

Capital Flows to Emerging Market Economies

January 24, 2012

- After falling to \$910 billion last year, net private capital inflows to emerging economies are projected to be \$746 billion in 2012 and \$893 billion in 2013.
- Intensifying tensions in the Euro Area have prompted us to cut our capital flows projections by \$338 billion for 2012 and reduce our 2011 estimate by \$143 billion.
- Growth prospects in emerging economies have so far been quite resilient to financial shocks from Europe. Economic fundamentals would thus warrant a rapid rebound in capital flows if confidence can be restored in Europe.
- Global current account imbalances have narrowed as key surplus countries have seen their currencies appreciate. We project global imbalances to decline further.

Philip Suttle

CHIEF ECONOMIST AND
DEPUTY MANAGING DIRECTOR

1-202-857-3609
psuttle@iif.com

Robin Koepke

SENIOR RESEARCH ASSISTANT
Global Macroeconomic Analysis

1-202-857-3313
rkoepke@iif.com

Emre Tiftik

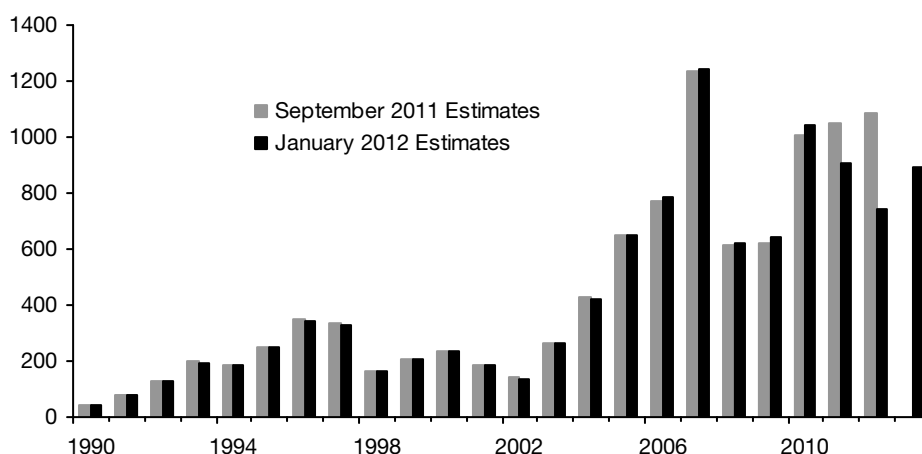
RESEARCH ASSISTANT
Global Macroeconomic Analysis

1-202-857-3321
etiftik@iif.com

Net private capital flows to our sample of 30 major emerging market economies have faltered in recent months. Net flows are now estimated to have been \$910 billion in 2011, and projected to be \$746 billion in 2012 (Table 1, next page). Our latest estimate for 2011 is \$143 billion below the full year projection made in September 2011 (Chart 1). Although our dataset is annual rather than quarterly, this would be consistent with a sharp drop-off in capital flows beginning late in the third quarter of 2011 and extending through Q4. This weakness has persisted into 2012. Our lower projection for 2012 (\$338 billion less than in September 2011) essentially extrapolates the weakness evident in flows in the last few months of 2011 through the first half of 2012.

Capital flows to EM economies have fallen sharply since the third quarter of 2011

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



Capital Flows to Emerging Market Economies

Table 1
Emerging Market Economies: Capital Flows

\$ billion

	2010	2011e	2012f	2013f
Capital Inflows				
<i>Total Inflows, Net:</i>	<u>1107</u>	<u>958</u>	<u>789</u>	<u>927</u>
Private Inflows, Net	1040	910	746	893
Equity Investment, Net	559	472	497	557
Direct Investment, Net	366	428	420	441
Portfolio Investment, Net	193	44	76	116
Private Creditors, Net	481	438	249	336
Commercial Banks, Net	162	137	38	96
Nonbanks, Net	319	301	211	240
Official Inflows, Net	67	47	43	34
International Financial Institutions	31	20	17	10
Bilateral Creditors	36	27	26	24
Capital Outflows				
<i>Total Outflows, Net</i>	<u>-1470</u>	<u>-1318</u>	<u>-1053</u>	<u>-985</u>
Private Outflows, Net	-664	-707	-672	-699
Equity Investment Abroad, Net	-289	-277	-316	-372
Resident Lending/Other, Net	-375	-430	-356	-327
Reserves (- = Increase)	-806	-611	-380	-286
<i>Memo:</i>				
<i>Current Account Balance</i>	<u>363</u>	<u>360</u>	<u>264</u>	<u>58</u>

We believe that we do not have to look far to explain this unexpected decline in net private capital flows to emerging economies. While there are a number of factors responsible, the proximate major cause is the onset of renewed financial turbulence in the Euro Area. Initially, it might seem odd that heightened turbulence within the Euro Area would dampen capital flows to emerging economies. After all, the combination of lower ECB interest rates and rising relative creditworthiness of emerging economies might be expected over time to divert capital flows from the Euro Area to emerging market economies. In due course, these factors should indeed become dominant themes. For now, however, the Euro Area crisis has damaged the willingness and ability of investors and lenders in the region to *supply* financing to businesses and borrowers in emerging economies. This reduction in supply will hold back growth in some emerging economies below what it might otherwise have been — especially in Emerging Europe, where the ties with the Euro Area are very significant.

The main weakness in private capital flows to emerging economies in recent months has come in the form of a lower flow of bank lending (Box 1, next page). This reflects a key transmission mechanism of the Euro Area crisis to the global economy. As sovereign debt problems deteriorated within the Euro Area in the second half of 2011, banks in the region came under intense funding pressure, especially in international markets. These greater funding difficulties — particularly in the dollar market — led many Euro Area banks to begin

The Euro Area crisis has damaged the willingness and ability of investors and lenders in the region to *supply* financing to emerging economies

Capital Flows to Emerging Market Economies

BOX 1: REVISIONS TO IIF FORECASTS

Since our September 2011 Report, we have made large downward revisions to our capital flows forecasts (Table 2). We now estimate that in 2011 net private capital inflows to emerging economies were \$143 billion lower than we previously thought. Most of our downward revisions are for the year 2012, however. The weakness is concentrated in EM Europe and EM Asia, the two regions most affected by Euro Area external deleveraging. In EM Europe, close banking ties with the neighboring Euro Area have resulted in substantial spillovers. In EM Asia, withdrawals of equity and debt holdings by European investors have led to sharply lower inflows.

