at end-April. Flows into **Saudi Arabia** also fell in 2011 as previously held balances with GCC banks flowed out in response to the liquidity squeeze in the Euro Area.

We project private flows for the seven countries under consideration to rise gradually to \$62 billion in 2012 and \$79 billion in 2013, still well below the levels reached in each of the years between 2006-2008 (Table 9). The expected modest improvement in inflows is largely explained by a modest recovery in capital flows to Egypt as the political situation gradually improves, following the presidential election starting in late May 2012. Liberalization of non-resident equity investment regulations should also increase equity flows.

This improvement in capital flows to Egypt also hinges on an agreement with the IMF (a loan facility of \$3.2 billion) in the next few months, which could also mobilize additional financing from multilateral and bilateral creditors. Even with modest exchange rate flexibility, Egypt's

Private capital flows amounted to \$58 billion in 2011, \$41 billion lower than in 2010

Capital Flows to Emerging Market Economies

gross external financing needs for 2012 and 2013 are in excess of \$25 billion. Capital markets are unlikely to provide more than half of these funds, and thus timely official financing will be critical.

For the seven countries, FDI is expected to increase from \$37 billion in 2011 to \$46 billion by 2013, still well below the levels reached in 2005-2010. Portfolio equity flows to the region will rise but remain small. Several countries in the region remain large exporters of capital with wider current account surpluses resulting from higher oil and gas revenue.

Official foreign exchange reserves (excluding sovereign wealth funds, SWFs) for the seven countries are expected to continue rising from \$743 billion in 2011 to \$888 billion at end-2012, led by Saudi Arabia. The accumulation of foreign assets in the UAE is reflected largely in the Emirates' SWFs, which are expected to increase to \$630 billion by the end of this year. Real GDP growth for the group is expected to moderate from 4.7% to around 4.0% in 2012 and 2013 due to a deceleration in the growth of crude oil production in Saudi Arabia and the UAE.

Global market conditions are the main determinant of flows into **South Africa** where there are large, liquid bond and equity markets, making the country the main recipient of financial flows in the Sub Saharan African region. Over the past few years when interest rates in the

For the seven countries, FDI is expected to increase from \$37 billion in 2011 to \$46 billion by 2013

Global market conditions are the main determinant of flows to South Africa

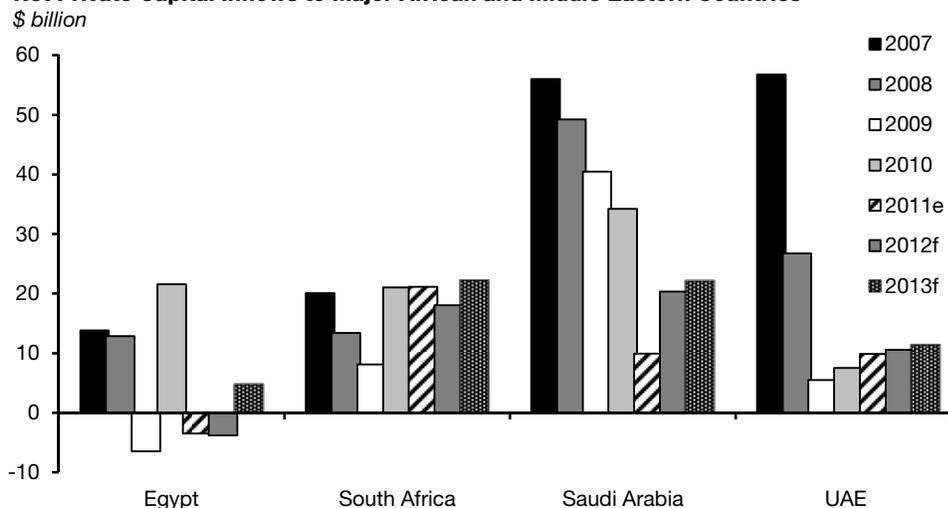
Table 9
Africa and Middle East: Capital Flows

\$ billion

	2010	2011e	2012f	2013f
Capital Inflows				
<i>Total Inflows, Net:</i>	<u>100.9</u>	<u>59.5</u>	<u>68.8</u>	<u>86.8</u>
Private Inflows, Net	98.1	57.6	62.5	79.1
Equity Investment, Net	68.1	35.7	46.3	55.7
Direct Investment, Net	51.5	37.4	40.2	46.5
Portfolio Investment, Net	16.6	-1.6	6.2	9.2
Private Creditors, Net	30.1	21.9	16.1	23.3
Commercial Banks, Net	8.2	0.3	1.3	5.3
Nonbanks, Net	21.9	21.5	14.8	18.1
Official Inflows, Net	2.8	1.9	6.4	7.7
International Financial Institutions	3.8	2.0	4.7	6.8
Bilateral Creditors	-1.0	-0.1	1.7	0.9
Capital Outflows				
<i>Total Outflows, Net</i>	-160.3	-246.4	-270.0	-216.0
Private Outflows, Net	-105.2	-143.6	-123.0	-102.6
Equity Investment Abroad, Net	-33.1	-37.3	-39.6	-39.1
Resident Lending/Other, Net	-72.1	-106.3	-83.4	-63.5
Reserves (- = Increase)	-42.7	-104.4	-147.0	-113.4
<i>Memo:</i>				
<i>Errors and Omissions</i>	<u>-12.4</u>	<u>1.7</u>	<u>0.0</u>	<u>0.0</u>
<i>Current Account Balance</i>	<u>59.4</u>	<u>186.9</u>	<u>201.2</u>	<u>129.2</u>

