



June 26, 2013

- Private capital inflows to EM economies are forecast to fall in 2013 and 2014
- Market volatility amid concerns about an end to ultra-easy U.S. monetary policy will continue to weigh on flows
- Weaker growth in emerging economies contributes to the worsening outlook
- Some EM economies seem vulnerable to a retrenchment of foreign capital
- Other EMs have become important sources of external financing in the global economy, with EM private outflows projected to rise to \$1 trillion this year

FLOWS FEAR THE FED

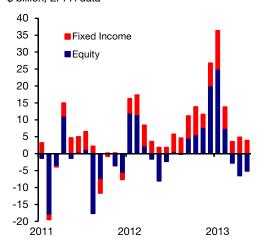
The environment for capital flows to emerging economies has worsened recently. Global risk aversion has surged amid concerns about the duration of ultra-easy U.S. monetary policy, sending ripples through EMs. EM currencies have plummeted in recent months, driven in part by a reversal of portfolio equity flows and reduced bond inflows since March (Chart 1).

Overall, we project that private capital inflows to EMs will amount to \$1,145bn this year, a decline of \$36bn relative to 2012 (Chart 2 and Table 1, next pages). For 2014, we envisage a further decline to \$1,112bn – the lowest level since 2009. Relative to our January Capital Flows Report, we have revised up our estimate of flows in 2012 and, to a lesser extent, in 2013, but lowered our 2014 forecasts. Capital outflows by EM residents continue to grow, with "private" (non-reserve) outflows projected to reach \$1 trillion in 2013, a 10-fold increase since the early 2000s (see page 11).

Chart 1
Selected Emerging Market Currencies index, 1/1/2011=100, drop=EM







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A key driver of capital inflows over past years had been loose monetary policies in mature economies, which were "pushing" money into the EM world. This was helped by strong growth in EMs, "pulling" money into those countries. We developed a quantitative framework for this "push-pull" analysis in our <u>January Capital Flows Report</u>. Both factors have recently lost strength: investors have become increasingly concerned about an exit from easy monetary conditions, notwithstanding the announcement of an aggressive expansionary policy in Japan. Additionally, growth in emerging economies has lost some momentum recently, while growth prospects in mature economies have brightened somewhat, thus reducing the relative attractiveness for developed market investors to move capital abroad.

Investors have become increasingly concerned about an exit from easy monetary conditions

Our baseline forecast for capital flows assumes that volatility in bond markets will remain a feature going forward. While an increase in policy rates by the Federal Reserve may still be some time away – not least because the U.S. unemployment rate may decline more slowly going forward and core inflation remains low – a process of normalization would be in line with the fact that U.S. growth has recovered from the extraordinary weakness during the Great Recession. The Fed's June 19 post-meeting guidance clarified that tapering of asset purchases should occur before year-end, with QE3 expected to end in mid-2014.

The outlook for emerging economy growth may benefit from a pick-up in domestic demand, helped by substantial past monetary policy stimulus, but the prospects for a reacceleration in overall growth are limited. In particular, many EMs face important country-specific policy challenges to reach a higher growth level (see regional sections on pages 12-22).

In an environment of increased volatility and the prospect of further increases in U.S. bond yields, inflows from private creditors other than banks are projected to suffer particularly. These inflows, which are dominated by non-residents purchases of bonds, had benefitted disproportionally during the prior period of search for yield. Portfolio equity flows are projected to fall sharply this year on the back of revised growth expectations but are forecast to recover in 2014. The declining trend in FDI inflows to emerging economies is seen to

Inflows from private creditors other than banks are projected to suffer particularly

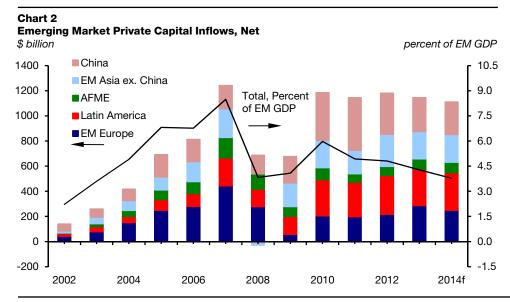


Table 1 **Emerging Market Economies: Capital Flows** \$ billion 2011 2012e 2013f 2014f Capital Inflows Total Inflows, Net: 1207 1212 1187 1167 Private Inflows, Net 1146 1181 1145 1112 598 670 631 633 Equity Investment, Net Direct Investment, Net 593 545 541 523 5 125 89 Portfolio Investment, Net 110 Private Creditors, Net 548 511 514 479 Commercial Banks, Net 121 195 144 154 353 Nonbanks, Net 390 369 325 Official Inflows, Net 61 31 43 55 21 International Financial Institutions 17 6 4 37 35 **Bilateral Creditors** 44 27 **Capital Outflows** Total Outflows, Net <u>-1396</u> <u>-1481</u> <u>-1289</u> <u>-1396</u> Private Outflows, Net -932 -1000 -1000 -811 Equity Investment Abroad, Net -262 -320 -375 -357 Resident Lending/Other, Net -549 -612 -624 -643 Reserves (- = Increase) -670 -357 -397 -396 Memo: Net Errors and Omissions 17 -211 0 0 288 Current Account Balance 257 209 229

e=IIF estimate, f=IIF forecast

BOX 1: IIF CAPITAL FLOWS DATA - A LAYMAN'S GUIDE

Capital flows arise through the transfer of ownership of assets from one country to another. When analyzing capital flows, we care about who buys an asset and who sells it. If a foreign investor (a non-resident) buys an emerging market asset, we refer to this as a capital <u>inflow</u> in our terminology. We report capital inflows on a net basis. For example, if foreign investors buy \$10 billion of assets in a particular country and sell \$2 billion of that country's assets during the same period, we show this as a (net) capital inflow of \$8 billion. Note that net capital inflows can be negative, namely if foreign investors sell more assets of a country than they buy in a given period. Our "net private capital inflows to emerging markets" measure is the sum of all net purchases of EM assets by private foreign investors.

Correspondingly, if an investor from an emerging market country (a resident) buys a foreign asset, we call this a capital <u>outflow</u>. Net capital outflows can also be positive or negative. Following standard balance of payments conventions, we show a net increase in the assets of EM residents (a capital outflow) with a negative sign.

For further details regarding terminology, concepts and compilation of our data, please consult our <u>Capital Flows User Guide</u>.

If a foreign investor (a nonresident) buys an emerging market asset, we refer to this as a capital <u>inflow</u>

BOX 2: REVISIONS TO IIF FORECASTS

Relative to our January 2013 Capital Flows Report, we have revised up our inflows estimates for the years 2011-2013, but have lowered our forecast for 2014 (Table 2). The upward revisions are mainly due to Emerging Europe (though in 2013 this is primarily accounted for by a single large transaction in Russia, see page 17). Meanwhile, we have reduced our projections for inflows to EM Asia, led by China and Korea.