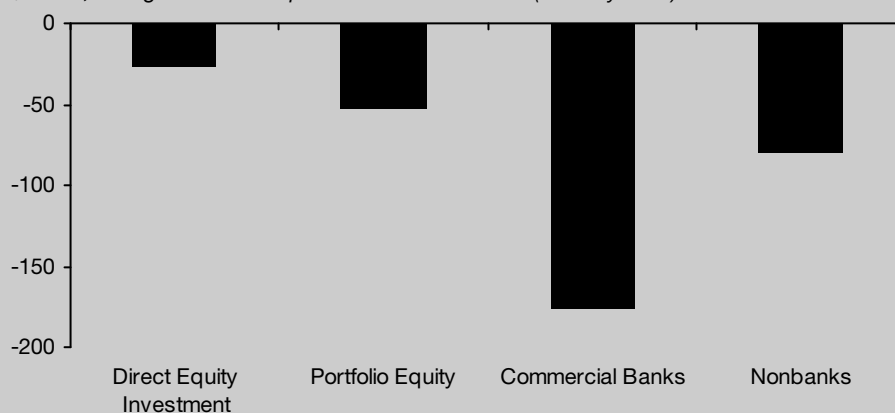
Our downward revisions are concentrated in EM Europe and Asia, the two regions most affected by Euro Area external deleveraging

Table 2
Revisions to IIF Net Private Capital Inflows
\$ billion

	2009	2010	2011e	2012f
IIF Capital Flows				
January 2012	643	1,040	910	746
September 2011	623	1,009	1,053	1,084
Difference	20	31	-143	-338
Revisions by Region				
Latin America	-1.3	1.7	1.1	-5.0
Emerging Europe	3.9	1.7	-46.4	-143.2
Africa/Middle East	20.8	18.6	21.8	-0.8
Emerging Asia	-2.7	9.4	-119.8	-188.9

We expect bank lending to emerging economies to be particularly affected by the ongoing Euro Area tensions (Chart 2). Credit extended by commercial banks is projected to fall to around \$38 billion in 2012, sharply lower than the previous forecast of \$215 billion. All other components were revised down as well, with direct equity investment the least affected.

Chart 2
Revisions to Private Capital Inflow Estimates for 2012 by Component
\$ billion, change between September 2011 and latest (January 2012) estimates

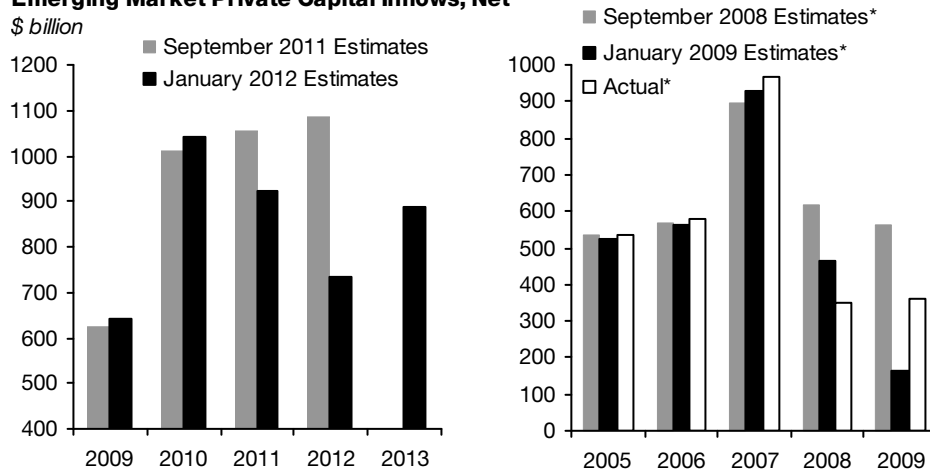


Capital Flows to Emerging Market Economies

Chart 3

Emerging Market Private Capital Inflows, Net

\$ billion



*Old IIF Measure: equity flows by EM residents are subtracted from net private capital inflows

to trim international assets aggressively, starting in 2011Q3. This deleveraging was accelerated by measures taken by the European Banking Authority (EBA) in an attempt to shore up Euro Area banks by forcing them achieve a 9% core Tier 1 capital ratio by the middle of 2012. In an environment where raising new capital was extremely expensive, Euro Area banks responded by accelerating asset shedding, especially in foreign markets.

It is interesting to contrast this shock to capital flows to emerging economies with that which occurred in the aftermath of the Lehman crisis in 2008 (Chart 3). Ironically, the timing is somewhat similar — a significant shock that occurred in the late summer, which then had severe ripples through Q4 and into the new year. In the case of Lehman, it was 2008-09; in the case of the Euro crisis, it is 2011-12. Looking back at how our estimates of the Lehman shock evolved, one lesson seems to be that flows are apt to be a little more cyclical than we project in the midst of the crisis. For example, in January 2009 we cut our estimates for 2009 as a whole too aggressively (relative to those of September 2008), but were still overstating flows for the last part of 2008. There is no inevitability that we will repeat these errors in coming quarters (we are certainly not planning to!), but it is helpful to bear this experience in mind.

Flows to two regions were most affected by the cutbacks. Not surprisingly, flows to Emerging Europe were reduced, and these cutbacks are likely to be extended through 2012 (Table 2, previous page). Perhaps more surprisingly, however, flows into Emerging Asia were much reduced as well. Among other factors, interbank lending from European banks to banks across Emerging Asia seems to have fallen substantially. This development was corroborated by our Emerging Market Bank Lending Survey (Box 2, page 9).

It should be emphasized that the Euro Area crisis was not the only factor dampening capital flows to Emerging Asia in the last part of 2011 and, most likely, for 2012 relative to our earlier expectations. In China, prospects for slower growth and lower interest rates seem to have curtailed short-term flows. Perhaps more importantly, evidence of a much reduced Chinese external surplus seem to have dampened expectations for continued CNY appreciation. Net

After the 2008 Lehman shock capital flows turned out to be more cyclical than we expected

Capital Flows to Emerging Market Economies

Chart 4
Emerging Economies: Changes in FX Reserves*

\$ billion, end of month, not seasonally adjusted



*21 Emerging Economies: Argentina, Brazil, Chile, China, Ecuador, Egypt, Hungary, India, Indonesia, Korea, Malaysia, Mexico, Peru, Philippines, Russia, South Africa, Thailand, Turkey, Ukraine, Uruguay, Venezuela.

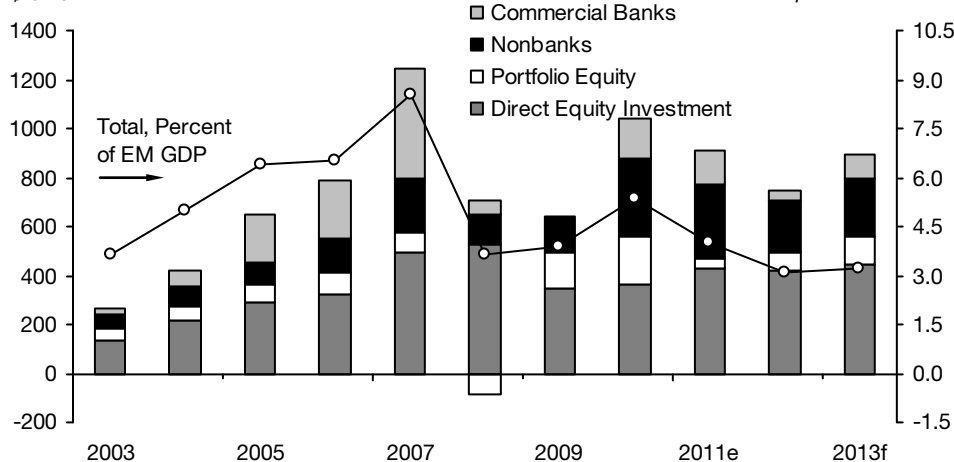
inflows into China were much lower than we had projected, leading to both less upward pressure on the currency, as well as less need for the authorities to acquire foreign exchange reserves. The stock of Chinese FX reserves expressed in dollar terms actually fell in the second half of the year, although we believe that this was more than accounted for by the appreciation of the dollar against the euro. FX reserves also fell in other emerging economies (Chart 4).

