IIF RESEARCH NOTE

Capital Flows to Emerging Market Economies

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- **Private flows to EM economies projected to rise in both 2013 and 2014**
- **Flows declined slightly in 2012, despite a boost from lower risk aversion in 2012H2**
- **Current momentum is strong, but not expected to be sustained into 2013H2**
- **Factors pushing capital from mature economies and pulling capital to EM economies are both powerful**
- **Ultra-easy monetary policy increases risk of boom-bust cycle in flows**
- **Major rotation underway in Chinese capital outflows**

Private capital flows to emerging economies have revived strongly, supported by a generally more risk-friendly attitude of investors since mid-2012. The macroeconomic backdrop remains unusually favorable for private capital flows to emerging economies. On the one hand, very easy monetary policy in mature economies and the prospect of poor returns is "pushing" money out of those markets. On the other hand, higher growth in emerging economies, combined with higher interest rates is "pulling" funds in. This "push" versus "pull" debate has taken on new vigor following the latest round of the latest round of central bank easing, notably by the U.S. Federal Reserve. Our research shows that both sets of factors are important (pages 6 to 10). We envisage flows to increase modestly in 2013, to $1,118 billion, from $1,080 billion in 2012. We currently expect flows to rise further in 2014, to $1,150 billion. We estimate that overall inflows in 2012 were slightly lower than in 2011, despite a strong pick-up in momentum in 2012H2, partly driven by the unfolding dramas in

Chart 1
Private Capital Inflows to Emerging Market Economies
$ billion

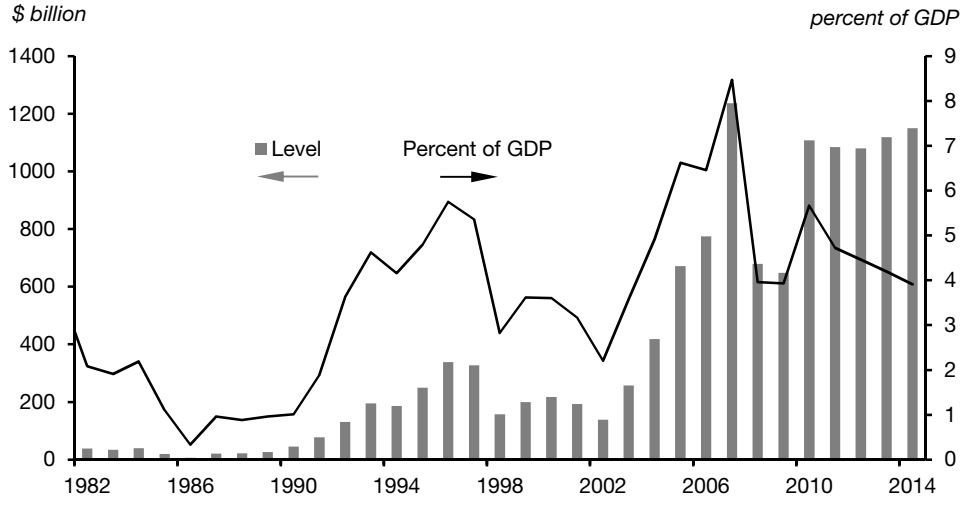


Table 1
Emerging Market Economies: Capital Flows
$ billion

	2011	2012e	2013f	2014f
Capital Inflows				
Total Inflows, Net:	*1145*	*1113*	*1173*	*1209*
Private Inflows, Net	1084	1080	1118	1150
Equity Investment, Net	528	572	616	646
Direct Investment, Net	524	499	517	536
Portfolio Investment, Net	4	73	99	110
Private Creditors, Net	556	508	502	504
Commercial Banks, Net	177	143	152	175
Nonbanks, Net	379	365	351	329
Official Inflows, Net	61	33	55	59
International Financial Institutions	17	0	18	22
Bilateral Creditors	44	33	37	37
Capital Outflows				
Total Outflows, Net	*-1445*	*-1427*	*-1390*	*-1359*
Private Outflows, Net	-721	-975	-1016	-1026
Equity Investment Abroad, Net	-221	-314	-342	-371
Resident Lending/Other, Net	-499	-661	-675	-655
Reserves (- = Increase)	-666	-378	-374	-333
Memo:				
Net Errors and Omissions	-58	-74	0	0
Current Account Balance	*300*	*314*	*217*	*150*

the Euro Area (where stresses peaked in late July). Expressed as a share of mature economies' GDP (still the main source of these flows), they would average about 2.5% in 2013, up from 2.4% in 2012. Expressed as a share of the GDP of emerging economies, however, inflows would decline in proportionate terms, reflecting the buoyancy of nominal GDP (in dollar terms) in emerging economies (Chart 1, previous page).

There is also more risk of greater cyclicality in capital flows to emerging economies in the next 18-24 months than seemed likely a few months ago. Central banks in mature economies have embarked on a new round of quantitative easing in recent months (the latest eager participant being Japan) and this seems to have jump started capital flows to emerging economies. At the same time, the Federal Reserve has outlined the condition under which it would move away from its current extreme stance. At the recent rate of decline in the U.S. unemployment rate, this condition could be approached during 2014, raising the possibility of a significant correction in both global interest rate markets and, if history is any guide, in capital flows to emerging economies. Policymakers in emerging economies may have a long enough memory to avoid some of the pitfalls associated with such a boom-bust cycle in flows, but not all may be quite so restrained, especially in capital-hungry low income economies. Nor is it likely that investors will be quite so disciplined. The risk of market participants being unprepared for a reversal of rates is real and needs to be seriously considered to avoid disruption.

There is more risk of greater cyclicality in capital flows

BOX 1: REVISIONS TO IIF FORECASTS

Revisions to our capital flows projections since our October 2012 Capital Flows Report are relatively moderate (Table 2). Our current estimates for 2012 private inflows to emerging market economies are $54 billion higher than projected in October. In that period, flows have been higher than expected in all four regions, suggesting that the improved global environment has lifted flows throughout the EM world. We have also increased our forecasts for the current year, mainly due to somewhat better prospects for EM Europe.

Revisions to our capital flows projections are relatively moderate

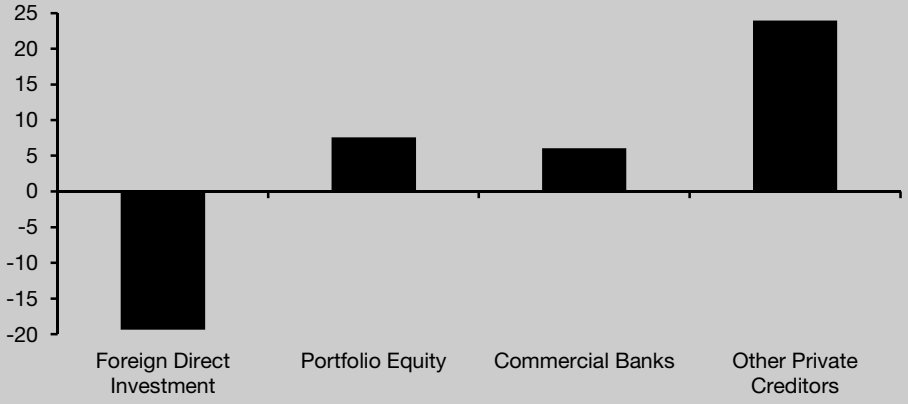
Table 2
Revisions to IIF Private Capital Inflows to Emerging Markets
$ billion

	2010	2011	2012e	2013f	2014f
IIF Private Capital Inflows					
January 2013 Forecast	1,108	1,084	1,080	1,118	1,150
October 2012 Forecast	1,110	1,063	1,026	1,100	
Revision	-2	21	54	18	
Revisions by Region					
Latin America	3.8	5.6	5.7	2.3	
Emerging Europe	1.2	8.2	15.9	11.3	
Africa/Middle East	-11.0	10.3	8.2	-1.0	
Emerging Asia	4.0	-2.8	23.6	5.7	

On a component basis, we reduced our projections for 2013 foreign direct investment, which is mostly due to less buoyant inflows to some of the major recipients of FDI, including Mexico, Russia and Brazil (Chart 2). Our forecasts for all other components have been notched up, led by cross-border lending from non-bank creditors (which include instruments such as foreign purchases of emerging market bonds).

For 2013, we have revised up capital flows forecasts for all components except FDI

Chart 2
Revisions to Private Capital Inflow Forecasts for 2013 by Component
$ billion, change between October 2012 and latest (January 2013) forecasts



Strong inflows into emerging market bond and equity funds over the second half of 2012 have led us to revise upwards our overall 2012 estimate by $54 billion (to $1,080 billion) relative to our last projections in October 2012 (Table 1, page 2). In particular, flows from nonbank sources have been higher than envisaged, with Emerging Europe and Asia being the main beneficiaries of higher inflows.

It is important to note that, even with these increases, aggregate flows in nominal terms will remain around 10% below their historic peak reached in 2007, as commercial banking flows remain subdued. This relative weakness in aggregate banking flows is a reminder of the damage done to financial intermediaries based in mature economies by the global financial crisis. Financial firms—especially banks—are still generally deleveraging in mature economies. By contrast, their counterparts in emerging economies are in a more expansionary phase. Although our data do not break down flows by source country, it is certain that a growing share of capital flows to emerging economies (both private and public) is coming from creditors in other emerging economies (see pages 12 to 16 for a discussion of the growing role of China as a capital exporter).

Aggregate flows in nominal terms will remain around 10% below their historic peak reached in 2007

Importantly, creditors in emerging economies are playing an increasingly relevant role in providing emergency support for other EM countries in difficulty. For example, Egypt has been able to maintain its international reserves in the absence of an IMF program thanks to support from GCC creditors. Russia has been an important source of finance to Ukraine.

A VERY SUPPORTIVE MACROECONOMIC ENVIRONMENT

The macroeconomic environment has further improved over recent months and remains very favorable for capital flows. Our analysis of the drivers of capital flows in the past (see pages 6 to 10) points to the importance of three factors at present:

First, the growth outlook for emerging markets remains bright (Table 3, next page). In particular, higher growth in Emerging Asia and Latin America is likely to lead the emerging world, which is expected to grow by over 5%. By contrast, mature economy GDP growth is set to remain sluggish this year at around 1%. Thus, the growth differential between mature and emerging economies will remain above its average of around 3.5 percentage points since the mid-1990s.

Second, risk aversion on financial markets has fallen significantly over the past months, resulting in strong increases in stock markets and reductions in risk spreads. For example, the U.S. BBB Corporate Bond spread over Treasuries, a common measure of global risk aversion, has fallen by around 75 basis points since mid-2012). This partly reflects a calming of the risks surrounding the Euro Area crisis. Italian and Spanish stock markets are among those with the strongest gains in mature markets.

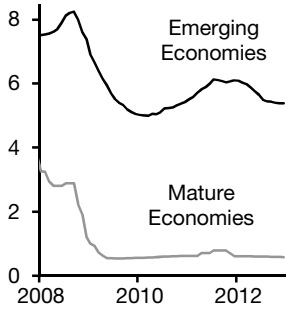
Third, monetary conditions in mature economies remain exceptionally easy. The U.S. Fed has scaled up its asset purchases in January, as projected in our October 2012 report. While there has been some debate about the importance of U.S. monetary policy for capital flows

Table 3
Global Output Growth
percent change over previous year

	2011	2012e	2013f	2014f
Mature Economies	**1.4**	**1.2**	**1.1**	**1.8**
United States	1.8	2.3	2.0	2.4
Euro Area	1.5	-0.4	-0.1	1.3
Japan	-0.5	2.1	0.5	0.8
Other Mature Economies	2.0	1.5	1.4	1.9
Emerging Economies	**6.1**	**4.8**	**5.3**	**5.6**
Latin America	4.0	2.5	3.6	4.0
Argentina	6.5	1.1	2.7	2.1
Brazil	2.7	1.0	3.7	4.2
Mexico	3.9	3.9	3.7	4.2
Emerging Europe	4.9	2.4	2.2	3.4
Russia	4.3	3.5	2.5	3.5
Turkey	8.5	2.8	4.0	5.0
Asia/Pacific	7.5	6.7	7.2	7.0
China	9.3	7.8	8.2	7.8
India	6.5	5.7	6.5	7.0
Africa/Middle East	5.1	4.2	4.0	4.3
South Africa	3.5	2.5	2.9	3.5
World	**3.0**	**2.5**	**2.7**	**3.3**

to emerging markets, our estimates support the view that the increased U.S. money supply is indeed a driving factor (though not the dominant one, see page 6). Recent policy decisions in Japan point to even more easing there in the months ahead. It should not be forgotten that the easing of Japanese monetary policy in the 1990s, and the associated increase in the external exposures of Japanese banks, was one factor that contributed to the East Asian financial crisis of 1997-98. While central banks in emerging economies have lowered their policy rates significantly over the past year, the interest rate differential with mature economies remains wide (Chart 3). However, policy interest rates are an increasingly unreliable measure of relative monetary conditions in a QE-driven world.