Table 2 **Revisions to IIF Private Capital Inflows to Emerging Markets** \$ billion 2011 2012e 2013f 2014f IIF Private Capital Inflows 1,146 1,181 1,145 1,112 June 2013 Forecast 1,084 1,080 1,118 1,150 January 2013 Forecast 62 101 27 -38 Revision Revisions by Region 20.0 -8.2 -5.9 Latin America 3.0 23.7 67.8 19.3 1.0 **Emerging Europe** -3.1 -3.6 -1.3 5.5 Africa/Middle East Emerging Asia 59.1 51.5 -29.9 -48.0 e=IIF estimate, f=IIF forecast

continue this year and next, with the projected volume of inflows in 2014 standing at around 6% below their 2012 level. This is mainly due to less buoyant direct investment in EM Asia. By contrast, inflows are envisaged to grow in the Africa and Middle East region.

The main downside risk to our forecasts is a sharp further repricing of mature economy bond yields if markets abruptly reassess their expectations of Fed exit (even absent any action by the Fed). While earlier episodes of such repricing suggest that they do not necessarily lead to reversals of aggregate flows to EM, the risk is that it adversely impacts individual countries, as happened in the aftermath of the 1994 U.S. bond crash. Some parts of Emerging Europe look vulnerable in such a scenario, including Turkey (see page 16). However, the structure of international capital flows has changed substantially over the last decades. Notable developments are the rise of EM outflows in both gross and net terms and increased flows among EMs ("south-south flows"), which could potentially offset declining flows from mature economies (see page 11).

However, there is also upside risk to the forecasts, namely in the case that (1) EM growth picks up more than expected or (2) investors adjust their expectations for Fed exit backwards (e.g., as the U.S. unemployment rate stabilizes above 6.5%, inflation falls further or concerns about asset price misalignments lessen). Also, flows to EMs as a share of EM GDP have not been particularly high, at least when compared to the period leading up to the Great Recession. Over the longer term, inflows to EMs are likely to continue their secular

The main downside risk to our forecasts is a sharp further repricing of mature economy bond yields

Upside risks include better EM growth and the possibility of investors adjusting their expectations for Fed exit backwards

upward trend, supported by economic and financial development as well as increasing international financial integration.

MODERATE GLOBAL GROWTH AS EM ECONOMIES UNDERPERFORM

The global growth outlook remains one of moderate economic expansion – disappointing even five years into the recovery after the Great Recession. World GDP growth is expected to be 2.5% this year and 3.3% in 2014. This compares to a historical average of 3.1% over the period 1996 to 2007.

In recent months there have been some tentative signs of a rotation in growth drivers between regions. First, emerging economies in aggregate have performed weaker at the start of the year than envisaged at the end of 2012 (Chart 3). Within emerging economies, downward revisions have been particularly large for Latin America. Second, mature economies have performed better, led by solid underlying U.S. growth in the face of substantial fiscal tightening. In Japan, the stimulus from the onset of monetary expansion has started to feed through to domestic demand, and the Euro Area has seen some recovery from the very weak growth outcomes at the end of 2012 (Chart 4). In many cases, the revisions to annual growth forecasts reflect outcomes for 2013Q1, but there have also been marked changes to 2014 growth.

Growth in emerging economies has slowed in recent months, while mature economies have performed better

To some extent, the better growth outlook in mature economies is one trigger for the Fed exit debate as good news on the economy translates into bad news for bond markets (since investors perceive the end of ultra-easy monetary conditions to be nearer).

In sum, the global outlook has become less supportive for capital flows as the relative growth prospects of emerging economies have weakened. Using the quantitative framework we laid out in the last Capital Flows Report, the weakening of EM growth would translate into lower flows on the order of \$30-40 bn this year and \$15-20 bn in 2014.

In sum, the global outlook has become less supportive for capital flows



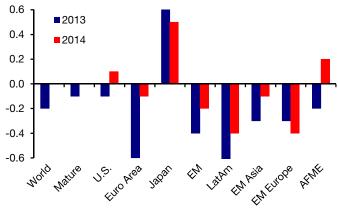
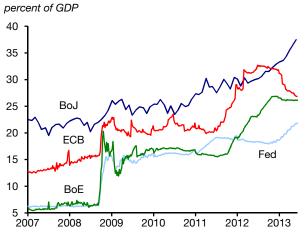
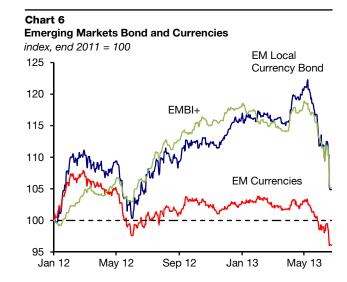


Chart 4
G4 Central Bank Balance Sheets: Total Assets







A TASTE OF EXIT: EMERGING MARKET EQUITIES AND BONDS REPRICE

During the recent adjustment in market expectations of the timing of a U.S. exit from monetary accommodation—and a rise of 100 basis points in U.S. bond yields—repricing in EM assets has been striking. Emerging market equities are down almost 15% since May 22, significantly underperforming their mature market counterparts (down 6.5% during that period, and still up 5% year to date—see Chart 5). EM sovereign bonds—both hard—and local-currency—are down more than 10-15% since May 22 (Chart 6), with spreads on sovereign and corporate bonds some 70-90 basis points wider. In contrast, U.S. 10yr Treasury bond prices are down only about 6-7% in price since May 22.

Emerging market currencies in aggregate are down almost 7% since early May, with the Brazilian real, the South African rand, the Indian rupee and the Indonesian rupiah hit particularly hard. These markets collectively have seen almost \$5 billion in net outflows from dedicated equity funds over the past month. Both EM equity and bond funds have seen marked net outflows in the weeks since May 22 (Chart 7, next page)—equity funds have seen a net \$18 billion withdrawn, while bond funds have lost over \$7 billion. The reversal in EM bond fund flows is quite striking given the heavy inflows seen in 2012 and through mid-May 2013 while the search for yield dominated.

EM equities have significantly underperformed mature markets in recent months

WITHDRAWAL OF LIQUIDITY PUTS THE FOCUS ON GROWTH

The more substantial correction in emerging market assets as markets adjust to perceptions of an earlier Fed "tapering" timetable highlights the role of liquidity (or more specifically, the presumption of ongoing liquidity) in underpinning fund flows to emerging market assets and compression in emerging market bond spreads. The marked divergence in developed and emerging market equity prices this year—even more pronounced since May 22—is a worrying signal of investor concern about EM growth prospects more broadly. The "engine of growth" status enjoyed by EM economies between

Chart 7
Emerging Market Equity and Bond Fund Flows
\$ billion, EPFR data

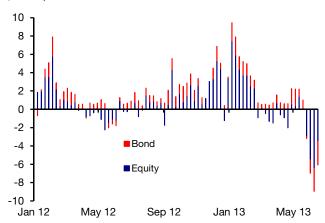
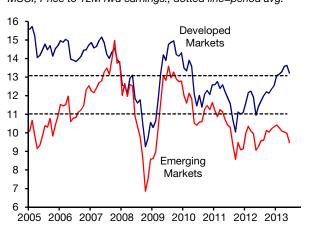


Chart 8
Developed & EM Equity Markets: Forward P/E Ratios
MSCI, Price to 12M fwd earnings.; dotted line=period avg.