The Euro Area crisis will take many quarters to resolve, but we believe that its impact on the environment for capital flows to emerging economies will fade somewhat, especially in the second half of 2012 and into 2013. Indeed, some flows — most notably FDI flows — have barely been affected by the turbulence in Europe (Chart 5). Growth in emerging economies remains quite resilient and, as emphasized, the latest round of turmoil in mature economies — this time centered on Europe — is apt to remind global investors that mature economies are liable to be a region of low nominal returns and higher risk for an extended period. One

FDI flows have barely been affected by the turbulence in Europe

Chart 5
Emerging Market Private Capital Inflows, Net

\$ billion



Capital Flows to Emerging Market Economies

Chart 6
Sovereign Credit Ratings on Long-Term Debt
average of Moody's S&P, and Fitch long-term ratings

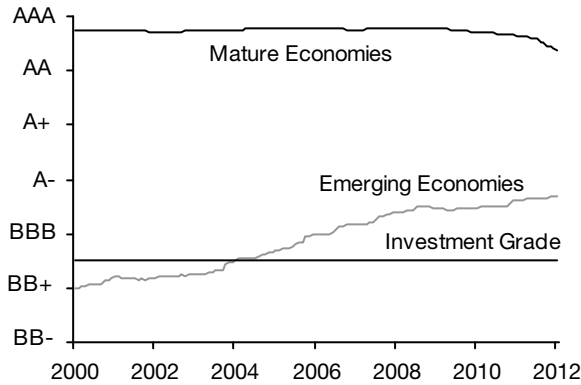
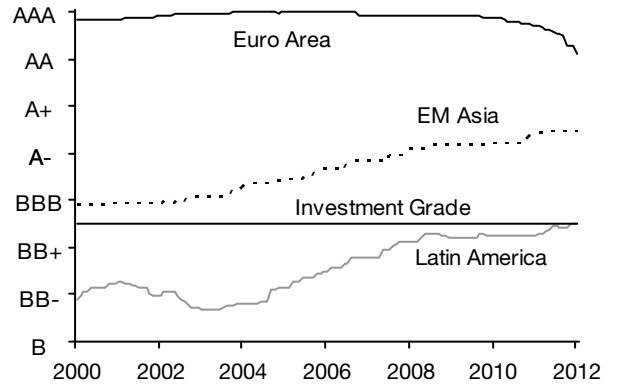


Chart 7
Sovereign Credit Ratings on Long-Term Debt
average of Moody's S&P, and Fitch long-term ratings



outcome of the Euro crisis is that it has made it even more likely that interest rates in all major economies will be pushed to and then held at 0.5% or below throughout 2013. Another is that it has reminded investors that relative risk perceptions — as proxied by sovereign ratings — keep moving in favor of emerging economies (Charts 6 and 7).

Issuance by emerging market borrowers in debt markets has also begun to rebound in recent weeks, and the strength of emerging equity markets in January 2012 is consistent with a revival in portfolio equity flows (Charts 8 and 9).

There is thus very good reason to expect flows to re-accelerate in 2013, when we project them to be \$927 billion. The projected rise in FDI flows, to \$441 billion, is particularly eye-catching. Importantly, there is growing evidence of emerging economies — which have long been sizeable capital exporters to mature economies — investing in one another. Countries with already sizeable foreign exchange reserve holdings are apt to become leery of expanding them further and may prefer instead to relax controls on outward capital flows

Countries with already sizeable foreign exchange reserve holdings may relax controls on outward capital flows by private sector residents

Chart 8
Emerging Market Total Bond Issuance
\$ billion

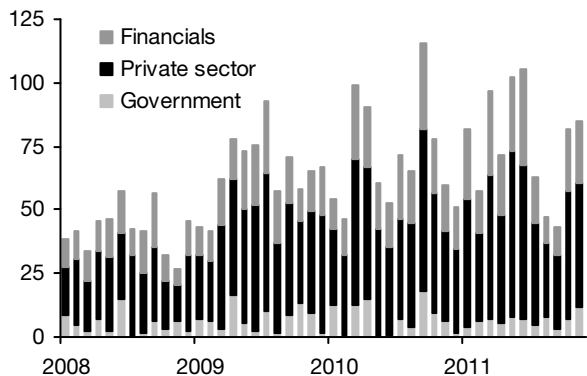
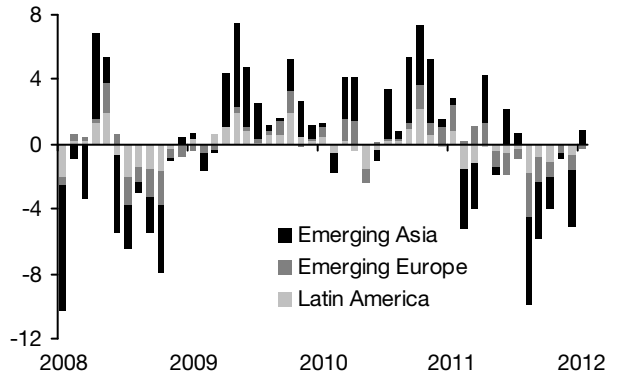


Chart 9
Emerging Market Regional Equity Fund Flows*
\$ billion



* Flows from dedicated funds.

Capital Flows to Emerging Market Economies

by private sector residents. Such outflows are more likely to be driven by considerations of relative risk and return and could thus favor more emerging market destinations, rather than low yielding mature economies. The withdrawal of European banks from Emerging Asia could, for example, open the way for Chinese banks to become more involved in the region. By way of illustration, three Chinese banks (China Development Bank, Export-Import Bank of China and Industrial and Commercial Bank of China) made a loan of \$1.2 billion to Reliance Communications of India (7 year maturity, at 5%) in mid-January. The loan will be used to repay maturing foreign currency convertible bonds, which are not being converted to equity because of the fall in the stock market.

EURO AREA EXTERNAL DELEVERAGING TAKES A TOLL ON EM FLOWS

IIF analysis of capital flows traditionally focuses on inflows into emerging economies from non-residents (i.e. flows coming from investors and lenders located outside the EM country in question). In the years leading up to the financial crisis, the Euro Area was one of the largest sources of foreign capital in the world, accounting for 58% of G3 capital outflows during the capital flows surge of 2004-2007 (Chart 10). The sheer volume of flows coming from the region means that conditions in Europe are a key determinant of aggregate capital flows to emerging economies.