Chart 3
Official Interest Rates
%, GDP-weighted average



Despite the world appearing a somewhat calmer place in the opening months of 2013, there are at least three sources of volatility that could flare up.

- While tail risks in the Euro Area have decreased with the introduction of the ECB OMT program, numerous uncertainties remain including the situation in Cyprus, the Italian election outcome, and the possibility of a lack of progress on the reform agenda (notably banking union) during a German election year. Other factors to watch are the possibilities that (a) regional growth yet again disappoints in 2013H1, as yet more fiscal austerity takes effect; and (b) that budget deficit outturns for 2012 (due during the first few months of 2013) exceed promised amounts.

- While most of the tax hikes associated with the U.S. fiscal cliff were avoided at the beginning of the year, most decisions on spending cuts were merely postponed.

Discussions about a rise in the U.S. debt ceiling at the end of February may therefore lead to a period of uncertainty, similar to the episode in mid-2011, which would weigh on capital flows. Also, if there were a decision to fully implement the spending cuts (sequestration) that were postponed at the start of the year (worth around 0.5% of GDP), this would weigh on U.S. GDP growth from 2013Q2 onwards. In addition, over the medium term, the Federal Reserve's announcement to link future decisions on policy rates (and implicitly on asset purchases) to developments in the labor market may introduce volatility, if financial markets start to price in an interest rate hike ahead of the actual decision. This may have adverse effects on capital flows, with the events of 1994 being an important precedent (see Box 2).

- Event risk in emerging economies. Paradoxically, emerging economies seem far less prone to abrupt rounds of financial volatility than mature economies, but there are important exceptions. In Egypt, major political uncertainties remain and the Egyptian pound has now come under pressure. Global markets have stopped focusing on the risk of conflict between Iran and Israel. In Emerging Europe, many countries are stressed—especially Ukraine. Also, Hungary could be particularly vulnerable to a shift in market sentiment, from bullish to bearish.

Emerging economies seem far less prone to abrupt rounds of financial volatility than mature economies

YOUR FAULT OR MINE?: "PUSH" VERSUS "PULL" FACTORS IN EM FLOWS

The debate about the underlying factors that drive capital flows to emerging economies has heated up in recent quarters, against the backdrop of ultra-easy monetary policies in many mature economies. The main tension is that a number of leading emerging market policymakers—most explicitly Finance Minister Mantega of Brazil—have accused G3 policymakers of currency manipulation, with easy money "pushing" capital into countries where rates are higher. On the other hand, some central bankers in the mature world—for example, Federal Reserve Chairman Bernanke —have responded by arguing that the primary driver of capital flows to emerging economies is the attractiveness of emerging economies as an investment destination "pulling" capital in from abroad. This "push" versus "pull" debate is not new.[1]

In order to gain more insight into the relative importance of the fundamental driving factors on aggregate capital flows, we have constructed a simple model containing variables for both "push" and "pull" factors (Box 3). The model fits the actual data quite well and explains about 68% of the variation in capital flows over our sample period, which has seen highly volatile capital flows (Chart 8, page 8).

The results indicate that EM real GDP growth is a key predictor of capital inflows. It is statistically highly significant and economically important, not only for our aggregate measure of private capital flows, but also for each of the four major components (FDI,

EM real GDP growth is a key predictor of capital inflows

[1] Some of the seminal papers in the early literature on the drivers of capital flows include:
(1) Calvo, Guillermo A., Leonardo Leiderman, and Carmen M. Reinhart. 1993. "Capital Inflows and the Real Exchange Rate Appreciation in Latin America: The Role of External Factors." *IMF Staff Papers* 40(I):108-51.
(2) Fernandez-Arias, Eduardo. 1996. "The New Wave of Capital Inflows: Push or Pull?" *Journal of Development Economics* 48:389—418.
(3) Taylor, M. P., and Sarno, L. 1997. Capital Flows to Developing Countries: Long- and Short-Term Determinants. *The World Bank Economic Review*, *11*(III), 451-470.

BOX 2: 1994 AND ALL THAT

The events of 1994 are a very important case study for analysts looking for signs of what might happen when, eventually, the Federal Reserve changes course on monetary policy. The Fed had cut the funds rate to 3% in September 1992, and had signaled a willingness to maintain low rates to ensure a recovery through 1993 (Europe was in recession in 1993). By early 1994, the U.S. was almost three years into an expansion, and the Fed decided that it was time to hike rates. The results for financial markets were stunning. Far from anticipating a shift in direction from the Fed, market participants had locked into many "low for long" trades. As these trades began to lose money in a rising rate environment, there was a scramble to exit, which dragged down all major bond markets. Higher Fed funds rates initially led to a steeper, not a flatter U.S. yield curve (Chart 4); European bond markets sold off in lock step with U.S. bond markets, even though European central banks (notably the Bundesbank) were still in easing mode (Chart 5); emerging market asset prices (which had risen sharply in 1991-93) slumped (in two stages) through 1994 and early 1995 (Chart 6); and, most importantly, private capital flows to Turkey and to Latin America – especially Mexico – collapsed, culminating in near default by Mexico in 1995Q1 (Chart 7).

Chart 4
United States: Benchmark Interest Rates
percent per annum

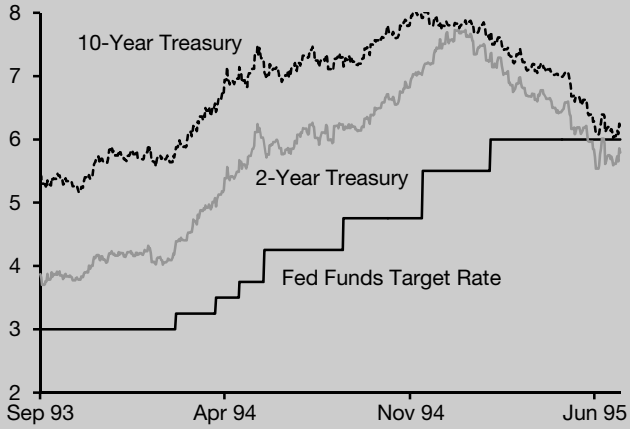


Chart 5
United States and Germany: Benchmark Interest Rates
percent per annum

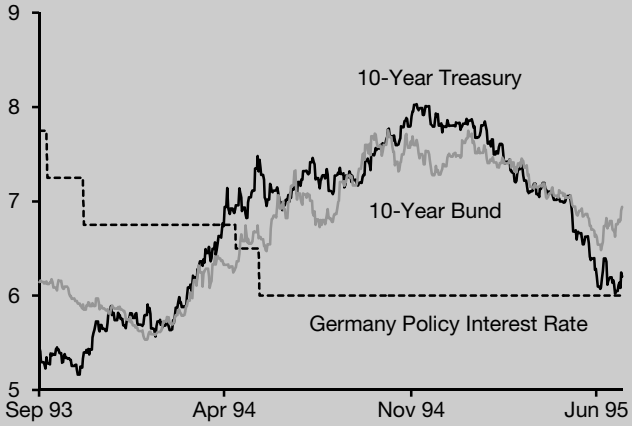


Chart 6
Measures of EM Equity and Bond Performance
index; Dec 31, 1993 = 100

Chart 7
Mexico: Private Capital Inflows
$ billion

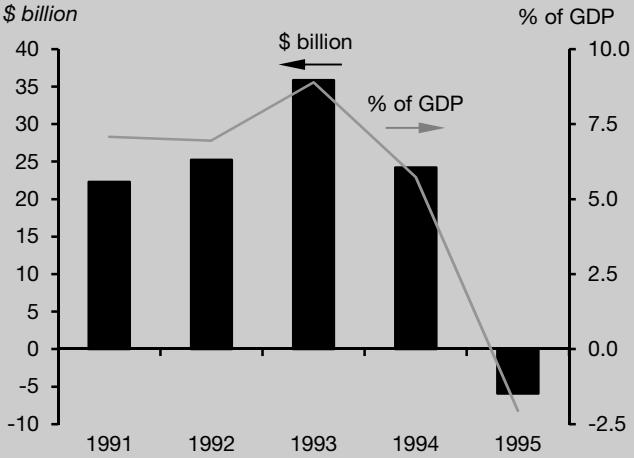


Chart 8
Private Capital Inflows to Emerging Markets
$ billion

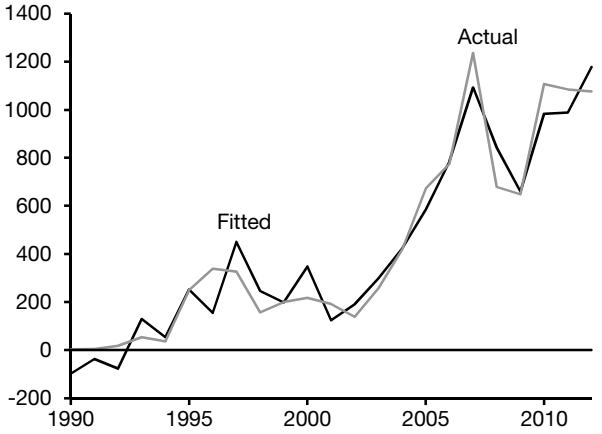
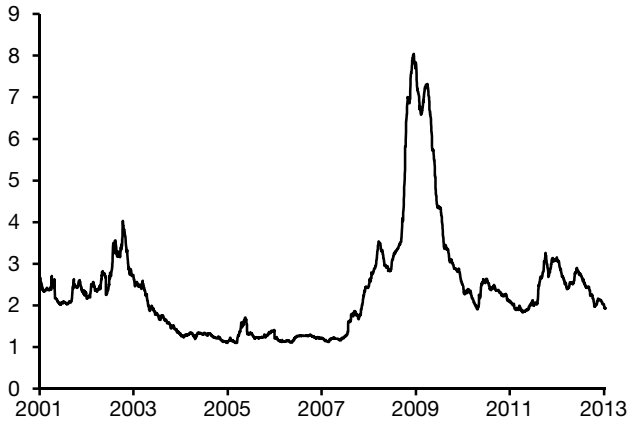


Chart 9
U.S. BBB Corporate Bond Spread over Treasuries
percentage points



portfolio equity, bank flows and other private creditors). An increase in EM real GDP growth by 1 percentage point is typically associated with a $82.1 billion increase in capital flows (in 2012 dollars).

Risk aversion is also an important predictor of capital flows. The proxy with the best fit is the U.S. corporate BBB spread over U.S. Treasuries (although the VIX is also a robust predictor). A 1 percentage point increase in the BBB spread is typically associated with a decline in capital flows of $142 billion (in 2012 dollars). During the crisis year of 2008, the BBB spread increased by more than 2.5 percentage points, while flows declined by over $550 billion (Chart 9).

Risk aversion is also an important predictor of capital flows

These factors appear to have been roughly equally important in driving capital flows over the past 15 years (Chart 10). However, the estimated contribution to changes in capital flows of each driver strongly depends on the prevailing global macroeconomic environment.