2004-2007 (real GDP growth averaged nearly 8% during this period) appears worn: our forecasts look for under 5% growth in 2013, with only a modest pick-up to 5.4% in 2014. These concerns are reflected in equity market valuations: forward price-earnings ratios for emerging market economies are well below their long-run levels (Chart 8), while those for developed economies remain relatively high. This sharp divergence underscores the high degree of uncertainty surrounding EM growth and corporate earnings forecasts—and the challenges for EM policymakers during this unprecedented transition.

There is a high degree of uncertainty surrounding EM growth and corporate earnings forecasts

NORMALIZATION OF MONETARY POLICY POSES RISKS TO EMS

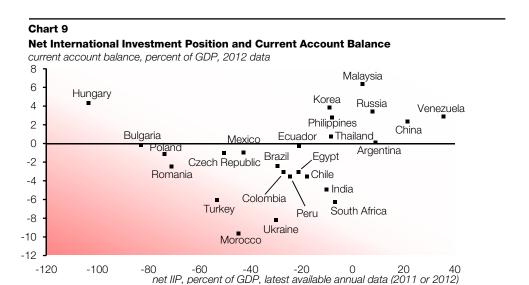
The need to unwind the unprecedented monetary expansion will pose formidable challenges to many central bankers in mature economies over the next several years. Currently, the market focus is on the U.S., where economic conditions are correctly perceived to have improved sufficiently to warrant contemplating a scaling back of QE and to start a process of normalization. Global monetary policy settings are an important driver of capital flows and the impending withdrawal of monetary support is likely to be a source of volatility and risk in global financial markets. Emerging markets tend to be affected disproportionately because foreign capital movements can be huge relative to their domestic financial markets. We would highlight three points in this regard:

EMs tend to be affected disproportionately because foreign capital movements can be huge relative to their domestic financial markets

1. The boost to EM capital inflows from global monetary policy will fade over the medium term. A narrowing interest rate differential between EM and mature economies should reduce the search for yield by global investors. If the monetary exit progresses in a smooth fashion (i.e. unfolding broadly as anticipated by markets), solid fundamentals in EM economies should help keep aggregate capital inflows relatively steady (though less buoyant than they would be in the absence of monetary exit).

3.

Capital Flows to Emerging Market Economies



- 2. Watch for accidents! A global environment of weaker supply of external financing can easily amplify country-specific vulnerabilities. Countries with large external financing needs are particularly exposed to a potential retrenchment of foreign capital flows. If external financing dries up, borrowers (both sovereigns and private sector entities) could find themselves in liquidity and solvency difficulties. Important risk factors to watch include indicators such as the current account deficit, which indicates a country's external financing needs in a given period. The corresponding stock variable is the net international investment position, which indicates the net assets (or liabilities) of a country. The more negative a country's IIP, the higher the claims of foreigners on residents. Applying these two simple metrics, countries like Turkey, Romania, Poland and Morocco stand out for their large external financing needs (Chart 9; see also page 16). Of course there are numerous other factors affecting country risk, such as levels of external debt, FX reserves, growth prospects and the quality of institutions.
 - Tail risks are significant. Following the recent shift in market expectations on the timing of a U.S. exit from monetary accommodation, a further sharp increase in bond yields could send severe ripples across the global financial system. While our baseline scenario assumes a relatively smooth exit, an accelerated rise in U.S. bond yields (and, if history is any guide, yields in other major bond markets as well) could prompt a further increase in global risk aversion. Such a development could easily feed on itself, resulting in a sharp retrenchment of foreign capital from emerging economies. The volatility that accompanied the recent shift in market expectations provided a glimpse of what such a market environment could look like (Chart 10, next page). The current exceptionally low level of U.S. interest rates means that the magnitude of the ultimate shift up could potentially be very significant—tail risks associated with a rapid and sizeable further increase in U.S. rates are unusually large. The Fed's experience with previous exits in 1994 and 2004 are important precedents in this regard (Box 3, next page).

Countries with large external financing needs are particularly exposed to a potential retrenchment of foreign capital flows

Tail risks associated with a rapid and sizeable further increase in U.S. rates are unusually large 2008

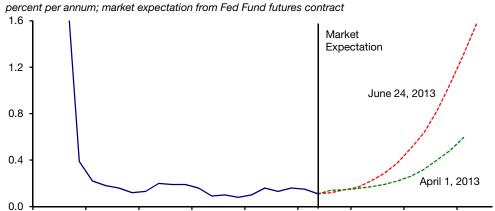
2009

Capital Flows to Emerging Market Economies

2015

2016

Chart 10
United States: Federal Funds Effective Rate



2012

2013

2014

BOX 3: FED EXITS-1994, 2004, 2014?

2010

2011

Following the 2008 financial crisis, the Fed has taken unprecedented policy measures to support economic recovery and financial stability. While lowering policy rates to record-low levels, the Fed's three rounds of unconventional large-scale asset purchases (QE) have increased the size of its balance sheet threefold since 2007. As the U.S. economy continues to recover, the Fed must eventually reverse its current loose policy stance; recent remarks by Chairman Bernanke have led to the expectation that the Fed will taper its purchases before year-end. Regardless of the timing or scale of this tapering, or the timing of an eventual rate hike, the repricing process has begun—U.S. 10yr bond yields have risen some 100 basis points from this year's lows, to 2.65%. Going forward, the success of a possible Fed exit from QE—and thus from a prolonged period of low interest rates—will largely depend on (1) the timing and pace of exit, and (2) the Fed's communication strategy. The lack of a "credible communication" strategy on an exit (as in 1994) and the failure to adopt an appropriate "timing and pace of policy firming" (as in 2004) were widely viewed as mistakes. Any similar signaling error as the Fed's 2013-15 exit strategy evolves could trigger a more abrupt and pronounced rise in U.S. bond yields, with potentially significant adverse impacts on both the domestic and global economy.

Fed's 1994 Exit: After the 1990-91 crisis, the Fed's first rate hike came in February 1994 and was largely unanticipated by markets. Over a course of twelve months, the Fed increased its policy rate from 3% to 6%. During the same period, the yields on 10yr Treasury bonds rose by around 200 basis points (Chart 11, next page). The sharp and sudden rise in bond yields did not only trigger the Orange County bankruptcy but also had significant international spillover effects on global financial markets. Sovereign bond yields increased in many developed and emerging market economies. Global asset prices slumped, particularly in Latin America as portfolio inflows into the region fell sharply (Chart 12, next page).