Since the onset of the global financial crisis in 2008, however, capital outflows from Europe have been disproportionately weak. These flows averaged \$1.6 trillion per year from 2004-2007, but fell to only \$300 billion per year in 2008-2011. Recent data suggest that portfolio equity and debt flows have been particularly affected by the ongoing debt crisis, contracting by \$69 billion and \$49 billion in 2011Q3, respectively (Chart 11). Bank flows were positive in 2011H1, but are likely to have declined in H2. Foreign direct investment will probably be the only component to make a positive contribution to outward flows from the Euro Area in 2011H2.

Our baseline forecast assumes that flows from Europe will continue to be remarkably weak

During the capital flows surge of 2004-2007 the Euro Area accounted for 58% of G3 capital outflows

Chart 10
Net Private Capital Outflows

\$ billion, net private flows by residency of investors & lenders

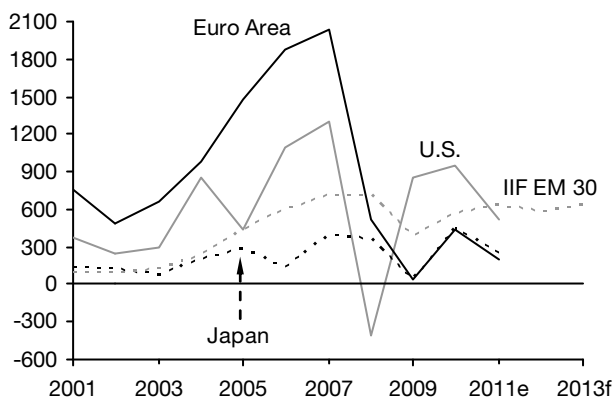
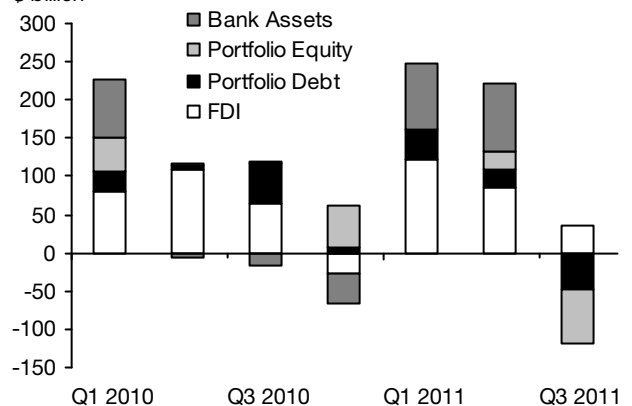


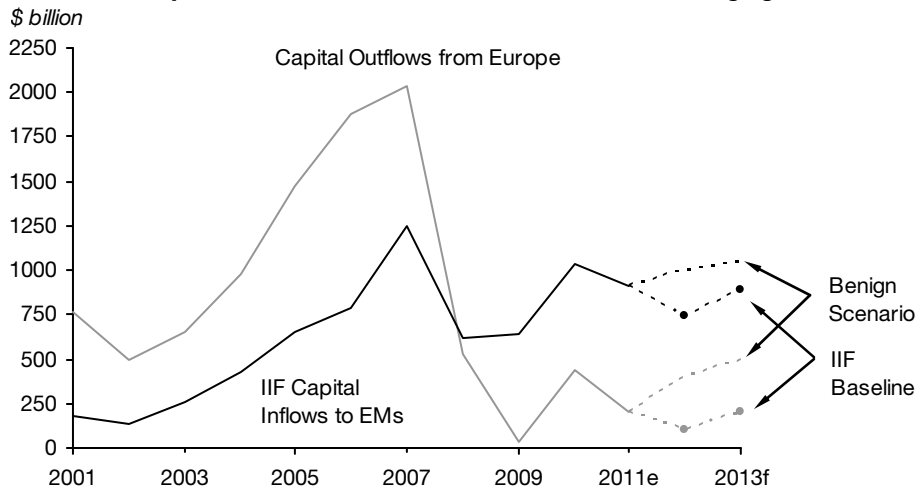
Chart 11
Euro Area: Net Private Capital Outflows

\$ billion



Capital Flows to Emerging Market Economies

Chart 12
Net Private Capital Outflows from Euro Area and Inflows to Emerging Markets



(Chart 12). This forecast is based on our view that tensions in Europe are likely to subside only gradually. We believe these tensions have already pulled the Euro Area into recession and will result in an anemic recovery of economic activity later this year. We currently forecast a mild recession for the region, with output contracting at a 1.5-2% annualized pace from 2011Q4 to 2012Q2. This will be followed by a sluggish resumption of growth in 2012H2. During this period, outward flows from Europe are expected to resume only gradually. In 2013, outward investment and lending are likely to accelerate moderately, supporting a rebound in capital inflows to emerging economies.

A more timely and comprehensive resolution of the Euro Area crisis would have large positive effects on emerging economies. If decisive policy action is taken to restore confidence in financial markets, this could result in a major resumption of capital outflows. In this benign scenario, capital flows to emerging economies could be closer to \$1 trillion in 2012 and 2013, rather than the \$700 billion and \$900 billion we currently forecast. A sustained easing in European financial tensions is thus a major upside risk to our forecast.

We view our current assumptions about the Euro Area as reasonably conservative, but they are certainly not a worst-case scenario. If Euro Area tensions were to escalate in the core European economies, the implications for global capital flows could be massive. While this is an important tail risk, the repercussions of such an adverse scenario on global capital flows are difficult to quantify. BIS data on cross-border bank claims are useful to see the magnitude of international exposures. European banks hold very large claims on the rest of the world (Chart 14 and 15, page 10). As of 2011Q2, the latest available data, European banks had total claims in the amount of \$14.1 trillion on advanced economies and \$4.8 trillion on emerging economies (measured on an ultimate risk basis, which includes guarantees and credit commitments). This is equal to about 21% of emerging market GDP.

Large cross-border exposures serve to highlight that the current economic and financial challenges in Europe may have severe repercussions that could go far beyond the region. A

A more timely resolution of the Euro Area crisis would have large positive effects on emerging economies.

Capital Flows to Emerging Market Economies

BOX 2: IIF EMERGING MARKETS BANK LENDING CONDITIONS SURVEY

In order to monitor the financial stability of emerging markets, the IIF has been conducting a quarterly survey of bank lending since December 2009. The IIF's Emerging Markets Bank Lending Conditions Survey (EMLC) addresses five different topics: credit standards, demand for loans, funding conditions, trade finance and nonperforming loans. The latest EMLC Survey covering 2011 Q4 was published on January 24. The results of the survey are presented as diffusion indices: A reading above 50 implies improvement while a reading below 50 indicates deterioration.