Chart 10
Estimated Contributions to Changes in EM Capital Flows
$ billion

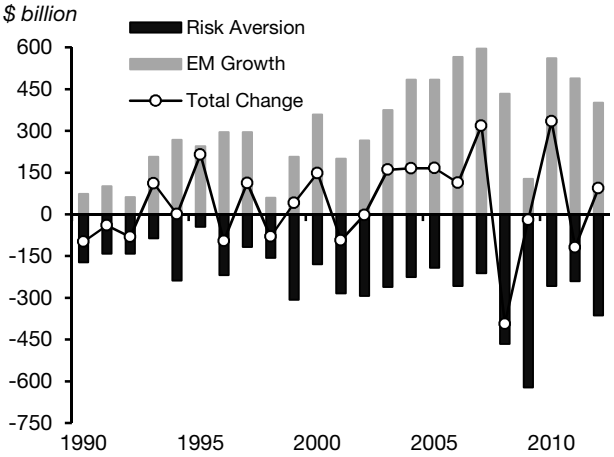
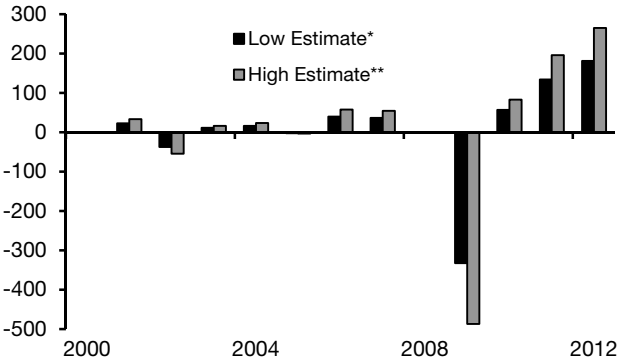


Chart 11
Contribution of U.S. Liquidity to Change in Capital Flows
$ billion



*The low estimate is based on a regression that includes a measure of risk aversion (the VIX). Because the two variables are correlated, this estimate may be too conservative.
** The high estimate is based on a regression that does not include a measure of risk aversion. The coefficient may thus be overestimated because the regression may suffer from omitted variable bias.

BOX 3: A SIMPLE MODEL FOR CAPITAL FLOWS

We have constructed a simple econometric model to analyze the importance of "push" and "pull" factors in driving aggregate capital flows over the past two decades. We use the unique IIF measure of private capital flows, which is based on our country-level analysis of flows to 30 major EM economies. Explanatory variables include a variety of push and pull factors, as well as the lagged dependent variable (Table 4). On the pull side, we test for the significance of EM real GDP growth, stock market performance, and inflation. On the push side, we include different proxies for risk aversion and several proxies for global interest rates and liquidity.

We have constructed a simple econometric model to analyze the importance of "push" and "pull" factors in driving aggregate capital flows

Table 4
Candidate Variables Tested in Model

Dependent Variable
Total Private Capital Flows to Emerging Markets in $ billion, deflated by U.S. headline CPI

Independent Variables	Expected Sign	Sign of Estimated Coefficient	Statistically Significant (95% level)
Pull Factors			
Emerging Market Real GDP Growth	Positive	Positive	Yes
Emerging Market Stock Market Index: MSCI EM	Positive	Positive	No
Inflation	Ambiguous	Positive	No
Push Factors			
Global Risk Aversion			
U.S. BBB Corporate Bond Spread over Treasuries	Negative	Negative	Yes
U.S. Equity Volatility Index (VIX)	Negative	Negative	Yes
Emerging Market Bond Index Global (EMBIG)	Negative	Negative	Yes
Interest Rates			
Federal Funds Rate	Negative	Positive	No
Treasury Yields: 2-Year	Negative	Negative	No
Treasury Yields: 10-Year	Negative	Negative	Yes
Other Liquidity Measures			
Total U.S. Financial Sector Liabilities	Positive	Positive	Yes
Mature Economy Real GDP Growth	Ambiguous	Positive	No

We estimate the following baseline model over a sample period starting in 1990:

$$Flows_t = 82.1*Growth_t - 141.8*Risk_t - 0.79*Flows_{t-1} \qquad \text{adj. } R^2 = 0.68$$
$$(11.8) \qquad (24.6) \qquad (0.15)$$

$Flows_t$ is the first difference of private capital inflows to EM economies in year t in $ billion, deflated by the U.S. headline consumer price index; *$Growth_t$* is emerging market real GDP growth, *$Risk_t$* is the U.S. corporate BBB spread over Treasuries, and *$Flows_{t-1}$* is the first lag of the dependent variable. Standard errors are in parentheses; all independent variables are significant at the 1% level. We conducted a range of robustness checks, such as scaling flows by EM GDP, with very similar results. We also ran a series of panel regressions using the 30 countries in our sample. The panel results support the finding that EM growth and risk aversion are important driving factors and that flows are autocorrelated (though the sign is positive at the country level).

EM growth and risk aversion are important driving factors

In stable times, variations in EM growth rates account for a larger portion of the variation in capital flows, whereas in volatile times (such as during the global financial crisis) risk factors are more important in driving capital flows.

The notion that low interest rates in mature economies "push" capital flows to emerging markets is difficult to establish in our simple framework. Instead, we employ an alternative measure of liquidity to investigate the impact of monetary policy on capital flows. In line with some recent academic work on measuring global liquidity, we use U.S. total financial sector liabilities as a proxy for liquidity conditions.[2] One advantage of this measure is that it also picks up the effect of unconventional monetary policy, such as quantitative easing. This measure of liquidity exhibits a statistically significant relationship with capital flows. According to our estimates, the contraction in U.S. liquidity during the crisis may have subtracted roughly $400 billion from private capital flows to emerging markets (Chart 11, page 8). The subsequent expansion in U.S. liquidity in the years 2010-2012 appears to have lifted the level of annual capital flows to emerging markets by some $450 billion.

There are two important takeaways from this analysis. First, as is too often the case in economics, *both* "push" and "pull" factors are important in driving capital flows — everyone is right in this debate! Second, and more importantly, these drivers can go to extremes in both directions (especially since they tend to reinforce each other). Flows rise when EM growth is higher; risk aversion lower; and U.S. liquidity growth higher. When all these factors move in the other direction, however, a reversal of flows should be expected. In this context, it is worth bearing in mind the experience of 1994. Then (as now) Federal Reserve policy had been easy for an extended period and this had fueled rapid growth in private capital flows to emerging economies (especially Latin America). A shift in Fed policy in February 1994 initiated a sequence of abrupt dislocations in global financial markets. Combined with Mexico's dogged refusal to devalue ahead of the Presidential election, this culminated in a full-fledged currency and debt crisis in December 1994.

***Both* "push" and "pull" factors are important in driving flows**

EQUITY INVESTMENTS TO BENEFIT PARTICULARLY

While capital inflows are currently driven especially by buoyant bond flows, the macroeconomic outlook for 2013-14 seems to favor equity investments. These benefit from a more favorable growth outlook in emerging markets. By contrast, fixed income investments, which are currently strong, will eventually suffer from uncertainty about the end of very easy monetary conditions in mature economies. Indeed, the projected increase in private capital flows both this year and next is solely accounted for by increased equity inflows. Debt inflows are projected to decline this year and be broadly stable in 2014 as declining flows from nonbank sources mostly offset modest increases in inflows by commercial banks (from a low starting level).

Direct investment flows, which account for half of all private capital flows, are projected to grow by about 3.5% both this year and next, reaching a historic high of $536 billion in 2014.

[2] Chen, M. S., Liu, M. P., Maechler, A. M., Marsh, C., Saksonovs, M. S., & Shin, M. H. S. (2012). Exploring the Dynamics of Global Liquidity. International Monetary Fund.

BOX 4: WHAT IS HOLDING BACK CAPITAL FLOWS?

With both "push" and "pull" factors supporting capital flows to emerging markets, it might be expected that aggregate flows to emerging economies would be reaching new record highs. In fact, under the assumption that risk aversion remains at its current low levels until 2014, our model suggests a sharp increase in absolute terms (Chart 12). However, as a percentage of EM GDP, flows remain well below the levels reached over the years 2005-07 even under the optimistic assumptions of the model. A swift return to the levels reached in 2007 is unlikely, as this year was characterized by an unusual buoyancy of capital flows (partly related to large inflows to Emerging Europe following the EU accession of several countries), but flows as a share of EM GDP currently are only at their level of the mid-1990s and thus seem unusually low.

As a percentage of EM GDP, flows remain well below the levels reached over the years 2005-07

There are two ways of thinking about this. First, it is a reminder that, although EM conditions are favorable now, they were more favorable in 2007. Second, there are a number of more specific factors that continue to be relevant over the forecast horizon:

- The impact of the Euro Area crisis has dampened capital flows into Emerging Europe (and the MENA region), which remain only at around half their 2007 level. By contrast, in Latin America and EM Asia, capital inflows have recovered more rapidly and are now more than 30% above their 2007 levels.
- Bank lending flows have collapsed since 2007 and have only partly recovered since then (Chart 13). Deleveraging of banks has added to this outcome, notably in Europe. This is partly due to tougher capital standards and increased uncertainty about changes to the regulatory environment .
- Countries increasingly resort to capital control measures to dampen inflows, a trend that is most pronounced in some Latin American countries, such as Brazil and Uruguay (see page 22).

Chart 13
Claims by European Banks on EM Regions
$ billion, ultimate risk basis

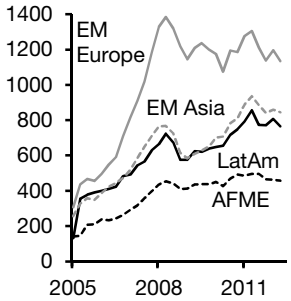


Chart 12
Private Capital Inflows to Emerging Markets
percent of GDP *$ billion*

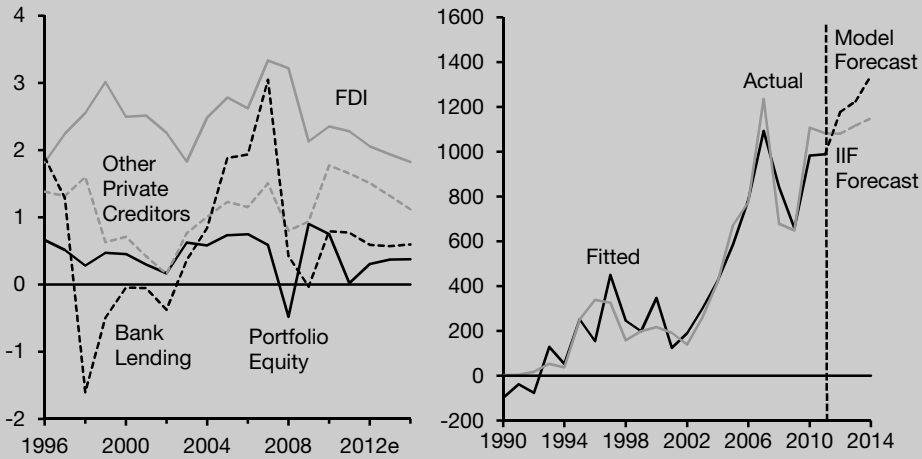
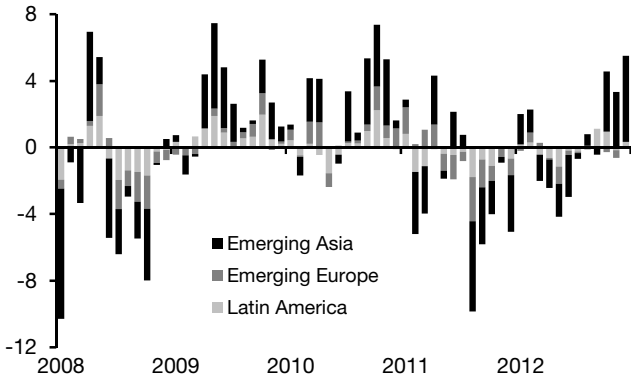
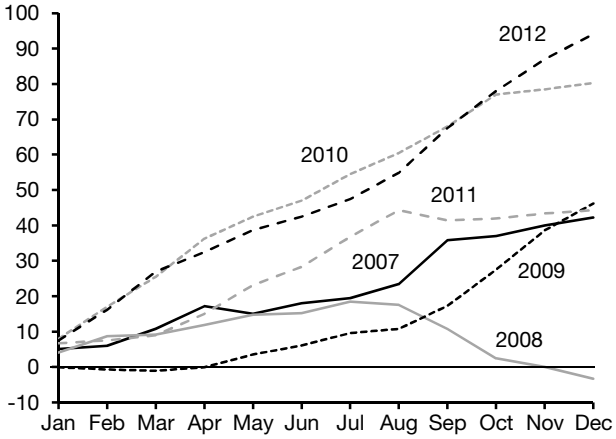


Chart 14
Emerging Market Regional Equity Fund Flows*
$ billion



* Flows from dedicated funds.