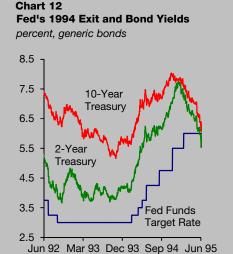
The 1994 Fed exit was largely unanticipated by markets

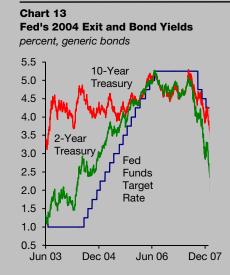
Fed's 2004 Exit: The Fed's 2004 exit was largely anticipated. During the 2004-2006 period, the Fed increased its policy rate gradually from 1% to 5.25% by following a preannounced schedule of actions (Chart 13). Although this slow exit strategy enabled the Fed to avoid a bond-market crash (the increase in long-term rates was small while short-term rates increased sharply) and had a limited initial impact on global markets compared with the 1994-95 cycle, it contributed to financial excesses in the U.S. economy (i.e., credit and asset bubbles). After an initial decline U.S. stock markets recovered and continued to advance until the onset of the subprime crisis (Chart 14).

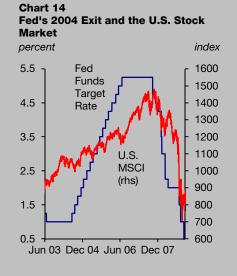
The Fed's 2004 exit was largely anticipated, but contributed to financial excesses

Given the degree of monetary accommodation provided in recent years, completing the exit this time will likely be even more challenging for the Fed than before.









EM CAPITAL OUTFLOWS ARE LARGE AND GROWING

International capital flows have historically been important in financing the current account deficits of EM economies. Typically, an emerging market country would borrow abroad in order to invest at home above and beyond what residents saved. For over a decade, however, many EM economies have been running current account surpluses, i.e., they were net capital exporters rather than net recipients of foreign capital. On aggregate, our sample of 30 major EMs was running a current account surplus of \$288 billion in 2012 (Chart 15).

A handful of EM economies have accumulated very large holdings of foreign assets in recent years by running persistent current account surpluses. These countries include several major oil exporters (such as Saudi Arabia, UAE, Russia) as well as China and Korea. Much of their current surpluses are recycled via asset accumulation by sovereign wealth funds (SWFs). Indeed, most of the world's largest SWFs are located in EM economies (Chart 16).

While *net* capital flows from EM to mature economies have declined since peaking in 2008, *gross* capital flows in and out of EM economies are on a secular upward trend. In other words, inflows from foreigners have increased in tandem with outflows from EM residents. The rise of two-way capital flows was particularly sharp in the mid-2000s, supported by financial deepening in EM economies and greater openness of financial accounts.

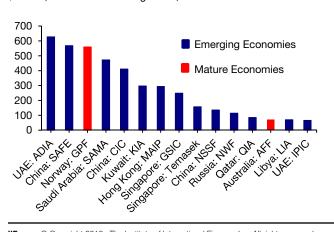
In recent years, there has been an important rotation in the composition of EM capital exports. Until the mid-2000s, the lion's share of EM capital outflows was in the form of official reserve accumulation. In the last few years, however, private sector outflows have surged in a number of key EM economies, including China (Chart 17). Outward investment and lending by EM residents (excluding reserve accumulation) is projected to reach \$1 trillion in 2013, having averaged just \$103 billion in 2000-2003. One implication is that EM external asset accumulation has gradually shifted away from low-yielding assets like sovereign bonds to higher-yielding assets like equity investments (both portfolio and direct). Looking ahead, outward flows are likely to receive further support from a liberalization of EM financial accounts (e.g. in China), as well as financial sector development in EMs, which will help channel domestic savings to global capital markets.

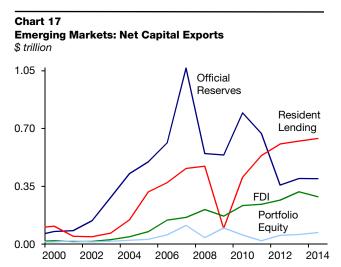
Chart 15
EMs: Aggreg. CA Balance \$ billion

600
400
200
1978
1996
2014f
f=IIF Forecast

There has been an important rotation in the composition of EM capital exports

Chart 16
World's Largest Sovereign Wealth Funds
\$ billion, assets under management, 2011 data





EMERGING ASIA: DOWN, BUT NOT OUT

While favorable growth relative to other regions and additional global liquidity from stepped-up monetary stimulus in Japan are supportive factors, capital inflows to Emerging Asia are being dampened by the prospects for a scaling back of quantitative easing in the U.S. After the runup from mid-2012, they have also become more volatile with the selloff of emerging market stocks and bonds from late May precipitated by Fed statements of a tapering off of QE3. The pullback from Asia was amplified because of the important role of foreign portfolio investors. The overall mix of positive and negative factors means that private capital flows for our seven countries constituting Emerging Asia may be around \$480 billion this year and next, somewhat below the recent high of \$606 billion in 2011 (Chart 18 and Table 3).

The region's share in total emerging market inflows should average 43% this year and next, down slightly from 50% in 2010 and 2011. Along with the plateauing of annual capital inflows, periodic swings are set to continue because of potential unpredictable shifts in global conditions along with individual country concerns impacting the sentiment of foreign creditors and investors. Nevertheless, although the region's renewed economic momentum from the second half of 2012 waned early this year, calibrated policies to stimulate the economy in **China** along with support from domestic demand in Southeast Asia and policy efforts to

Chart 18
Net Private Capital
Inflows to Emerging Asia
\$ billion

600
500
400
200
100
0
2008
2011
2014f

Table 3
Emerging Asia: Capital Flows
\$ billion

	2011	2012e	2013f	2014f
Capital Inflows				
Total Inflows, Net:	<u>627</u>	<u>594</u>	<u>497</u>	<u>493</u>
Private Inflows, Net	606	583	487	480
Equity Investment, Net	358	402	338	331
Direct Investment, Net	350	321	292	271
Portfolio Investment, Net	8	81	46	60
Private Creditors, Net	249	181	149	149
Commercial Banks, Net	138	66	48	57
Nonbanks, Net	111	115	101	92
Official Inflows, Net	21	11	10	13
International Financial Institutions	3	3	3	3
Bilateral Creditors	18	8	7	10
Capital Outflows				
Total Outflows, Net	<u>-855</u>	<u>-628</u>	<u>-682</u>	<u>-737</u>
Private Outflows, Net	-410	-502	-449	-493
Equity Investment Abroad, Net	-137	-160	-165	-189
Resident Lending/Other, Net	-273	-343	-284	-305
Reserves (- = Increase)	-445	-125	-232	-244
Memo:				
Errors and Omissions	<u>97</u>	<u>-116</u>	<u>0</u>	<u>0</u>
Current Account Balance	<u>130</u>	<u>150</u>	<u>185</u>	<u>245</u>

e=IIF estimate, f=IIF forecast

revive the Indian economy suggest that real GDP growth for Emerging Asia should remain at around 7% in 2013 and 2014 (Chart 19). This is well above the 2-4% for the rest of the emerging markets and 1-2% for the mature economies.