The survey results indicate a gloomier outlook than previous surveys, with global bank lending conditions weakening substantially over the past three months, and across all major regions (Chart 13). Noteworthy features of this quarter's survey results include:

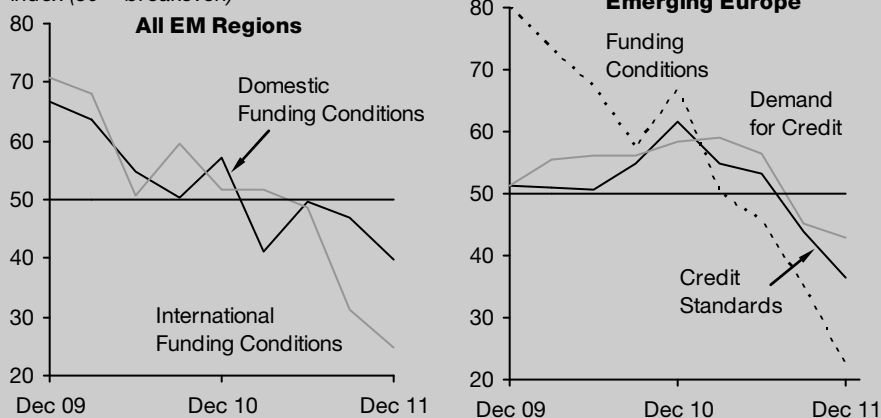
- 1) A sharp deterioration in bank lending conditions across all regions. The most significant deterioration has occurred once again in funding conditions;
- 2) There was a sharp tightening in credit standards across all categories of loans in our survey (business, real estate and consumer);
- 3) The situation has deteriorated the most in Emerging Europe. All indices for the Emerging Europe, especially credit standards index, declined to worrying low levels;
- 4) Demand for credit in emerging economies is generally holding up quite well (with the exception of Emerging Europe);
- 5) Encouragingly, international trade finance conditions continued to improve, especially in Asia;
- 6) Our overall index of non-performing loans showed the second straight quarterly deterioration (note a reading of our NPL index below 50 implies rising NPLs).

Banks domiciled in emerging market economies, especially in Emerging Europe, continue to experience tighter bank lending conditions

Chart 13

IIF EMLC Survey: EM Bank Funding Conditions

index (50 = breakeven)



Capital Flows to Emerging Market Economies

Chart 14
Foreign Claims by European Banks

\$ trillion, ultimate risk basis

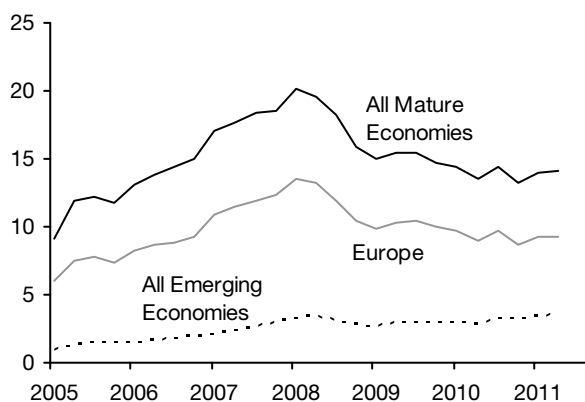
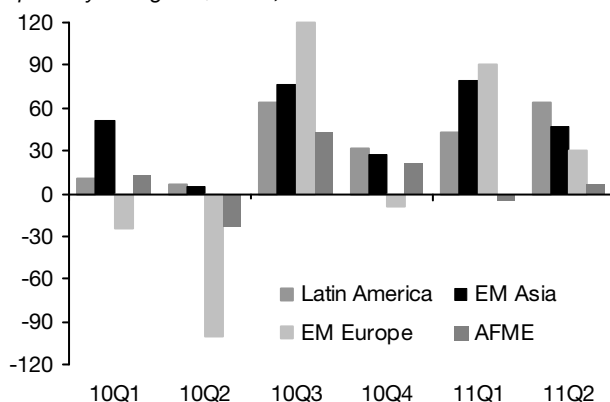


Chart 15
Claims by European Banks on EM Regions

quarterly change in \$ billion, ultimate risk basis



decisive move by policymakers to restore confidence and fiscal sustainability is needed to reduce the adverse impact on emerging markets and on the global economy more broadly.

EM OUTLOOK: MARKETS WEAK, FUNDAMENTALS STRONG

Emerging market equities and currencies fell broadly in 2011H2, led by Emerging Europe and Asia. The decline in asset prices was mainly driven by external factors rather than domestic ones, however. Economic fundamentals continue to be robust, with growth prospects remaining far better than in the mature economies. Emerging economies are forecast to grow by 5.4% and 6.1% this year and next led by Emerging Asia (Table 3). This compares to 0.9% and 1.9% growth forecast for mature economies. China accounts for a large portion of global output growth, with GDP likely to slow only modestly to 8.6% in 2012 before reaccelerating to 9% in 2013. Emerging Europe is the region by far the most affected by spillovers from the Euro Area. Growth is likely to slow markedly from 4.6% in 2011 to only 2.6% this year.

Since we published our last Capital Flows Report in September 2011, we have notched down our aggregate EM growth forecast for 2012 by just under 0.7 percentage points. Meanwhile, our forecasts for the Euro Area and Japan were cut by 2.3 and 0.9 percentage points, respectively. Indeed, we believe the Euro Area is already in recession and will see its output contract by 1% in 2012. The U.S. is the only major economy that surprised a little on the upside, reflected in an upward revision of 0.4 percentage points for 2012 since our September report. Private consumption has been more solid in recent months and labor market conditions have improved somewhat. Nonetheless, fiscal tightening and a weaker global economy are likely to hold growth back to around 2.2% in 2012 and 2.4% in 2013.

Better relative growth prospects provide a favorable backdrop for equity inflows to EMs, both in the form of foreign direct investment (FDI) and portfolio investment. This is mainly because economic growth creates opportunities for businesses to invest profitably.

Economic fundamentals in emerging economies continue to be robust, with growth prospects remaining far better than in the mature economies

Capital Flows to Emerging Market Economies

Table 3
Global Output Growth
percent change over previous year

	2010	2011e	2012f	2013f
Mature Economies	2.8	1.3	0.9	1.9
United States	3.0	1.7	2.2	2.4
Euro Area	1.8	1.5	-1.0	1.2
Japan	4.5	-0.9	1.9	1.8
Other Mature Economies	2.7	1.8	1.1	2.0
Emerging Economies	7.2	6.0	5.4	6.1
Latin America	6.2	4.0	3.4	4.2
Argentina	9.2	6.5	3.5	3.0
Brazil	7.5	2.8	3.0	5.0
Mexico	5.4	4.0	3.3	3.5
Emerging Europe	4.5	4.6	2.6	3.6
Russia	4.0	4.0	3.6	4.0
Turkey	9.0	8.5	3.2	4.5
Asia/Pacific	9.1	7.7	7.4	7.9
China	10.4	9.3	8.6	9.0
India	8.5	7.0	6.5	7.0
Africa/Middle East	4.3	4.6	3.9	4.0
South Africa	2.9	3.1	2.9	3.7
World	4.4	3.2	2.8	3.7

Emerging economies' long-term growth potential is one of the key driving forces behind what we think will be a secular trend towards greater capital flows to emerging economies. Our downward revisions to capital flows should thus be seen as a temporary deviation from a long-term trend towards greater inflows to EMs. It is not a fundamental reassessment of emerging markets' economic and financial development prospects. Indeed, the positive EM growth outlook means that the economic backdrop for a rebound in capital inflows to emerging market economies remains highly favorable if confidence can be restored in the Euro Area.