Chart 15
Fixed Income Flows into Emerging Market Funds
$ billion, cumulative flows



Strong FDI will be broad-based by sectors, but will include continued sizeable flows into commodity extraction. The only exception is Emerging Asia, where such inflows are expected to remain broadly unchanged. This partly reflects some diversification of manufacturing production out of China to other countries and heightened Sino-Japanese geopolitical tensions (see page 16).

The more volatile portfolio equity inflows have surged in recent months and are expected to continue to rise in 2013 (Chart 14). In 2014, they are forecast to amount to $110 billion, a 50% increase over 2012 but still below the $150 billion mark reached in both 2009 and 2010.

In line with a calming of the Euro Area crisis since mid-2012, commercial banking flows have started to recover and are set to increase over this year and next, albeit to very modest levels relative to 2004-07. Emerging Europe is the main beneficiary of this trend, with banking flows estimated to rise to $44 billion in 2014. This compares with $180 billion reached in 2007.

By contrast, the strong inflows into bond markets over recent months are expected to level off (Chart 15). Inflows from nonbank sources are estimated to have amounted to $365 billion in 2012, and thus remained close to the high levels reached in 2010 and 2011. This reflects in particular strong inflows in the second half of the year, which are likely to continue 2013H1, but trail off during the second half.

CHINESE CAPITAL OUTFLOWS: A GROWING FORCE IN THE WORLD ECONOMY

Chinese capital flows have surged over the past decade

Chinese capital flows have surged over the past decade, both in terms of inflows to China by foreign investors and outflows by Chinese residents. Chinese inflows account for about 40% of all inflows in our sample of 30 major emerging market economies. Chinese capital outflows are even larger and have become an important factor in the global financial system. The role of Chinese investments and lending in the global economy is likely to gain even

more importance in coming years, with important implications for both mature and emerging market economies.

Understanding the nature and drivers of these flows is therefore becoming increasingly important. This task is complicated by the fact that Chinese data on capital flows are generally quite sparse. In addition, different data sources can be difficult to reconcile, making it difficult to obtain a complete picture of past developments (or produce accurate projections for future developments for that matter). Nonetheless, a number of important insights can be gained from the data that is published by both national and foreign sources on Chinese capital flows.

Inflows of foreign capital to China are dominated by FDI

Inflows of foreign capital to China are dominated by FDI, which is typically long-term in nature and involves an investor taking a controlling stake in a company. By contrast, other forms of net capital inflows remain relatively modest. This is mainly because China maintains extensive controls on inward flows from banks as well as flows from portfolio debt and equity investors. While these restrictions are being progressively eased, they remain relatively tight compared to most other emerging economies.

For most of the past decade, total capital outflows from China had been significantly smaller than those from the U.S. and the Euro Area, the two biggest sources of capital flows. Flows

Table 5
China: Capital Flows
$ billion

	2011	2012e	2013f	2014f
Capital Inflows				
Total Inflows, Net:	*370.4*	*301.1*	*313.1*	*312.6*
Private Inflows, Net	359.5	293.7	303.6	303.2
Equity Investment, Net	225.4	212.0	215.0	215.0
Direct Investment, Net	220.1	205.0	200.0	195.0
Portfolio Investment, Net	5.3	7.0	15.0	20.0
Private Creditors, Net	134.1	81.7	88.6	88.2
Commercial Banks, Net	88.1	38.9	46.1	48.3
Nonbanks, Net	46.0	42.7	42.5	39.9
Official Inflows, Net	10.9	7.5	9.5	9.4
International Financial Institutions	0.1	-0.2	-0.5	-0.7
Bilateral Creditors	10.9	7.6	10.0	10.1
Capital Outflows				
Total Outflows, Net	-572.1	-498.6	-488.1	-492.6
Private Outflows, Net	-182.6	-363.0	-407.2	-412.0
Equity Investment Abroad, Net	-48.6	-93.0	-125.0	-140.0
Resident Lending/Other, Net	-134.0	-270.0	-282.2	-272.0
Reserves (- = Increase)	-387.8	-85.0	-80.9	-80.6
Memo:				
Net Errors and Omissions	*-1.7*	*-50.6*	0.0	0.0
Current Account Balance	*201.7*	*197.5*	*175.0*	*180.0*

Chart 16
G3 and China: Total Outflows
$ billion

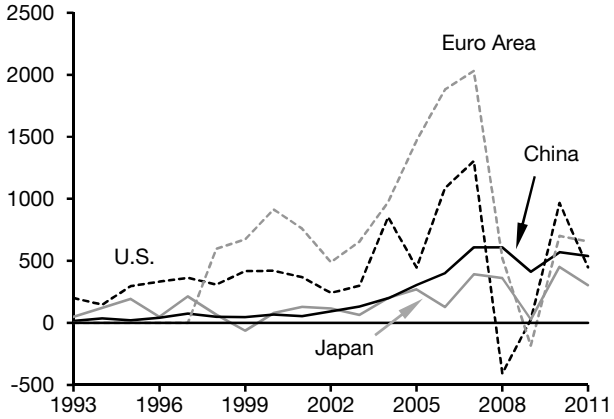
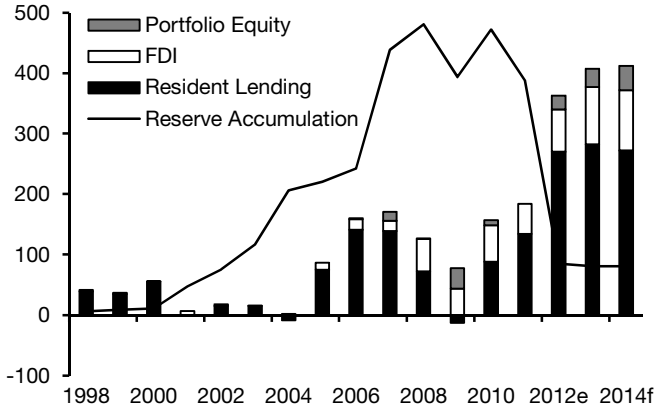


Chart 17
China: Capital Outflows by Component
$ billion



from China have not only increased rapidly in recent years but have also been less volatile, especially during the global financial crisis of 2008/2009. In 2009, when capital outflows from the G3 economies collapsed, Chinese flows to the rest of the world fell only moderately, as reserve accumulation continued at a pace of nearly $400 billion per year (Table 5, previous page). One possible reason for this is that flows from the G3 economies come from private investors and lenders, and are thus driven by considerations of risk-adjusted returns and changes in market sentiment. Chinese flows, however, have until recently been driven by policy preferences, which are usually not affected by short-term market developments (Chart 16).

Second, it is important to note that there has been a major shift in the composition of Chinese capital exports in recent years, especially in 2012 (Chart 17). Reserve accumulation has declined substantially. Meanwhile, equity and debt outflows by Chinese residents (i.e. the private sector plus state-owned enterprises) have surged. On the back of the government's "going global" policy, restrictions on private capital outflows have been eased, making it easier for residents to undertake outward investment and lending. Other emerging market economies seem to benefit disproportionately from this shift, as a significant share of Chinese outward direct investment targets resource-rich countries in Latin America, Africa, and other parts of Emerging Asia (see page 16).

CHINESE RESIDENT LENDING ABROAD APPEARS TO HAVE SURGED IN 2012

While the precise composition of non-reserve asset accumulation is unknown, the component that appears to have risen the most in recent years is resident lending abroad (Chart 18, next page). This all-embracing category encompasses accumulation of debt claims on foreigners, with the exception of foreign exchange accumulation by the State Administration of Foreign Exchange (SAFE). It thus includes bank lending, purchases of foreign bonds by residents and intercompany loans. Data availability on Chinese resident lending abroad is very limited. However, we can infer the surge in resident lending abroad

The component that appears to have risen the most in recent years is resident lending abroad

Chart 18
China: Resident Lending Abroad
$ billion

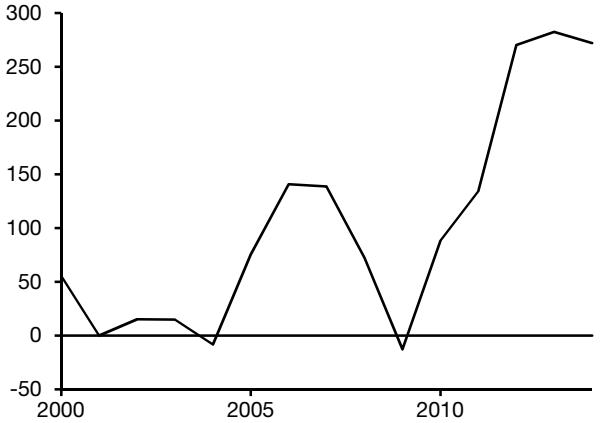
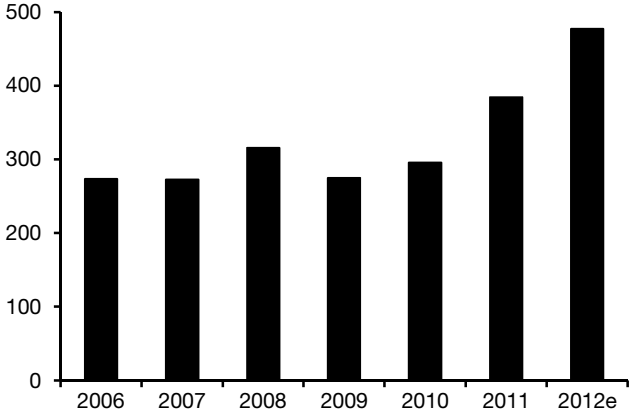


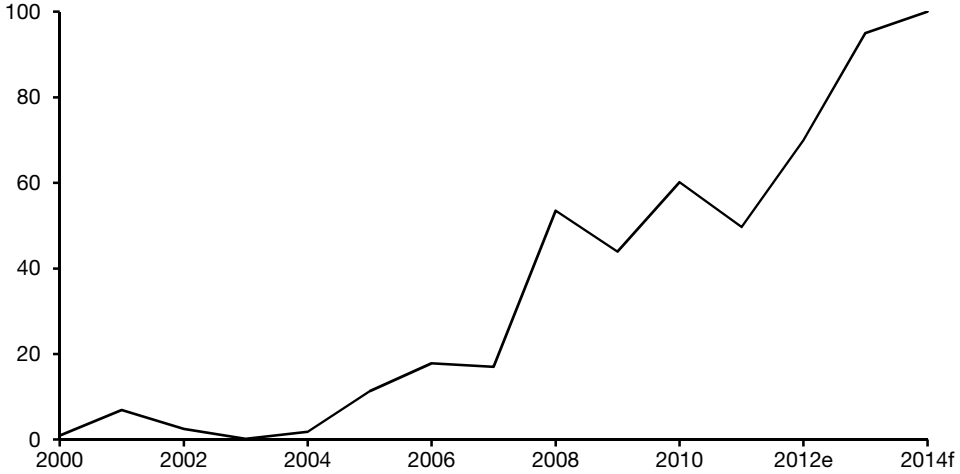
Chart 19
Foreign Assets of Chinese Banks
$ billion, end of period



from the other items in the Chinese balance of payments (i.e. by imposing the balance of payments accounting identity). For example, in 2012 reserve accumulation declined by about $300 billion relative to 2011, to only $85 billion. This large drop was only partly offset by lower private capital inflows, greater outward equity investment and negative net errors and omissions, while the current account surplus actually increased. Overall, resident lending abroad is estimated to have doubled to $270 billion in 2012 relative to 2011.