Inflows of foreign direct equity investment have been less volatile than the other components and are being sustained by the attraction of large domestic markets as well as the region serving as a base for exports of goods and services, despite some loss of competitiveness to Japan due to the weak yen. Inward FDI to the region is set to remain around \$270-290 billion a year. China will continue to dominate, but its share may progressively slip from a recent high of 76% in 2011 to 72% in 2014 because of a number of factors. These include rising labor costs, some diversification of manufacturing to other countries in the region and Sino-Japanese geopolitical tensions. After FDI inflows to Indonesia rose to a record \$16 billion in 2012, they should also be checked around that level as the commodity-induced surge dissipates along with structural impediments and restrictions on resource-based exports.

In contrast, the gradual opening up of previously closed sectors and the withdrawal of controversial tax plans should help lift FDI inflows to India to \$35 billion in the fiscal year ending March 2015 from \$28 billion in 2012/13, although dampened by infrastructural deficiencies and administrative hurdles. Infrastructure is also proving to be a challenge in **Thailand**, but inward FDI may rise from \$7.6 billion in 2011 to \$11.5 billion in 2014, benefitting from easy operating conditions and being favored by Japanese firms.

Turning to portfolio equity inflows, the recent temporary pullback in global equity markets means that foreign purchases of domestic stocks will fall from \$58 billion in 2012 to \$46 billion in 2013 before reviving to \$60 billion in 2014. Although there have been periodic swings, inflows to **India** of around \$24 billion a year continue to lead the region, attracted by a recovery in real GDP growth from a 10yr low along with investor-friendly measures. In China, governance and growth concerns limited stock purchases by foreign investors to \$7 billion in 2012, but they should rise to \$20 billion in 2014 in response to recent liberalization measures. Inward portfolio equity investment in **Korea** is set to slump from \$17 billion in 2012 to \$3 billion in 2013 due to the weak economy before rising somewhat to \$7 billion in 2014.

Net inflows from nonbank private creditors, which were at a record high of \$115 billion in 2012 due to a surge in foreign purchases of domestic bonds along with a low spread-induced jump in international issuance, will fall to \$101 billion in 2013 and \$92 billion in 2014 as yield differentials narrow. In India, the intra-year swings are most evident from foreign purchases of domestic bonds of \$1.1 billion in May shifting to net sales of \$1.6 billion in the first ten days of June on market concerns of a scaling back of QE3. Meanwhile, **Indonesian** issuers raised \$8 billion through international bonds in the first five months of 2013, following \$11.8 billion in 2012.

In contrast, the deleveraging underway along with more stringent global banking regulations and funding conditions means that net new credits from foreign banks will fall from a record high of \$138 billion in 2011 to \$50-60 billion this year and next. In this regard, the **Philip-**

Chart 19 **Emerging Asia: Real GDP** annual percent change ■EM Asia ■EM ex Asia 8 7 6 5 4 3 2 1 0 2012e 2013f 2014f

e = estimate, f = IIF Forecast

Portfolio equity inflows to India continue to lead the region

pines stands out with foreign banks providing net new credits of around \$4 billion annually, which comprises more than 50% of total private capital inflows. The outlook for strong growth along with the boost from sovereign credit ratings upgrades has bolstered foreign interest in the Philippines.

While capital inflows are plateauing, the regional current account surplus rises from a recent low of \$130 billion in 2011 to \$245 billion in 2014, 2.5% of GDP, although well below the record-high of \$433 billion in 2008. The upturn reflects the slow progress in rebalancing the Chinese economy and tackling the structural imbalances in Korea. Meanwhile, the current account deficit is set to remain large in Indonesia due to domestic demand-led import growth and anemic exports along with India because of rising energy and gold imports. The large foreign holdings of domestic bonds and stocks make financial markets in the region vulnerable to unpredictable shifts in global conditions. The concerns are greater for Indonesia and India because of their dependence on external financing.

In line with the increase in the current account surplus and leveling off of capital inflows, the official foreign exchange reserve build-up for the region picks up somewhat from a recent low of \$125 billion in 2012 to \$251 billion in 2014, although well below the peak of \$588 billion in 2010. China continues to account for around 80% of the total. The region also remains a major exporter of capital led by loans and investments abroad, which are set to be sustained at around \$450-500 billion a year by the expansion of Chinese banks and going-global policy of the government.

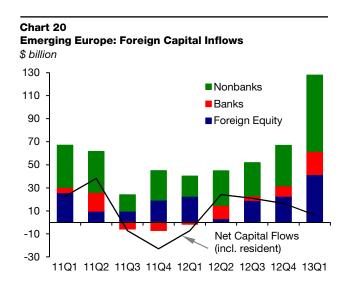
Outward foreign direct equity investment is likely to progressively rise from \$137 billion in 2011 to \$170 billion in 2014. This is being motivated by the desire to secure energy and commodity supplies as well as expand marketing and production operations, accompanied by diversification by the region's sovereign wealth funds. In addition, FDI from China is being liberalized. Outward portfolio equity investments are also being sustained at a moderate \$40-55 billion a year with the recovery in the U.S. a key driver.

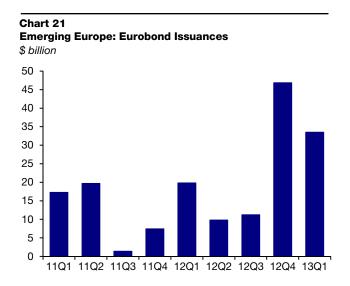
The region remains a major exporter of capital led by loans and investments abroad

EM EUROPE: GLOBAL RISK AVERSION TO CONSTRAIN PORTFOLIO INFLOWS

Capital inflows to Emerging Europe have risen sharply since the middle of last year, thanks mainly to ample global liquidity and ultra-low foreign interest rates spurred by ongoing quantitative easing in the mature economies. With global risk appetite increasing sharply following the announcement of the ECB's OMT facility, inflows of foreign private capital rose from \$43 billion a quarter on average during the first half of 2012 to \$53 billion in the third, \$68 billion in the fourth and \$129 billion in the first quarter of 2013 (Chart 20, next page). Two-thirds of the first-quarter increase, however, reflected operations related to the acquisition of TNK-BP, a privately-owned Russian oil company by Rosneft, **Russia's** largest oil company (Box 4, page 17). Excluding this transaction, which had minimal impact on net flows, inflows of foreign private capital rose to a still impressive \$85 billion. The rise in capital inflows during the second half of 2012 boosted last year's total to \$217 billion from \$198 billion in 2011 (Table 4, next page).