In addition, higher yields on debt instruments should also support foreign lending to emerging economies. Bond yields generally rise when policy interest rates are hiked. Emerging economies went through an extended phase of monetary tightening that ended in the fall of 2011 (Chart 16, next page). Tighter monetary policy helped ease inflation, which fell to 5.7% from 6.2% in 2010 (Table 4, next page). Lower inflation in turn increased the real yield on debt instruments, making this market more attractive to foreign lenders. Mature economies, on the other hand, have maintained near-zero policy interest rates and in some cases reversed what little tightening they had done. In addition, a temporary rise in commodity and energy prices resulted in an acceleration of inflation in 2011, increasing headline inflation in the mature economies to 2.6% from 1.4% in 2010. This has narrowed the inflation differential vis-à-vis emerging economies. As a result, real interest rates are now much higher in emerging markets than in mature economies (Chart 17, next page). Higher real interest rates translate into higher real returns on debt instruments (provided that these are not offset by currency movements).

EM growth prospects are one of the key driving forces behind what we think will be a secular trend towards greater capital flows to emerging economies

Capital Flows to Emerging Market Economies

Table 4
Consumer Prices

percent change over a year ago, end of period

	2010	2011f	2012f	2013f
Mature Economies	1.4	2.6	1.4	1.8
United States	1.2	3.3	1.5	2.3
Euro Area	2.0	2.6	1.7	2.0
Japan	-0.3	-0.1	-0.1	0.0
Other Mature	2.8	3.7	2.0	2.0
Emerging Economies	6.2	5.6	5.1	5.1
Latin America	8.1	8.3	7.6	8.6
Argentina	22.9	21.2	22.4	21.5
Brazil	5.9	6.5	5.0	5.5
Mexico	4.4	3.8	3.4	3.8
Emerging Europe	6.8	6.4	6.6	5.7
Russia	8.8	6.1	8.1	7.0
Turkey	6.4	10.4	7.4	6.3
Asia/Pacific	5.3	4.2	3.5	3.5
China	4.6	3.6	3.1	3.0
India	9.7	6.5	4.5	4.8
Africa/Middle East	5.3	5.9	5.6	5.1
South Africa	3.5	6.1	5.6	5.0
World	3.2	3.8	3.0	3.3

In 2012, inflation is likely to decline globally, in line with decelerating economic activity. Emerging economies are expected to ease monetary policy somewhat in order to cushion the slowdown in output growth. Some economies have already cut policy rates, including most recently Brazil and the Philippines. Even with some further easing in policy rates, it seems likely that a favorable real interest rate differential will make debt instruments an attractive investment in 2012 and 2013. Monetary conditions should thus support fixed income flows as investors chase the higher yields in emerging economies.

Chart 16
Trends in Official Interest Rates
percent per annum, GDP-weighted averages

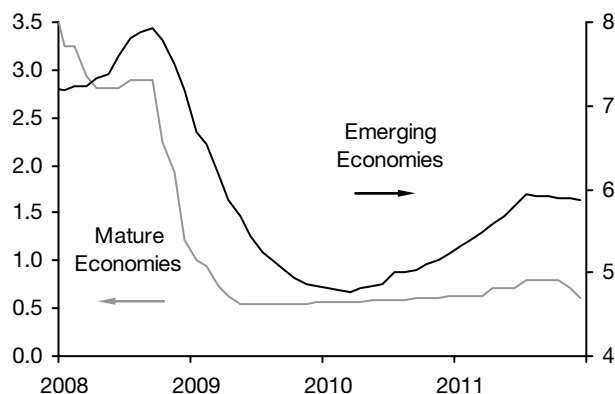
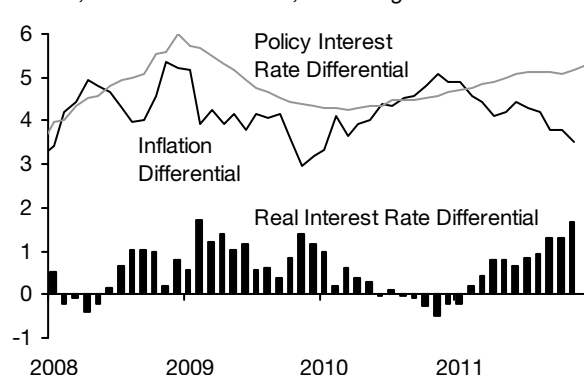
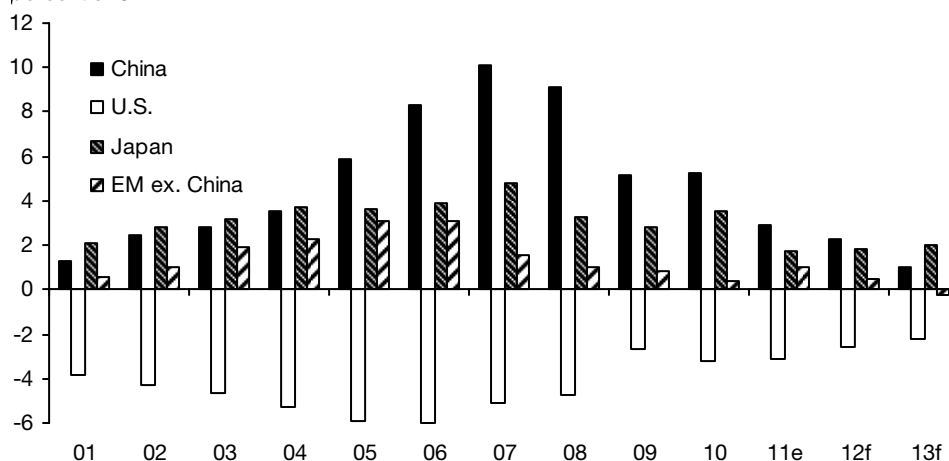


Chart 17
Inflation & Interest Rates: Differential EM-Mature
inflation=percent change oya, interest rates=percent per annum; both EM less Mature, GDP-weighted



Capital Flows to Emerging Market Economies

Chart 18
Global Current Account Balances
percent of GDP

NARROWING OF GLOBAL IMBALANCES IS PROJECTED TO CONTINUE

In 2011, current account imbalances have narrowed substantially in a number of key countries (Table 5). The surpluses of China and Japan dropped from 10.1% and 4.8% of GDP in 2007 to about 2.9% and 1.8% of GDP in 2011, respectively (Chart 18). In the same period, the U.S. deficit narrowed from 5.1% to about 3.1% of GDP. This is welcome news in a world where shocks in one region can reverberate globally. Arguably, the narrowing of global imbalances has been due in part to idiosyncratic factors, such as the earthquake in Japan, which reduced the country's export capacity. More importantly, however, this adjustment is the result of favorable exchange rate movements and welcome relative demand trends.