One component that seems to have contributed to the rise in recent years is overseas assets by Chinese financial institutions (Chart 19). The value of total external assets increased by $203 billion from end-2009 to end-2012, which accounts for about 41% of Chinese resident lending abroad during that period. Supported by a gradual relaxation of controls on outward lending, banks have increasingly diversified their loan portfolios internationally.

Chart 20
China: Outward Direct Investment
$ billion



CHINESE OUTWARD FDI CONTINUES TO RISE RAPIDLY

China's outward direct investment (ODI) rose to $49.7 billion in 2011 (Chart 20, previous page). The share of the services sector remained the largest in total investment, followed by the primary sector and the manufacturing sector. Two industries have attracted the most funding in the ODI portfolio, namely the business service industries (typically to facilitate exports) and the natural resources industries (to satisfy domestic demands). By contrast, ODI in the manufacturing sectors has remained limited, in line with the current policy goal of strengthening domestic economies of scale rather than shifting production overseas.

The share of the services sector remained the largest in total investment

GEOGRAPHIC DISTRIBUTION OF CHINESE OUTWARD FDI

The majority of China's outward FDI flows appears to be concentrated in its neighboring Asian economies. In 2011, the top overseas destination of capital outflows was Hong Kong ($33.8 billion), accounting for 47.8% of ODI. However, a significant portion of these funds are likely to only pass through Hong Kong, as China's offshore platform, heading ultimately to host countries or flowing back to China later as FDI inflows. Due to long-term domestic financing constraints, many Chinese firms use Hong Kong as the offshore platform to raise capital for their domestic business activities or projects in third countries.

The majority of China's outward FDI flows appears to be concentrated in its neighboring Asian economies

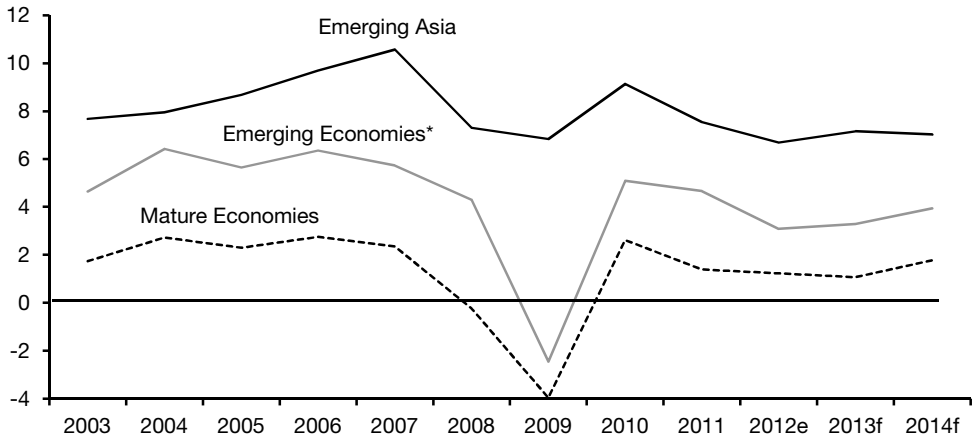
The size of investment flowing into Latin America seems to be large, but nearly 95% of investments in the region went to the two popular tax havens, the British Virgin Islands and the Cayman Islands. Most of these investments do not stay there but are reinvested in China for reasons of tax optimization, a phenomenon commonly known as round-tripping.

China's ODI to Africa has drawn wide public attention, increasing rapidly since the early 2000s, albeit from a very low base. In absolute terms, Chinese flows to Africa have so far been relatively small, with ODI amounting to $3.2 billion in 2011. Much of this ODI is believed to involve the acquisition of metals and mining assets. In fact, the large investment deals were executed almost entirely by large state-owned enterprises (SOEs) acquiring natural resources assets or developing natural resources' processing projects. To support and encourage Chinese firms to invest in Africa, in 2007 China founded the China-Africa Development Fund (CADF) with an initial investment of $1 billion. China's role as an investor in these regions is expected to grow significantly in coming years.

The clear trend is that China's ODI is flowing into mature economies at a slower pace than emerging economies. Total investment in the U.S., including in the financial sector, was only $1.8 billion in 2011 and $1.3 billion in 2010. Chinese executives point to protectionism and high host-country entry barriers as the main impediments. Investments in mature economies are expected to steadily expand in the next few years, not least because upgrading technological innovation capabilities and reducing energy consumption are key parts of China's 12th five-year plan (2011-2015).

The clear trend is that China's ODI is flowing into mature economies at a slower pace than emerging economies

Chart 21
Emerging Asia: Real GDP
percent change from previous year



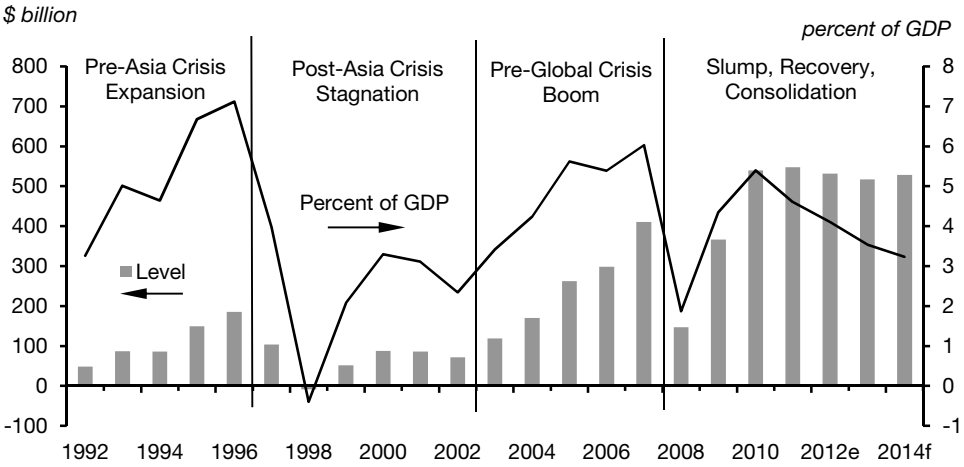
e = estimate, f = IIF forecast, *Excluding Asia

EMERGING ASIA: REMAINING A MAGNET FOR CAPITAL INFLOWS

Favorable regional fundamentals, amplified by easy mature economy financing conditions and a greater appetite for risk assets, are bolstering capital inflows to Emerging Asia. After bottoming out in the first half of 2012, real GDP growth for our seven countries constituting Emerging Asia is set to be sustained at around 7% in 2013 and 2014, compared with 3-4% for the rest of the emerging markets and 1-2% for the mature economies (Chart 21). While there could be periodic swings due to the potential for the return of risk aversion in the mature economies, accompanied by the drag from global bank deleveraging, private capital flows to Emerging Asia should remain close to their 2011 high of $547 billion over the projection horizon (Chart 22). The share of Emerging Asia in total private capital flows to emerging markets should average 46% this year and next, just short of the 50% in the previous two years.

Private capital flows to Emerging Asia should remain close to their 2011 high

Chart 22
Net Private Capital Inflows to Emerging Asia
$ billion



e = IIF estimate, f = IIF Forecast

Table 6
Emerging Asia: Capital Flows
$ billion

	2011	2012e	2013f	2014f
Capital Inflows				
Total Inflows, Net:	*568*	*548*	*537*	*550*
Private Inflows, Net	547	531	517	528
Equity Investment, Net	300	331	333	345
Direct Investment, Net	293	280	278	279
Portfolio Investment, Net	8	51	55	66
Private Creditors, Net	247	200	184	183
Commercial Banks, Net	136	80	75	81
Nonbanks, Net	111	120	109	102
Official Inflows, Net	21	17	20	22
International Financial Institutions	3	3	3	3
Bilateral Creditors	17	14	16	19
Capital Outflows				
Total Outflows, Net	*-765*	*-720*	*-682*	*-697*
Private Outflows, Net	-306	-514	-540	-550
Equity Investment Abroad, Net	-99	-150	-182	-203
Resident Lending/Other, Net	-207	-364	-358	-347
Reserves (- = Increase)	-440	-143	-142	-146
Memo:				
Errors and Omissions	-19	-62	0	0
Current Account Balance	*197*	*172*	*145*	*147*

Inflows of foreign direct equity investment are being sustained by the attractiveness of bases for exports of goods and services bolstered by large domestic markets. After inward FDI surged to $293 billion in 2011 from a post-global crisis low of $170 billion in 2009, it is set to plateau at around $280 billion this year and next (Table 6). While **China** will continue to dominate, its share is likely to drop from a high of 75% in 2011 to 70% in 2014 due to rising wages, some diversification of manufacturing production to other countries, and heightened Sino-Japanese geopolitical tensions. FDI inflows to **Indonesia** have been boosted by a commodity-induced surge, but they may now be checked by structural impediments and restrictions on resource-based exports. By contrast, FDI inflows to **India** will be lifted by the opening up of previously closed sectors and the withdrawal of controversial tax plans, although infrastructural deficiencies and administrative hurdles will remain dampening factors.

FDI inflows to India will be lifted by the opening up of previously closed sectors

The improvement in global sentiment from the third quarter of last year is reflected in revived foreign interest in the region's stock markets. In India, the resumption of the reform program is on course to lift foreign purchases of domestic stocks to $21 billion in the fiscal year ending March 2013, from $7.6 billion in 2011/12. In **Korea**, inward portfolio equity investment jumped to $13.5 billion in 2012 from net outflows of $7.5 billion in 2011. In contrast, governance and growth concerns in China limited stock purchases by foreign

investors to $7 billion in 2012, although they should rise to $20 billion in 2014 in response to recent measures by the Securities Regulatory Commission. For the region, foreign purchases of domestic stocks may be $55 billion this year and $66 billion next year, after jumping to $51 billion in 2012, from $8 billion in 2011.

Following the surge from $15 billion in 2008 to $120 billion in 2012, net inflows from nonbank private creditors should stabilize at around $100-110 billion this year and next, dampened somewhat by possible periodic bouts of risk aversion emanating from global uncertainties. Contagion from Europe led to a sell-off of domestic bonds by foreign investors in the second quarter of last year, before turning around in the third quarter following policy actions by mature economy central banks. Borrowers from the region are taking advantage of relatively low yields to increase issuance of international bonds, but these are likely to edge up over the forecast horizon.

Contagion from Europe led to a sell-off of domestic bonds by foreign investors in the second quarter of last year

In Korea, the intra-year swings are most evident from foreign purchases of domestic bonds shifting from net sales of $0.7 billion in the second quarter of 2012 to net purchases of $0.2 billion in the third quarter and $2.3 billion in the fourth. Meanwhile, Indonesian issuers raised $11.8 billion through international bonds in 2012, up from $6.7 billion in 2011, which helped finance part of the rising current account deficit. In India, the government's efforts to shore up the balance of payments by raising interest rates on deposits of Nonresident Indians in domestic banks attracted $11 billion in new deposits in the first eight months of the current fiscal year ending March 2013, following $12 billion in 2011/12.

In contrast, although some emerging market banks are expanding their activities in the region to take up the slack, the diminished role of foreign banks is set to remain a drag on capital inflows. This reflects the deleveraging underway along with more stringent global banking regulations and funding conditions. Net new bank credits are set to be around $75 -80 billion this year and next, compared with $110-140 billion in 2010 and 2011.

The diminished role of foreign banks is set to remain a drag on capital inflows

While capital inflows are set to plateau, the regional current account surplus should decline a bit further from around $170 billion this year after falling from a peak of $430 billion in 2008. The change reflects in part the correction in China's surplus from $412 billion to $180 billion between 2008 and 2014. Meanwhile, the current account in Indonesia shifted to a deficit of $21.5 billion in 2012, 2.4% of GDP, as a result of strong domestic demand-led import growth and anemic exports. Following a narrowing of the balance of payments surplus (due to the rise in the current account deficit), periodic downward pressures on the rupiah may continue over the near term. In India, the current account deficit is set to remain elevated at around $80 billion in 2012/13, 4.1% of GDP, before easing only slightly to $70 billion a year thereafter. The dependence on external financing makes India's balance of payments vulnerable to unpredictable shifts in investor and creditor sentiment, although stepped-up liberalization and reforms are helping bolster capital inflows.