Capital inflows to Emerging Europe have risen sharply since the middle of last year





The increase in foreign private capital inflows since the middle of last year has been mainly driven by a sharp increase in portfolio debt and equity inflows. Eurobond issues doubled in the second half of last year from the first to \$59 billion and remained strong at \$34 billion in the first quarter of this year (Chart 21). Non-resident purchases of local currency-

Table 4 **Emerging Europe: Capital Flows**

\$ billion

While portfolio debt and
equity inflows have risen
sharply,

	2011	2012e	2013f	2014f
Capital Inflows				
<u>Total Inflows, Net:</u>	<u>212</u>	<u>211</u>	<u>278</u>	<u>255</u>
Private Inflows, Net	198	217	286	249
Equity Investment, Net	68	73	95	85
Direct Investment, Net	75	59	85	75
Portfolio Investment, Net	-7	14	10	10
Private Creditors, Net	129	144	191	163
Commercial Banks, Net	18	27	59	48
Nonbanks, Net	111	117	132	116
Official Inflows, Net	14	-5	-8	6
International Financial Institutions	9	-5	-8	7
Bilateral Creditors	5	0	0	0
Capital Outflows				
Total Outflows, Net	<u>-197</u>	<u>-198</u>	<u>-244</u>	<u>-205</u>
Private Outflows, Net	-176	-143	-220	-191
Equity Investment Abroad, Net	-46	-61	-104	-57
Resident Lending/Other, Net	-130	-83	-116	-133
Reserves (- = Increase)	-21	-55	-24	-15
Memo:				
Errors and Omissions	<u>-5</u>	<u>-13</u>	<u>0</u>	<u>0</u>
Current Account Balance	<u>-10</u>	<u>0</u>	<u>-34</u>	<u>-50</u>
e=IIF estimate, f=IIF forecast				

denominated bonds followed a similar path. The jump in bond issuance has been driven by intensified search for yields, especially by non-European institutional investors, and sharply improved risk appetite that has enabled borrowers with weaker credit ratings to tap foreign capital markets at reasonable costs. Portfolio equity inflows have risen as well since the middle of last year, mainly supported by IPOs and SPOs by Russian and Turkish issuers, but remained relatively modest. Finally, net lending by foreign commercial banks rose markedly, too, but this reflected entirely stepped-up lending to **Turkey** and Russia. In the rest of the region, net repayments to commercial banks have continued, albeit at a slower pace.

On the other hand, direct equity inflows have remained subdued. After a particularly weak first half, they picked up somewhat in the second half of last year and further this year, but as a whole have remained modest (excluding Rosneft's operation). Last year as a whole, direct equity inflows fell to \$59 billion from \$72 billion in 2011 as a result. The decline mostly reflected lower reinvested earnings as a result of smaller profits among foreign-invested companies, but also subdued investment demand in Western Europe, which is the main source of FDI for the region. The rise in foreign capital inflows has been broadly matched by a similar increase in resident capital outflows, mostly from Russia and **Ukraine**. (A substantial part of the resident capital outflows from both countries appears to have reflected "round-tripping" of export earnings that subsequently return to Russia and Ukraine as foreign inflows, mainly in the form of FDI and trade credits).

Rising concerns about the potential winding down of the Fed's QE program appear to have caused the pace of private capital inflows to slow sharply in the second quarter. Partial data point to a reversal of portfolio equity inflows, while weakening currencies and rising bond yields suggest that inflows of portfolio debt have slowed sharply or may have reversed, too (Chart 22). Assuming no further deterioration and no monetary tightening in the mature markets through 2014, capital inflows should resume albeit at a more moderate pace than in the first quarter. For 2013 as a whole, net inflows of foreign private capital look likely to increase to \$286 billion from \$217 billion last year. Two-thirds of the increment would reflect the Rosneft transaction, with most of the remainder somewhat larger FDI inflows, mainly in **Poland** and Russia. The pace of both Eurobond issues and local currency-denominated government bond purchases by non-residents looks likely to slow markedly from the first-quarter pace. Lending by foreign banks should moderate as well in the remainder of the year as growth slows in Russia, but should be larger for the year as a whole than in 2012.

Downside risks to capital inflows during the remainder of the year are substantial. An earlier than expected winding down of the Fed's QE program, or actions by market participants in anticipation of such exit could trigger large capital outflows from the region. With most of the borrowing from foreign banks being medium and long-term, and a large part of borrowing from other private creditors representing intercompany loans, any potential withdrawals would be centered on portfolio equity and debt, especially from local currency bond markets. Countries that benefitted the most from the earlier inflows would be most at risk.

With an unsustainably high current account deficit, a de-facto fixed exchange rate and inconsistent policies, Ukraine is likely to be hit the hardest should access to foreign capital markets be lost or even constrained. Unless agreement is reached with the IMF (for which

... direct equity inflows have remained subdued



Downside risks to capital inflows during the remainder of the year remain substantial

Ukraine is likely to be hit the hardest should access to foreign capital markets be lost or even constrained

BOX 4: ROSNEFT'S ACQUISITION OF TNK-BP

In March, Rosneft, Russia's state-owned and largest oil company, completed the acquisition of TNK-BP, a large private Russian oil company. Rosneft paid \$55 billion for TNK-BP to its two owners: U.K.-based BP and A.A.R. Consortium, an offshore-based investment vehicle representing the Russian co-owners of TNK-BP. A.A.R. was paid all in cash while BP received \$12.5 billion in cash and a 19.75% stake in Rosneft valued at \$15 billion. The \$55 billion payment by Rosneft was reflected as direct equity investment abroad in the balance of payment statistics, while the acquisition of BP of the stake in Rosneft as direct equity inflow. The remainder of the acquisition was funded by borrowing from foreign banks (reported at \$29.5 billion) and domestic banks. The Rosneft transaction raised FDI inflows by \$15 billion in the first quarter and foreign borrowing by about \$29 billion, while boosting capital outflows by \$55 billion.

there is no political consensus at present in Kiev), odds for a major economic and financial dislocation would increase sharply.

Risks are likely to be substantial in Hungary as well given large external debt repayments both this year and next and heavy reliance on foreign purchases of forint-denominated government bonds for financing. While substantial foreign exchange reserves should provide some cushion, heavy exposure to foreign exchange-denominated debt both by the government and the private sector would markedly increase financing pressures.

Heavy reliance on mostly short-term foreign capital inflows to finance an outsized current account deficit leave <u>Turkey</u> at substantial risk as well. Portfolio inflows appear to have already reversed, intensifying downward pressures on the lira with concerns about QE reinforced by rising political uncertainty triggered by the mass anti-government demonstrations in recent days. Increased focus by the central bank on exchange rate stability should limit near-term risks for large currency depreciation, but at the expense of substantial drawdowns on foreign exchange reserves.

Risks are likely to be substantial in Hungary and Turkey as well

LATIN AMERICA: MODERATING INFLOWS, GROWING OUTFLOWS

Weaker-than-anticipated regional real GDP growth in the first quarter, prospects of monetary policy easing in key local economies, and risk of an earlier-than-foreseen end to bond buying by the U.S. Federal Reserve have curbed market enthusiasm for regional equity and fixed-income securities. Local currencies have depreciated across the board against the dollar, easing competitiveness pressures. Residents have further increased their exposures abroad, reflecting growing diversification by regional corporates, banks and pension funds. This trend is especially pronounced in the most financially integrated countries: Mexico, Chile, Brazil, Colombia and Peru (Table 5, next page).