China has gone through a multi-year process of substantial real exchange rate appreciation.

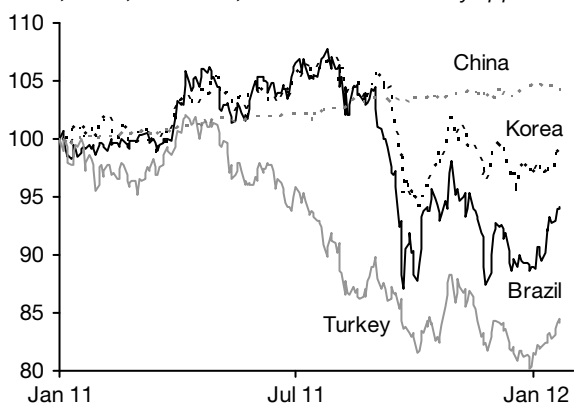
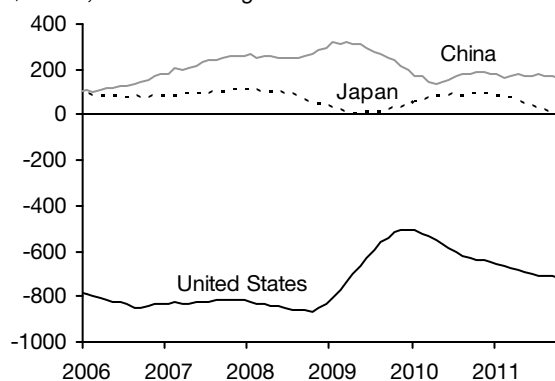
Narrowing of global imbalances is primarily the result of favorable exchange rate movements and welcome relative demand trends

Table 5
Global Current Account Balance
\$ billion

	2010	2011e	2012f	2013f
United States	-471	-462	-391	-353
Euro Area	-61	-54	11	44
Japan	196	107	110	118
Other Mature Economies	-21	-40	-37	-35
Emerging Economies (IIF 30)	363	360	264	58
Africa / Middle East	66	185	179	148
Latin America	-47	-43	-88	-97
Emerging Europe	0	-8	-26	-93
of which Russia	71	100	62	6
Emerging Asia	344	226	199	101
of which China	305	205	183	95
Other Countries*	-6	89	42	167

* Includes global discrepancy

Capital Flows to Emerging Market Economies

Chart 19
Selected Emerging Market Currencies
index, Jan 1, 2009=100, increase=EM currency appreciation

Chart 20
G3: Trade Balance
\$ billion, 12-month rolling sum


In the past 5 years, the Chinese renminbi appreciated an average of 4.4% per year against the U.S. dollar in nominal terms. During this period, Chinese inflation averaged 3.6%, compared with 2.3% in the United States. The gap in terms of wage inflation is even higher, making Chinese products less competitive. Overall, the Chinese currency has appreciated about 30% in real terms against the dollar and about 20% in real effective terms. Much of the appreciation in real effective terms occurred in 2011H2, when many emerging currencies fell sharply against the dollar (Chart 19). Combined with continued rapid growth in domestic demand, the real appreciation of the renminbi helped reduce China's current account surplus to 2.9% of GDP in 2011. We project a further decline in China's current account surplus to 2.3% in 2012 and 1.0% in 2013. This will also be supported by a gradual rebalancing towards greater domestic consumption, increasing Chinese imports.

We project a further decline in China's current account surplus to 2.3% in 2012 and 1.0% in 2013

The Japanese yen is trading close to a 15-year high against the dollar, undermining the competitiveness of the country's industrial sector. Japan is likely to post a trade deficit in 2011 for the first time since 1980, reducing the current account surplus to a mere 1.8%. We expect Japan's external surplus to increase only moderately in 2012 and 2013, before resuming a declining trend driven by the dissaving of the country's aging population.

The U.S. trade deficit narrowed sharply in 2009 but has gradually increased since then (Chart 20). At the same time, however, net foreign income grew much more rapidly than payments on U.S. assets held abroad. This resulted in a slightly improved current account balance in 2011. Over the next several years, the U.S. trade balance should benefit from robust export market growth, as emerging market economies are expected to grow at about 2.5 times the pace of the U.S. economy. This is the main driver behind our forecast of a gradual narrowing in the U.S. current account deficit to 2.6% of GDP this year and 2.2% in 2013.

A major exception to the trend of narrowing global imbalances are the surpluses of oil exporting countries. The average annual Brent oil price increased from \$62 per barrel (pb) in 2009 to \$80 pb in 2010 and \$111 in 2011. This boosted export revenues for oil producers, but weighed on the trade balances of oil-importing countries. The countries of the Gulf

Capital Flows to Emerging Market Economies

Cooperation Council (GCC), which also comprise most of the OPEC countries, doubled their current account surplus to over \$300 billion in 2011. In line with our projection of a very gradual decline in the oil price, we forecast the GCC region's surplus to narrow to \$288 billion in 2012 and \$260 billion in 2013.

EMERGING ASIA: RIDING OUT THE STORM

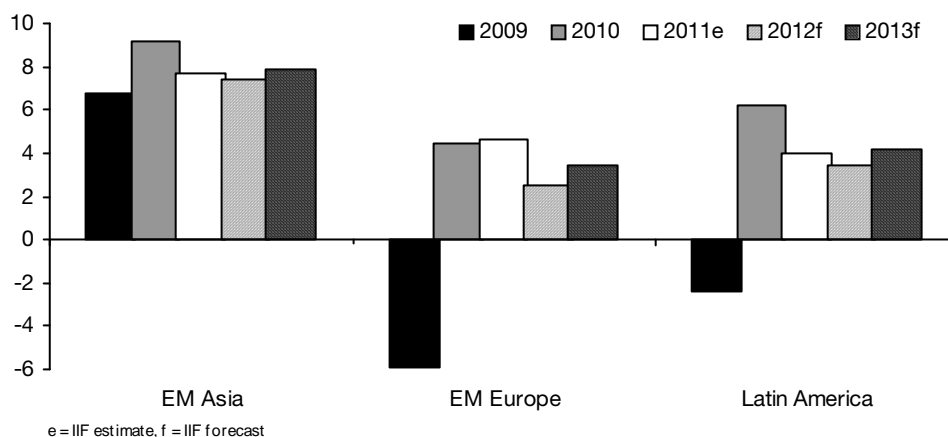
The turmoil brought on by the European debt crisis precipitated a sudden stop in capital flows to Emerging Asia late last year. In addition to rising risk aversion contributing to the pullback from regional equity and bond markets, the tightening in funding conditions encouraged foreign banks to shed assets. Asia was particularly vulnerable because of the prominent role played by European banks and large inflows leading up to the crisis.