The official foreign exchange reserve build-up for the region moderated from a peak of $588 billion in 2010 to $143 billion in 2012, and should stabilize at around that level, of which more than 50% is accounted for by China. Meanwhile, Emerging Asia continues to

expand its role as an exporter of capital. Outward foreign direct equity investment is likely to reach $150 billion in 2014, up from $95 billion in 2011. Asian firms are looking to secure energy and commodity supplies while expanding global marketing and production operations. These are being accompanied by investments by the region's sovereign wealth funds. In addition, loans and investments abroad are set to exceed $300 billion a year, fueled largely by the expansion of Chinese banks with government encouragement as part of the going global policy. Furthermore outward portfolio equity investments may rise to around $40-55 billion this year and next, up from $4 billion in 2011, due to greater diversification and the improved global outlook.

EMERGING EUROPE: IMPROVED EXTERNAL ENVIRONMENT TO BOOST CAPITAL INFLOWS IN 2013

Improved global market sentiment and ample ultra-cheap liquidity in the mature economies have helped boost private capital inflows to Emerging Europe since mid-2012. Private capital inflows rose to $52 billion a quarter on average during March-December from almost $40 billion a quarter during the preceding three quarters (Chart 23). The fourth quarter was particularly strong, with $58 billion in net inflows. These developments brought the 2012 total to $193 billion, only slightly less than the inflows in 2010 and 2011 (Table 7, next page).

Improved global market sentiment and ample ultra-cheap liquidity has helped boost private capital inflows to Emerging Europe

The recent increase came against the background of slowing output growth and narrowing current account deficits, suggesting that the pickup in private inflows was driven mainly by supply factors. This has been especially true since September 2012, when risk perceptions eased and risk premia dropped, following the announcement of the ECB's OMT program. In response, borrowers from the region rushed to avail themselves of the greatly improved conditions and pre-finance some of their 2013 borrowing needs. Eurobond (issues of foreign currency bonds to international investors) issues jumped as a result, to $46 billion in gross terms during the fourth quarter (half of which by Russian banks and corporations), about the same as during the preceding three quarters combined (Chart 24). Portfolio equity inflows

The recent pickup in net private capital inflows appears to have been driven by supply side factors

Chart 23
Emerging Europe: Foreign Capital Inflows
$ billion

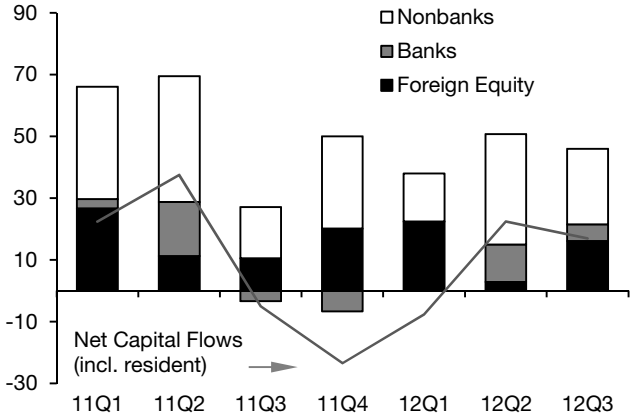


Chart 24
Emerging Europe: Eurobond Issuances
$ billion

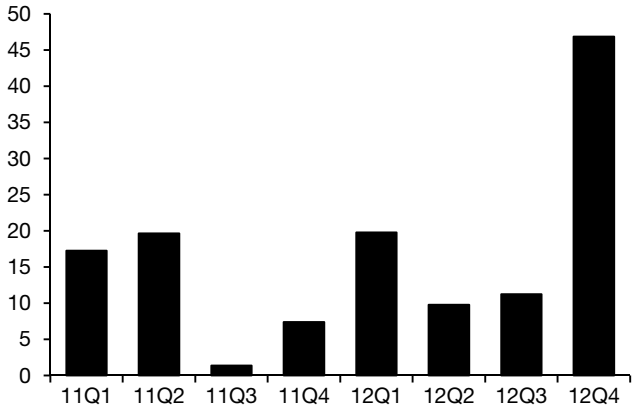


Table 7
Emerging Europe: Capital Flows
$ billion

	2011	2012e	2013f	2014f
Capital Inflows				
Total Inflows, Net:	*210*	*192*	*220*	*237*
Private Inflows, Net	197	193	218	229
Equity Investment, Net	64	60	77	83
Direct Investment, Net	71	56	71	75
Portfolio Investment, Net	-7	5	6	8
Private Creditors, Net	132	133	141	146
Commercial Banks, Net	2	32	37	44
Nonbanks, Net	130	101	104	102
Official Inflows, Net	13	-1	2	8
International Financial Institutions	9	-4	3	8
Bilateral Creditors	5	3	-1	0
Capital Outflows				
Total Outflows, Net	*-203*	*-188*	*-191*	*-176*
Private Outflows, Net	-166	-131	-163	-168
Equity Investment Abroad, Net	-47	-63	-64	-65
Resident Lending/Other, Net	-118	-67	-99	-103
Reserves (- = Increase)	-21	-47	-28	-8
Memo:				
Errors and Omissions	-16	-10	0	0
Current Account Balance	*-7*	*-4*	*-29*	*-61*

picked up, thanks to IPOs by Russian and Turkish issuers.

Borrowing by banks has rebounded as well, but the increase was mostly limited to **Turkey** and **Russia**. In the case of Russia, these inflows took the form of deposits, apparently to benefit from relatively high interbank rates. In the rest of the region, borrowing by banks remained subdued because of continued weak credit demand. FDI inflows have remained relatively modest, constrained by weak investment activity in Europe and sluggish growth in the host countries. The same factors kept corporate borrowing modest.

Even though net private capital inflows were little changed last year as a whole, their composition is different. A 23% drop in direct equity inflows was broadly offset by renewed portfolio equity inflows and stepped-up borrowing from commercial banks. The drop in direct equity inflows appears to have largely reflected lower reinvested earnings, as profits among foreign-invested companies fell and the withdrawal of foreign investors in Russia, **Poland** and **Romania**. The increase in bank borrowing was centered on Turkey and Russia. In most of the rest of the region, net repayments to commercial banks continued, with **Hungary**, the **Czech Republic**, Romania and Poland registering larger outflows than in 2011. While in Central Europe this mainly reflected reduced borrowing needs, as domestic demand weakened instead of being constrained by supply factors, the sharp increase in

Private capital inflows were little changed last year, but their composition is different

repayments to foreign banks in Ukraine was mainly due to a loss of market access.

In 2012, resident capital outflows slowed to $131 billion from $166 billion in 2011, thanks mainly to reduced capital flight from Russia once the political uncertainty associated with the March presidential elections eased, and from Ukraine because of smaller export earnings. By contrast, direct equity investment abroad rose, led by Russian investors.

Assuming the recent improvement in market sentiment is sustained, net private capital inflows to the region look likely to rebound to $218 billion this year and almost $230 billion in 2014. Although both figures would represent post-crisis highs, they will remain around one-third below the average inflows during 2005-2007. Roughly half of the increase next year is likely to reflect a recovery in direct equity inflows, to the equivalent of 1.7% of GDP from 1.4% of GDP in 2012, as last year's one-off factors lapse and reinvested earnings rise, along with profitability. Most of the rest is likely to reflect stepped-up portfolio inflows (both debt and equity) and interbank lending in search of higher yields, mainly in the countries with larger capital markets (Russia, Turkey and Poland). Nonresident purchases of local currency denominated government bonds should firm as well, reflecting in part the liberalization of Russia's ruble government bond market. Bond issues, on the other hand, are likely to be somewhat smaller next year, with some of the 2013 refinancing needs covered last year.

Net private capital inflows to the region look likely to rebound to $218 billion next year and near $230 billion in 2014

Turkey remains the only country in the region where demand for foreign capital is likely to increase, as output growth firms and the current account deficit widens again. Elsewhere in the region, demand for foreign capital is likely to be constrained by the weakening growth outlook and only moderate current account deficits. Bank borrowing, in particular, looks set to remain modest as a whole, given subdued credit demand and ongoing deleveraging by foreign parent banks, especially in Hungary and, to a lesser extent, in Romania. Capital inflows, under these circumstances, are likely to be mostly driven by the search for higher yields by foreign investors and mainly centered in countries with large bond markets (Russia, Turkey, Poland and Hungary) or attractive carry-trade opportunities (mainly Russia and Turkey). Ukraine will remain the only country in the region where market access will be constrained, at least until the government agrees on a new program with the IMF.

Turkey remains the only country in the region where demand for foreign capital is likely to increase

LATIN AMERICA: STRUGGLING TO MANAGE INFLOWS

The impulse to capital inflows stemming from ample global liquidity, supportive commodity prices ("push" factors) and the region's relatively stronger fundamentals ("pull" factor) has been mitigated by anti-appreciation policy activism in major countries, such as Brazil, and growing portfolio diversification overseas by regional corporates, a trend noticeable in **Mexico**, **Chile** (a large capital exporter) and **Brazil**.

The impulse to capital inflows stemming from ample global liquidity has been mitigated by anti-appreciation policy activism

We estimate that there was only a moderate increase in private capital inflows to the region last year (to $288 billion from $271 billion in 2011). One constraining factor was that controls on capital inflows have led to a decline in portfolio debt purchases by nonresidents in Brazil. Although private inflows are set to regain strength this year, the increase is likely to be held back by the region's policy response (Table 8, next page). Meanwhile broadening global

Table 8
Latin America: Capital Flows
$ billion

	2011	2012e	2013f	2014f
Capital Inflows				
Total Inflows, Net:	*293*	*304*	*321*	*326*
Private Inflows, Net	271	288	298	305
Equity Investment, Net	123	137	148	151
Direct Investment, Net	116	123	123	129
Portfolio Investment, Net	7	15	26	22
Private Creditors, Net	148	151	149	154
Commercial Banks, Net	33	33	34	43
Nonbanks, Net	115	118	116	111
Official Inflows, Net	22	15	23	21
International Financial Institutions	1	-1	5	5
Bilateral Creditors	21	17	18	16
Capital Outflows				
Total Outflows, Net	*-242*	*-237*	*-235*	*-218*
Private Outflows, Net	-126	-177	-152	-151
Equity Investment Abroad, Net	-33	-55	-48	-52
Resident Lending/Other, Net	-93	-122	-104	-99
Reserves (- = Increase)	-99	-60	-83	-67
Memo:				
Errors and Omissions	-17	0	0	0
Current Account Balance	*-51*	*-67*	*-86*	*-108*

investment strategies have boosted FDI outflows and net purchases of foreign portfolio equity by residents.

In **Brazil** controls on capital inflows have changed in their scale and composition. Aggressive anti-appreciation policy has resulted in a *de facto* target zone exchange regime, in which the *real* fluctuates between a R$2.00/$ floor and a R$2.10/$ ceiling. As a result, the *real* depreciated 8.7% against the dollar in 2012. Seeking to limit pass-through from currency depreciation to inflation, authorities have eased capital inflow controls. On-and-off capital controls on portfolio inflows (equity and fixed-income) and external financing by residents have, thus far, reduced inflows, by worsening market sentiment and shifting capital composition.