Private residents are forecast to increase overseas asset holdings by \$184 billion this year, up from \$133 billion in 2011. **Chile** is one of the largest regional capital exporters, and its

Local currencies have depreciated across the board against the dollar, easing competiveness pressures

corporations have led the region in outward direct equity investment so far in 2013 (Chart 23, next page). Investments have mostly targeted other markets in the region and spanned diverse sectors including financials (Banco de Crédito e Inversiones purchase of City National Bank of Florida for \$0.9 billion), energy (Endesa/Enersis acquisitions in South America for \$3.2 billion), and retail (Falabella acquisition of Brazilian home improvement company Construdecor).

Mexican corporations have continued broadening their global reach, taking advantage of their strong balance sheets and ample global liquidity (Table 6, next page). Investment overseas is well diversified by sectors (food, petrochemicals, telecommunications and construction) and regions (U.S., Europe and Latin America). Direct investment abroad was \$25.3 billion (2.2% of GDP) in 2012, and \$3.7 billion in the first quarter of 2013. Recent deals include the takeover of Coca Cola's bottling operations in the Philippines by retailer FEMSA (\$0.7 billion) and the purchase of assets belonging to U.S. company PolyOne by chemical producer Mexichem (\$0.3 billion).

In **Peru**, pension funds have increased their purchase of external assets. This reflects the lifting of the regulatory ceiling on overseas investments from 30% in January to 36% of total assets in April 2013. We expect overseas pension fund assets to top \$15 billion (8% of GDP)

Mexican corporations have continued broadening their global reach, taking advantage of their strong balance sheets and ample global liquidity

Latin America: Capital Flows \$ billion				
Ç Simo	2011	2012e	2013f	2014f
Capital Inflows				
Total Inflows, Net:	<u>296</u>	<u>330</u>	<u>314</u>	<u>322</u>
Private Inflows, Net	274	308	289	299
Equity Investment, Net	131	148	146	158
Direct Investment, Net	124	124	125	132
Portfolio Investment, Net	7	24	21	26
Private Creditors, Net	143	160	143	141
Commercial Banks, Net	35	30	28	38
Nonbanks, Net	108	130	115	103
Official Inflows, Net	22	22	24	23
International Financial Institutions	1	3	5	5
Bilateral Creditors	21	18	19	18
Capital Outflows				
Total Outflows, Net	<u>-232</u>	<u>-222</u>	<u>-206</u>	<u>-209</u>
Private Outflows, Net	-133	-169	-184	-180
Equity Investment Abroad, Net	-35	-65	-63	-64
Resident Lending/Other, Net	-98	-105	-121	-116
Reserves (- = Increase)	-99	-52	-21	-29
Memo:				
Errors and Omissions	<u>-11</u>	<u>-26</u>	<u>0</u>	<u>0</u>

-82

-108

<u>-113</u>

<u>-53</u>

e=IIF estimate, f=IIF forecast

Current Account Balance

Table 5

Chart 23
Chile: Outward Direct Equity Investment
\$ billion

7
6
5
4
3
2
1
1
1010
3010
1011
3011
1012
3012
1013

Table 6				
Latin Ai	merica: Major Out Target	Ward M&A Deals Acquirer	Type	\$bn
Jan 13	Cimpor Cimentos (Portugal)	Camargo Corrêa (Brazil)	Industrial	1.6
Jan 13	Coca-Cola Philippines	Coca-Cola FEMSA (Mexico)	Consumer	0.7
Jan 13	Helm Bank (Colombia)	Corpbanca (Chile)	Financial	1.3
Feb 13	HSBC Panama	Bancolombia (Colombia)	Financial	2.1
Mar 13	Energy assets in Peru, Colombia	Enersis/Endesa (Chile)	Energy	3.2
May 13	PolyOne Corp Assets (U.S.)	Mexichem (Mexico)	Industrial	0.3
May 13	City National Bank of Florida (U.S.)	BCI (Chile)	Financial	0.9
May 13	Construdecor (Brazil)	Falabella (Chile)	Consumer	0.2

Source: IIF based on Thomson Reuters.

this year. In **Brazil**, outward equity investment (FDI and portfolio) rose to \$14 billion in the twelve months through April from \$4.0 billion a year earlier. Intra-regional investment, however, is not without risk. Having invested \$2.5 billion, Brazil's Vale do Rio Doce (Vale), one of the world's largest mining companies, suspended its \$11 billion Rio Colorado potash project in Argentina, claiming rising inflation and foreign exchange controls had made it unprofitable.

Despite the global rise of the dollar, **Uruguay's** high yields (the policy rate stands at 9.25%) have continued to attract capital, leading the central bank to purchase \$0.8 billion (1.5% of GDP) from the exchange market in 2013 through May (above the 2012 total of \$0.7 billion). Concerned over competitiveness and the rapid rise in the share of foreign holdings of local government debt securities (50% of the total from under 10% less than a year ago), in early June the government imposed a 50% reserve requirement on foreign purchases of government treasuries and increased 10pp to 50% a similar requirement already in effect for central bank sterilization notes.

In early June the Uruguayan government imposed a 50% reserve requirement on foreign purchases of government treasuries

AFRICA AND MIDDLE EAST: FOREIGN INVESTORS CONTINUE TO FLOOD INTO HIGH-YIELDING AFRICAN MARKETS

Despite an easing in oil prices in April and May to close to \$100 per barrel, which pushed the average for the first five months down to about \$108 from an average of \$112 in 2012, we still expect large, albeit declining, surpluses in the major oil-exporting countries in the region. The bulk of these will likely again be invested in developed markets. However, the hydrocarbon-rich countries of the GCC will probably continue to provide financial support to other countries in the region such as Egypt, Jordan and Tunisia, whose balance of payments remain under pressure and which are struggling with the tide of political and social change that is sweeping across the MENA region. In addition, although still relatively small, there has also been an increase in flows to other emerging markets, including those in Sub-Saharan Africa, where investment opportunities are growing.

Global economic conditions and the associated easy money policies in developed markets have tended to be more of a driver of flows to Sub-Saharan Africa

Table 7

Capital Flows to Emerging Market Economies

Domestic political developments and geopolitical uncertainties have more of an impact on flows to non-oil exporting countries in the MENA region (Egypt, Lebanon, and Morocco). By contrast, global economic conditions and the associated easy money policies in developed markets have tended to be more of a driver of flows to Sub-Saharan Africa (Nigeria and South Africa), whose high-yielding bond markets have stimulated carry trade and where investment opportunities have attracted FDI flows.