Capital Flows to Emerging Market Economies

Chart 27
Net Private Capital Inflows to Major African and Middle Eastern Countries



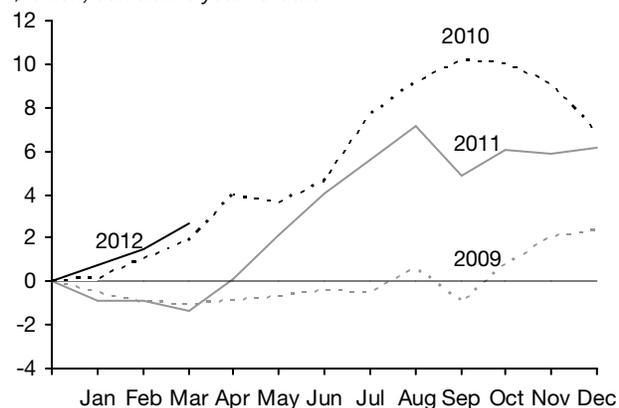
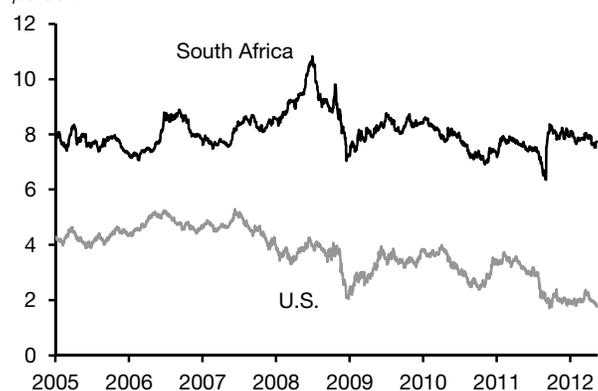
mature economies have been at historic lows, South Africa benefitted from the carry trade. In 2011, nonresidents purchased \$6.2 billion worth of fixed income securities following a record \$6.7 billion the year before (Chart 28). With the crisis in the Euro area and exceptional monetary easing in the U.S., the Euro Area and Japan likely to keep bond yields in mature markets low for some time to come, the yield differential between South Africa and these markets is likely to remain wide (Chart 29).

Against this background, we expect inflows into the bond market to remain robust over the next couple of years. In addition, the likely inclusion of South Africa in the Citibank World Global Bond Index (WGBI) in October, with a weight of around 0.43%, would broaden its investor base and trigger buying by index trackers. The only emerging markets currently included in the 22 country index are Malaysia, Poland and Mexico. More generally, foreign investors appear comfortable at present with the level of risk associated with South African paper. Although inflation has hit the upper limit of its 3-6% target range, it is likely to moderate later in the year and no monetary tightening is likely before 2013. The budget deficit, meanwhile, is projected to narrow, and the government debt-to-GDP ratio is projected to plateau at around 42%, allaying any lingering concerns over debt sustainability.

Flows into **Nigeria** tend to be foreign direct investment, primarily but not exclusively into the oil and gas sector. However, investment has been held back recently due to the continued delay in passing the Power Industry Bill, enabling legislation that is key to reforming the whole energy and power sector (including upstream and downstream oil activities, the gas sector, and electricity generation and distribution). Once passed, this could result in a new wave of FDI. Portfolio flows are less significant and in a bid to attract increased inflows, the Central Bank last year abolished the requirement that foreign investors must hold naira-denominated government debt for at least a year. Since then, the yield on 10-year government bonds has risen sharply, and currently stands at over 15%, providing an attractive carry trade opportunity. Inflation jumped at the beginning of 2012 following the

The likely inclusion of South Africa in the Citibank World Global Bond Index (WGBI) in October, with a weight of around 0.43%, would broaden its investor base and trigger buying by index trackers

Capital Flows to Emerging Market Economies

Chart 28
South Africa: Nonresidents' Purchases/Sales of Bonds
\$ billion, cumulative year-to-date

Chart 29
South Africa: 10-year Government Bond Yields
percent


partial removal of subsidies on gasoline, and, in April, the 12-month inflation rate stood at 12.9%, suggesting that yields will remain high this year. However, recent terrorist attacks and social unrest have increased currency risk which may dampen foreign investor appetite for the time being, despite the attractive interest rate differential.

IIF CAPITAL FLOW REPORT COUNTRY SAMPLE (30)
Emerging Europe
(8)

Bulgaria
Czech Republic
Hungary
Poland
Romania
Russian Federation
Turkey
Ukraine

Latin America
(8)

Argentina
Brazil
Chile
Colombia
Ecuador
Mexico
Peru
Venezuela

Emerging Asia
(7)

China
India
Indonesia
Malaysia
Philippines
South Korea
Thailand

Africa/Middle East
(7)

Egypt
Lebanon
Morocco
Nigeria
Saudi Arabia
South Africa
UAE

For questions about our capital flows data, please consult the User Guide located on our website at www.iif.com/emr/global/capflows.