We estimate that private capital inflows to Brazil declined somewhat in 2012 from a year earlier

We estimate that private capital inflows to Brazil declined somewhat in 2012 from a year earlier and remain well below their 2010 peak. Despite elimination of the 2% IOF tax in December 2011, portfolio equity inflows have not yet recovered from pre-capital control levels, reflecting sluggish growth and market uncertainty over the government's policy response (Chart 25, next page). After peaking at $63 billion (2.5% of GDP) in the 12 months through November 2011, capital control-exempted inward FDI inflows declined to $53 billion (2.1% of GDP) by November 2012, still substantially higher than the $22 billion in November 2009, prior to the imposition of controls. Inflows from portfolio equity and overseas debt

Chart 25
Brazil: IOF Tax (6%) on External Loans
years *reais per $ (inverted)*

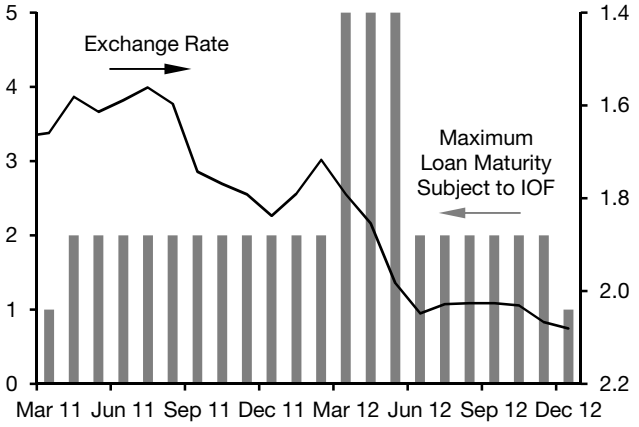
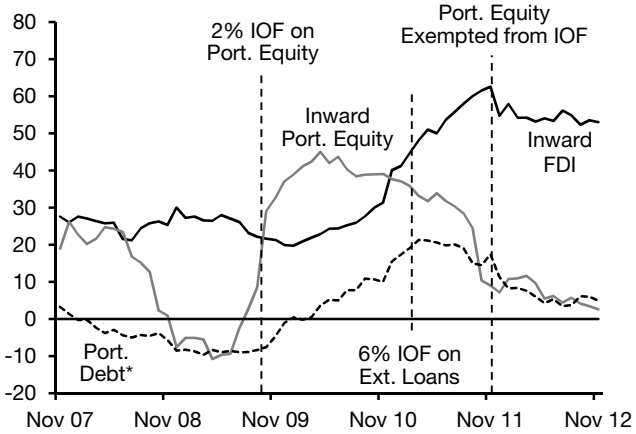


Chart 26
Brazil: Capital Inflows
$ billion, 12-month rolling sum



* Portfolio debt issued abroad, net

issuance have steadily declined (Chart 26).

Strong "pull" forces (real GDP growth above 6% and a significant interest rate differential) have made it difficult to stem currency appreciation in **Peru**. In October 2012, the central bank changed its intervention strategy in the spot market, with the aim of increasing nominal exchange rate volatility and discouraging one-sided bets in favor of the *sol*. Dollar purchases by the central bank are now more regular, regardless of conjectural market pressures. Macroprudential regulation of banks has also been tightened. While reserve requirements on short-term foreign-currency bank liabilities have been kept at 60%, the definition of "short-term" was broadened to include liabilities with maturities up to three years (up from two years). Regulatory limits to banks' short and long open dollar positions as a percentage of capital were also tightened in late 2012 (long positions from 15% to 10% and short from 60% to 50%).

In Peru the central bank changed its intervention strategy

In **Uruguay**, capital controls on central bank sterilization notes (LRMs), which took effect in October, have led to a moderation in foreign purchases of these instruments. However, the *peso* has risen to its strongest levels in over a year as attractive domestic interest rates (a powerful "pull" factor as the policy rate was hiked 25bps to 9.25% in December 2012) have fueled foreign demand for other domestic debt securities, adding to strong FDI inflows related to the construction of the Montes del Plata pulp mill.

With a fully open capital account and broadly flexible exchange regime, **Mexico** has continued to attract substantial foreign capital. Key underlying drivers are extremely accommodative monetary policies in mature economies ("push" factor), sound local macro policies and progress on the structural reform agenda ("pull" factors). Local-currency debt securities and equity have been the main inflow channels. Nonresident holdings accounted for 34.1% of internal public debt securities in November, up from 8.5% in 2005; inward FDI has been boosted by reinvestment of earnings by foreign-owned companies. FDI outflows, however, have outpaced inflows as Mexican corporations broaden their global reach. Reflecting significant portfolio equity inflows, stocks rose 18% and 28% in *peso* and dollar

With a fully open capital account and broadly flexible exchange regime, Mexico has continued to attract substantial foreign capital

Chart 27
Mexico: Bolsa Equity Index
index (Jan-08=100)

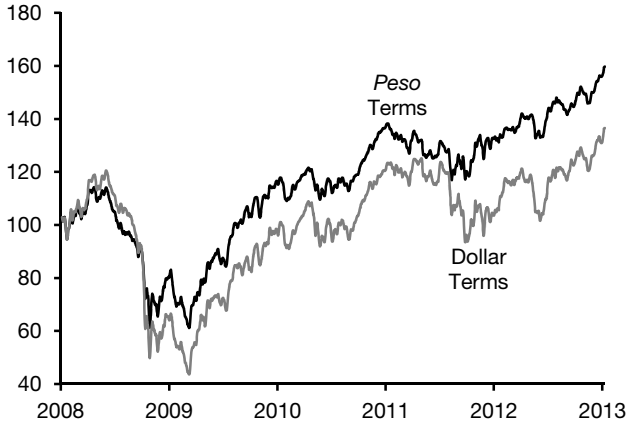
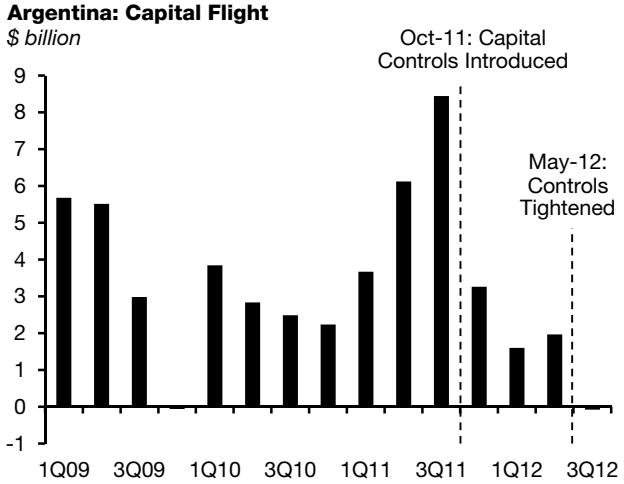


Chart 28
Argentina: Capital Flight
$ billion



terms in 2012 (Chart 27).

Unlike most counties in the region, **Argentina** is battling capital outflows. Unsettled external issues (litigation by holdout creditors, claims at the World Bank, Paris Club arrears and IMF Article IV review) and policy radicalization have eroded business confidence, forcing the government to tighten access to the official foreign exchange market in order to contain capital flight (Chart 28).

AFRICA AND MIDDLE EAST: OIL EXPORTERS PROVIDE FINANCIAL SUPPORT TO COUNTRIES IN TRANSITION

High oil prices, which averaged $112 per barrel for Brent crude in 2012, have resulted in large surpluses in the major oil-exporting countries in the region. While the bulk of these continue to be invested in developed markets and in real estate, the hydrocarbon-rich

Chart 29
AFME: Composition of Flows, 2013f

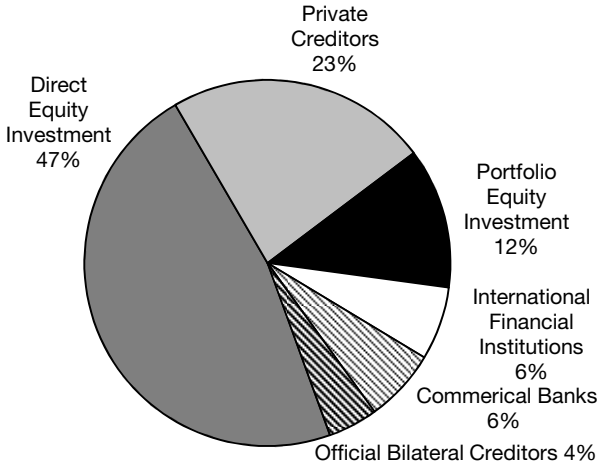


Chart 30
AFME: Change in Flows, 2012 - 2013
$ billion

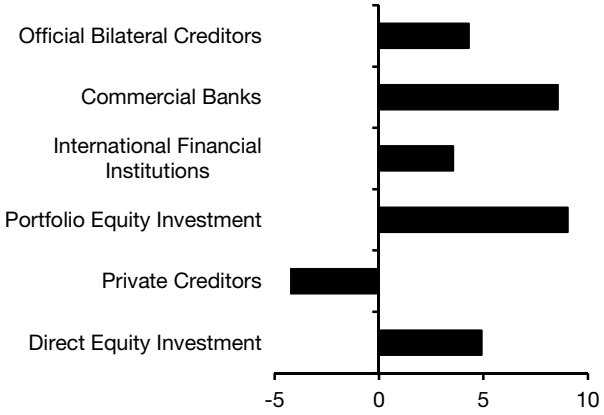


Table 9
Africa and Middle East (AFME): Capital Flows
$ billion

	2011	2012e	2013f	2014f
Capital Inflows				
Total Inflows, Net:	*74*	*70*	*96*	*96*
Private Inflows, Net	69	67	85	88
Equity Investment, Net	41	43	57	67
Direct Investment, Net	44	40	45	53
Portfolio Investment, Net	-3	3	12	14
Private Creditors, Net	29	24	28	20
Commercial Banks, Net	6	-2	6	7
Nonbanks, Net	23	26	22	13
Official Inflows, Net	5	3	10	9
International Financial Institutions	4	3	6	6
Bilateral Creditors	1	0	4	3
Capital Outflows				
Total Outflows, Net	*-236*	*-283*	*-283*	*-268*
Private Outflows, Net	-123	-152	-161	-156
Equity Investment Abroad, Net	-42	-45	-47	-50
Resident Lending/Other, Net	-81	-107	-114	-106
Reserves (- = Increase)	-107	-128	-121	-112
Memo:				
Errors and Omissions	-6	-2	0	0
Current Account Balance	*162*	*213*	*187*	*172*

countries of the GCC have also stepped in to provide financial support to transition countries in the region, such as Egypt and Jordan, whose balance of payments have come under increasing pressure over the past year or two. While global economic conditions have less of an impact on flows to the MENA region (Egypt, Lebanon, Morocco, Saudi Arabia, and the UAE) than domestic political developments and geopolitical uncertainties, easy money policies in the West have had more of an impact on flows to Sub-Saharan Africa (Nigeria and South Africa) whose high-yielding bond markets have attracted strong carry trade flows.

On an aggregated basis, private capital flows to Emerging Africa and Middle East are projected to rise sharply to about $85 billion in 2013 from an estimated $67 billion last year. This is still about half the peak reached in 2007, however (Table 9). The largest component of private inflows remains direct equity investment, which accounts for over half the total, at a projected $53 billion in 2013 (Chart 29, previous page). The largest increase in private flows between 2012 and 2013 is expected to be portfolio equity, which increases from $2.9 billion to $11.9 billion, while the only component that declines is other private creditors (Chart 30, previous page). The projected pickup in portfolio equity investment in 2013 mainly reflects a turnaround from outflows to small inflows in Egypt and renewed interest in the South Africa stock market, which is hitting new record highs. Official inflows are also projected to rise in 2013, to $10.4 billion from $2.6 billion last year, mainly reflecting the

Private capital flows to Emerging Africa and Middle East are projected to rise sharply to about $85 billion in 2013 from an estimated $67 billion last year

disbursement of IMF and other multilateral loans to Egypt, as well as financial support from other countries in the region.