On an aggregated basis, which disguises the differing trends within the region, net private capital inflows to Emerging Africa and Middle East are projected to rise sharply to about \$82 billion in 2013 from \$73 billion last year. This is still about half the peak reached in 2007, however (Table 7). The two largest components of private inflows are direct equity investment and flows from nonbank private creditors, projected at \$39 billion and \$21 billion in 2013, respectively. The largest increases between 2012 and 2013 are commercial bank lending, which swings from a small net retrenchment to a positive inflow of \$10 billion, and portfolio equity, which rises from \$6 billion last year to \$12 billion this year. Official inflows are also projected to rise sharply in 2013, to \$17 billion from \$4 billion last year, mainly reflecting loans from Qatar and Libya and the delayed IMF disbursement to Egypt.

Inflows into **Sub-Saharan Africa's** domestic capital markets have continued this year, although the relative attractiveness of different countries may have shifted a little. **Nigeria**

although the relative attractiveness of different countries may have

Africa and Middle East (AFME): Capital Flows \$ billion 2014f 2011 2012e 2013f Capital Inflows Total Inflows, Net: <u>72</u> <u>76</u> 99 97 Private Inflows, Net 68 73 82 84 Equity Investment, Net 47 52 58 41 Direct Investment, Net 44 41 39 45 Portfolio Investment. Net -3 6 12 14 Private Creditors, Net 27 31 25 26 Commercial Banks, Net 4 -3 10 11 Nonbanks, Net 23 28 21 15 Official Inflows. Net 4 4 17 13 International Financial Institutions 3 3 6 6 **Bilateral Creditors** 11 7 1 Capital Outflows Total Outflows, Net <u>-197</u> <u>-241</u> *-265* <u>-244</u> Private Outflows, Net -92 -117 -146 -136 Equity Investment Abroad, Net -44 -35 -43 -47 Resident Lending/Other, Net -48 -82 -103 -89 Reserves (- = Increase) -106 -124 -119 -108 Memo: Errors and Omissions -64 -55 0 0 Current Account Balance 190 220 166 <u>147</u> On an aggregated basis, net private capital flows are projected to rise sharply to about \$82 billion in 2013 from \$73 billion last year

e=IIF estimate, f=IIF forecast

experienced a surge in flows into both its equity and bond markets in the second half of 2012, and anecdotal evidence suggests this has continued apace this year (Chart 24, next page). Portfolio equity inflows surged to a record \$10 billion in 2012 from \$2.6 billion the year before and we expect this to continue going forward. The inclusion of Nigeria in JP Morgan's GBI-EM index last October and Barclays Emerging Market Local Currency Government Index this April, together with attractive yields and a fairly stable exchange rate, has spurred foreign interest in the local bond market. Foreigners have also continued to buy **South African** fixed income securities, but not in the same volumes as last year. Weak growth, lingering labor unrest, inflation near the top of its target range and sizable deficits on the fiscal and external current accounts appear to be weighing on investor sentiment and the rand has fallen. These conditions are likely to persist this year and pressure on the Reserve Bank to cut interest rates may increase as a result. Against this background, foreigners may exercise greater caution due to both interest rate and exchange rate risk. Inflows may slow as a result, even though the yield differential will remain attractive.

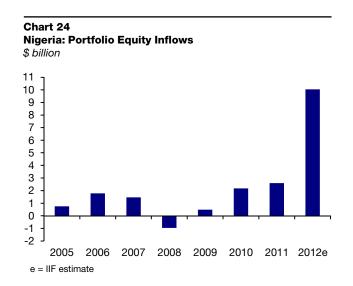
Direct equity investment is the other main source of capital inflows into Sub-Saharan Africa. However, last year's unrest in the mining sector in South Africa resulted in an outflow in the fourth quarter, when a non-resident mining company sold its equity stake in its South African subsidiary. Although we do not expect this to become a trend, the investment climate in the sector has deteriorated and may dampen inflows going forward. Nevertheless, investment into other sectors should continue to provide a steady inflow of capital this year and next, although the effect on the balance of payments is less noticeable due to higher outward investment into other Sub-Saharan Africa countries.

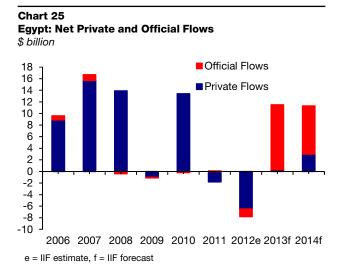
Short-term prospects in **Egypt** remain challenging. Net private capital flows have shifted from inflows of \$13.4 billion in FY2009/10 to a retrenchment of \$6.5 billion in FY2011/12. The sharp increase in net official flows in FY2012/13 is explained by the receipt of loans and deposits from Qatar and Libya (Chart 25, next page). Lingering political crisis, the delays in concluding an agreement with the IMF, continued weak economic activity, and large fiscal deficits have engendered a further drop in market confidence, postponement of private investment, and a sharp depreciation of the Egyptian pound. These conditions are likely to persist in the absence of strong economic policy actions (including fiscal adjustments), and the ruling Muslim Brotherhood-affiliated party will not be able to shore up confidence, thus deterring a revival of private sector inflows. Negotiations with the IMF continue, and an agreement may emerge soon. This would at least provide a framework for economic policy and help secure additional financing from other multilateral and official sources. We project Egypt's external financing requirement at \$14 billion (equivalent to 5% of GDP) for FY2013/14.

In **Lebanon**'s political order and economic stability could be threatened by the continued civil war in Syria and the recent open involvement of Lebanese (Shi'ite) Hezbollah militants on the side of the Syrian President against largely Sunni Muslim rebels. Net private capital flows have steadily declined from a peak of \$12 billion in 2009 to \$2.4 billion in 2012 and a forecast of \$1.6 billion in 2013. In **Morocco**, we expect private inflows (mostly in the form of FDI) to remain modest at around 4% of GDP, close to the average for emerging economies.

Weak growth, lingering labor unrest, inflation near the top of its target range and sizable deficits on the fiscal and external current accounts in South Africa appear to be weighing on investor sentiment

In Egypt, an agreement with the IMF would at least provide a framework for economic policy and help secure additional financing





Investors believe that Morocco's political tensions could be managed. Morocco is also taking steps to improve the investment climate and business environment

Reflecting firm oil prices, the combined current account surplus of **Saudi Arabia** and the **UAE** is projected to remain at around \$200 billion in 2013, close to the current account surplus of China. The accumulation of foreign assets, mostly in liquid fixed income securities, is reflected in large outflows of resident lending abroad and an increase in official reserves.

Morocco is taking steps to improve the investment climate and business environment

Emerging Europe	Bulgaria	Latin America	Argentina
(8)	Czech Republic	(8)	Brazil
	Hungary		Chile
	Poland		Colombia
	Romania		Ecuador
	Russian Federation		Mexico
	Turkey		Peru
	Ukraine		Venezuela
Emerging Asia	China	Africa/Middle East	Egypt
(7)	India	(7)	Lebanon
	Indonesia		Morocco
	Malaysia		Nigeria
	Philippines		Saudi Arabia
	South Korea		South Africa
	Thailand		UAE