Countries in **Sub-Saharan Africa** continue to attract foreign inflows into their domestic capital markets, where yields on fixed income securities are particularly attractive in a "risk-on" environment. In **South Africa,** where yields are around 6.5% for 5-10 year paper, nonresidents bought a record $10.5 billion worth of bonds in the first 11 months of 2012, far more than the previous 12-month records in 2010 and 2011 of $6.7 billion and $6.2 billion, respectively (Chart 31). There was some moderation in capital inflows starting in October, however. Up until then there had been strong foreign buying leading up to South Africa's inclusion in Citibank's World Global Bond Index (WGBI), which reinforced and added momentum to the carry trade. Post inclusion, inflows remained positive, but net purchases slowed to about $0.4 billion per month in October and November, from a peak of $2.6 billion in June. Even though the yield differential will remain large this year and into 2014, keeping the carry trade attractive, we expect foreign buying to moderate, as last year's "technical" boost will steadily fade. Investors may also exercise a little more caution in light of the larger current account deficit and increased foreign exchange market volatility. This is the reason for the reduction in the aggregated inflows from other private creditors to the region.

Countries in Sub-Saharan Africa continue to attract foreign inflows into their domestic capital markets

Nigeria is also benefiting from the global search for yield. Portfolio inflows (the bulk of which includes foreign buying of both equities and fixed income securities and proceeds from foreign issues) soared to $11.0 billion in the first three quarters of 2012 from $3.8 billion in the same period the year before. No quarterly breakdown between equity and debt is available, but it is likely that a large part of the increase was bond purchases. In addition to attractive yields and a fairly stable exchange rate, foreign investors had also been taking positions last year ahead of the inclusion of the three most liquid FGN securities in JP Morgan's GBI-EM index in October.

FDI (which is mainly direct equity investment, but also includes inter-company loans) is the other main source of capital inflows into Sub-Saharan Africa. Last year's unrest in the mining sector in **South Africa** may dampen inflows going forward. Lost production during the

Chart 31
South Africa: Nonresidents' Purchases/Sales of Bonds
$ billion, cumulative year-to-date

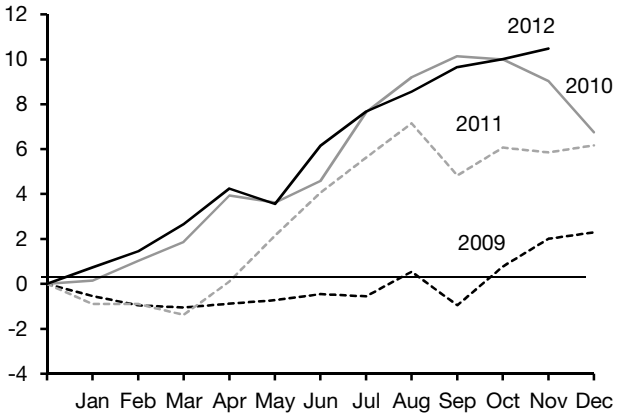
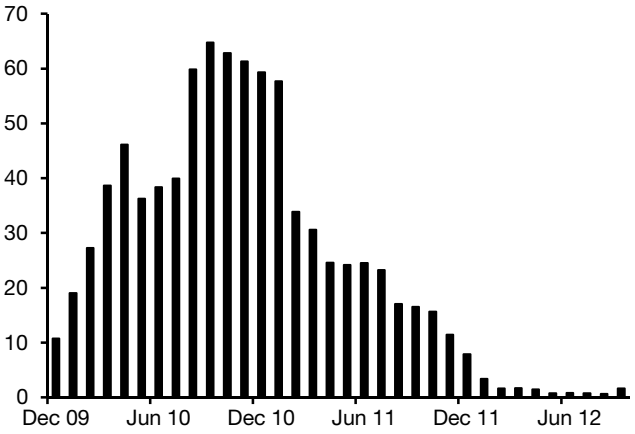


Chart 32
Egypt: Foreign Holdings of Treasury Bills
LE billion



strikes and the increase in wage–related costs will hit companies' profitability and may result in further mine or shaft closures as more operations become marginal. This, together with concerns over increased militancy (and the worrying trend of more frequent and spontaneous industrial action), may dampen investment in the sector. Nevertheless, direct equity investment into other sectors should continue to provide a steady (albeit possibly smaller) inflow of capital this year, although the effect on the overall balance of payments is reduced somewhat by outward investment into other Sub-Saharan Africa countries.

In **Nigeria**, the main source of capital inflows is traditionally FDI, principally in the oil sector through reinvested earnings and new capital for the expansion of current operations. However, other sectors such as manufacturing, financial services and telecommunications are also attracting foreign investment. This year, inflows are likely to be boosted by receipts from power sector privatization, which has elicited bids from foreign investors (possibly including other emerging market countries) as well as local companies. However, we do not expect any significant increase in inflows for now, as investment in new oil fields is contingent on the passage of the Petroleum Industry Bill, which remains bogged down in the National Assembly. Ongoing uncertainty over the proposed fiscal terms, which international oil companies fear may be too onerous, will likely continue to restrict new investment in the oil and gas sector.

Ongoing uncertainty over the proposed fiscal terms will likely continue to restrict new investment in Nigeria's oil and gas sector

Net private capital inflows to the major **MENA oil importers** (Egypt, Morocco and Lebanon) swung from a $20 billion inflow in 2010 to a small outflow in 2012, reflecting a large fall in FDI and outflows on debt instruments as foreign investors sought safer havens for their assets following the Arab Spring in early 2011. Prospects for the **Egyptian** economy now look less favorable than a few months ago. The political crisis over the new constitution and the delays of an IMF agreement have intensified pressures on the balance of payments. At end-2012, the Central Bank of Egypt moved to a more flexible exchange system by starting daily foreign exchange auctions, and tightening restrictions on foreign currency outflows. Since then, the pound fell by 6.5% to 6.60 to the U.S. dollar (as of January 18). The fundamentals of the Egyptian economy point to further depreciation of the pound, at least in the near term. Moreover, in the absence of an IMF program or strong economic policy actions (including fiscal adjustments), the ruling Muslim Brotherhood party will not be able to shore up confidence and avoid further large depreciation of the pound, thus deterring a revival of private sector inflows.

At end-2012, the Central Bank of Egypt moved to a more flexible exchange system

The HSBC PMI data series for Egypt suggests that the economy lost momentum over the second half of 2012, as output, new orders and external demand continued to stall, and employment growth has decelerated. Official reserves (excluding gold, currently valued at about $4 billion) have fallen from $32.5 billion at end-2010 to about $11 billion at end-2012 (less than three months of import cover) as a result of the widening current account deficit, the sharp fall in FDI, and liquidation of Treasury bills held by foreigners (Chart 32, previous page). Official reserves have remained at around $11 billion (excluding gold) since March 2012 despite the receipt of $2.0 billion from Qatar, which has raised its dollar loans to the Central Bank of Egypt to $4.0 billion. In addition, Qatar intends to invest $18 billion in Egypt over the next five years. The projects include $8 billion for gas, power and iron and steel

BOX 5: MENA OIL AND CAPITAL EXPORTERS' FOREIGN ASSETS INCREASE TO $3 TRILLION

MENA oil exporters' (Saudi Arabia, the UAE, Qatar, Kuwait, Oman, Bahrain, Algeria, Iran, Iraq, and Libya) combined current account surplus is projected to remain high at about $400 billion in 2013 (Chart 33). This surplus is projected to be partially offset by net capital outflows of about $150 billion, in part via sovereign wealth funds (SWFs). The resultant balance of payments surplus is partly reflected in official reserves, which are expected to increase further to $1.4 trillion by end-2013. The large surpluses of the region's oil exporters over the past decade have been an increasingly important element in the evolution of global imbalances. For example, the combined external surplus of Saudi Arabia and the UAE alone is estimated at $237 billion in 2012, or the equivalent of slightly more than half of the U.S. current account deficit. By way of comparison, China's surplus is estimated at $198 billion in 2012.

The diversified nature of investments and the projected continued large current account surpluses of MENA oil exporters should result in a further substantial increase in their stock of gross foreign assets (official reserves + SWFs + foreign assets of banks) to about $3.3 trillion by end-2014, against foreign liabilities of $0.5 trillion. About 40% of the foreign assets of the region are managed by SWFs with diversified portfolios of public equities, fixed income securities, real estate, and minority shares in big-name global companies. Reported FDI flows and other fragmentary evidence suggest increasingly strong interest in investing in emerging markets, particularly in the Middle East region and East Asia. Nonetheless, mature economies still remain an important destination for investment by the UAE, Qatar, and Kuwait, which together hold $1 trillion worth of assets (Chart 34). Saudi Arabia's foreign assets, which are largely in the form of official reserves ($670 billion at end-2012), are invested in liquid and low-yielding assets such as in foreign rated debt securities and deposits with banks abroad.

Reported FDI flows and other fragmentary evidence suggest increasingly strong interest in investing in emerging markets

Chart 33
MENA Oil Exporters: Current Account & Foreign Assets
$ billion

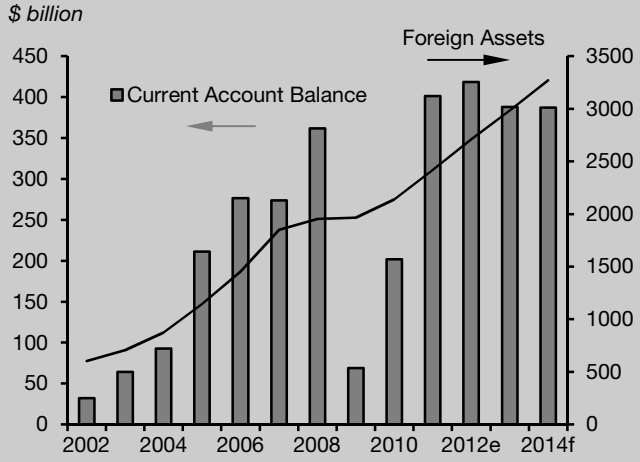
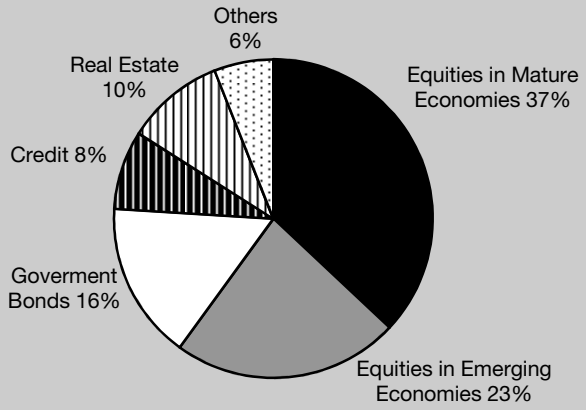


Chart 34
Rough Breakdown of SWFs (UAE, Kuwait, and Qatar)
percent of total



plants at the northern entrance to the Suez Canal and $10 billion for a giant Mediterranean tourist resort.

In **Morocco**, the large increase in the energy import bill, associated with high oil prices, and the decline in remittances and tourism receipts (due to a marked deterioration of economic activity in the Euro Area, Morocco's main trading partner) have widened the current account deficits in the past two years. This, combined with delays in official financing, has led to a decline in official reserves from $22.6 billion at end-2010 to $15.2 billion at end-2012 (equivalent to 3.8 months of import cover). Over the medium term, FDI is expected to increase with the implementation of several large-scale investment projects in the tourism, energy, and automobile sectors. Financial assistance from the GCC and the international community (in August, the IMF approved a $6.4 billion, two-year precautionary line of credit to Morocco) will help to cover the financing needs for 2013 and 2014, boosting total capital flows to about $4.1 billion a year and preventing a further decline in the official reserves.

Over the medium-term, FDI into Morocco is expected to increase

The deepening conflict in Syria continues to pose a threat to **Lebanon**'s political order and economic stability. Net private capital flows to Lebanon are expected to remain relatively low at around $4 billion in 2013 (which is well below the peak of $12 billion in 2009). Continued political uncertainty has led to a sharp fall in FDI and deceleration in the growth of nonresident deposits in domestic banks. Most FDI to Lebanon comes from the GCC countries. Lebanon needs to branch out and reduce its dependence on GCC countries for FDI and earnings from tourism.

The deepening conflict in Syria continues to pose a threat to Lebanon's political order and economic stability

IIF CAPITAL FLOW REPORT COUNTRY SAMPLE (30)

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

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