Looking ahead, deleveraging by European banks and more stringent global banking regulations are set to remain a drag on capital inflows. Moreover, investors and borrowers may be more cautious about cross-border exposures in the wake of the recent gyrations in currency markets. Regional central banks largely refrained from intervening to combat downward pressures after the earlier sharp run-ups, contrary to market expectations. Even the renminbi no longer appears a one-way bet for appreciation. In addition, regional borrowers may look to greater domestic funding due to the shift from monetary tightening to easing being made possible by lower inflation over the near term.

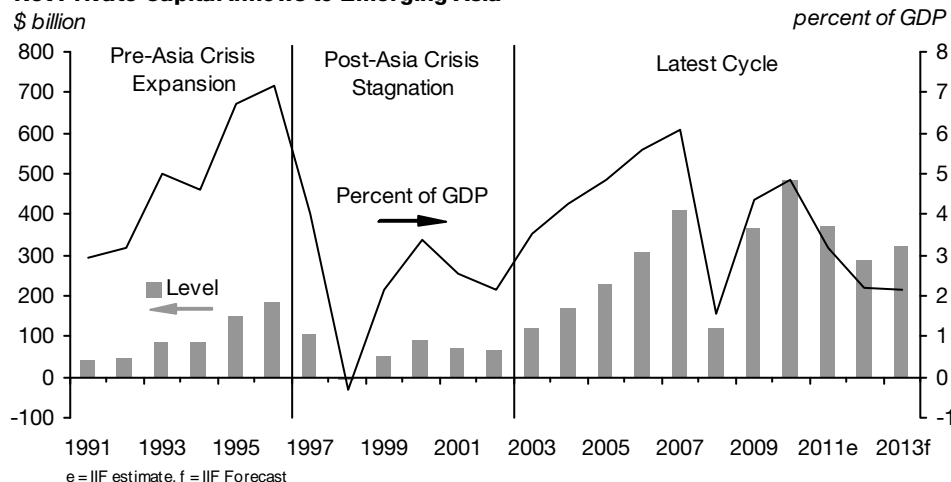
Nevertheless, the outlook for (1) the dissipation of the global turmoil, (2) a return to search for yields and (3) relatively strong regional economic performance, should result in a gradual upturn in capital inflows by 2013. Moreover, the leading emerging markets in the region, **China** and **India**, are rightly set to continue gradual liberalization of the capital account, for both inflows and outflows. Real GDP growth for our seven countries constituting Emerging Asia is set to moderate from 9.1% in 2010 to 7.7% in 2011 and 7.4% in 2012, due to the global headwinds along with the earlier policy tightening. We see growth reaccelerating to

Asia was particularly vulnerable due to the prominent role played by European banks and large inflows leading up to the crisis

Chart 21
Emerging Markets: Real GDP Growth
percent, y/y



Capital Flows to Emerging Market Economies

Chart 22
Net Private Capital Inflows to Emerging Asia


7.9% in 2013, with Asia continuing to outperform the rest of the world (Chart 21).

In view of the complex mix of factors and with the weakness of late 2011 set to linger into this year, private capital flows to Emerging Asia are likely to drop to \$290 billion in 2012 from \$370 billion in 2011 and \$490 billion in 2010, before reviving to \$320 billion in 2013 (Table 6, page 17). The share of Emerging Asia in total private capital flows to emerging markets also slipped from a record 59% in 2009 to 40% this year. While the region has witnessed a rebound in capital flows after the global crisis, this has been below the trend seen in the years leading up to the crisis (Chart 22).

Regional stock markets have borne the brunt of the global contagion. After a dramatic turnaround from foreign portfolio equity outflows of \$54 billion in 2008 to record net inflows of \$127 billion in 2010, renewed outflows late last year limited foreign purchases of domestic stocks to only \$21 billion in 2011. With improving valuations and relatively strong economic growth, foreign portfolio equity purchases should revive gradually to \$36 billion in 2012 and \$54 billion in 2013.

Deleveraging by foreign banks is on course to reduce net new credits extended by them from \$113 billion in 2010 to \$95 billion in 2011 and only \$21 billion in 2012, before edging up to \$34 billion in 2013. In contrast, net inflows from nonbank private creditors fall less from \$85 billion in 2010 to \$70 billion in 2011 and \$43 billion in 2012, before rising to \$51 billion in 2013. Moreover, inflows of foreign direct investment remain firm at around \$190 billion a year, due to the attraction of regional production and service bases for exports as well as large domestic markets.

While capital inflows are poised to revive, the aggregate regional current account surplus is set to fall from a recent high of \$350 billion in 2010 to only \$100 billion in 2013 with import growth outpacing the expansion in exports, led by China. At the same time, India is the only

The share of EM Asia in total private capital flows to emerging markets also slipped from a record 59% in 2009 to 40% this year

Capital Flows to Emerging Market Economies

Table 6
Emerging Asia: Capital Flows

\$ billion

	2010	2011	2012f	2013f
Capital Inflows				
<i>Total Inflows, Net:</i>	<u>511.6</u>	<u>392.4</u>	<u>299.8</u>	<u>335.7</u>
Private Inflows, Net	487.6	371.9	287.0	323.5
Equity Investment, Net	290.3	206.8	223.0	239.3
Direct Investment, Net	164.4	186.1	186.6	185.7
Portfolio Investment, Net	125.9	20.7	36.4	53.6
Private Creditors, Net	197.3	165.1	64.0	84.2
Commercial Banks, Net	112.7	94.8	21.4	33.5
Nonbanks, Net	84.7	70.3	42.6	50.7
Official Inflows, Net	24.0	20.5	12.8	12.1
International Financial Institutions	5.5	3.1	3.4	3.2
Bilateral Creditors	18.4	17.4	9.5	8.9
Capital Outflows				
<i>Total Outflows, Net</i>	<u>-855.4</u>	<u>-618.9</u>	<u>-498.2</u>	<u>-435.3</u>
Private Outflows, Net	-259.1	-239.2	-248.9	-281.2
Equity Investment Abroad, Net	-137.5	-140.7	-155.1	-186.4
Resident Lending/Other, Net	-121.6	-98.5	-93.8	-94.8
Reserves (- = Increase)	-596.4	-379.8	-249.3	-154.2
<i>Memo:</i>				
<i>Current Account Balance</i>	<u>343.8</u>	<u>226.5</u>	<u>198.5</u>	<u>100.6</u>

country in the region to be running a large current account deficit, which should moderate over the near term. The official foreign exchange reserve build-up also falls for Emerging Asia, but the region is set to remain a major exporter of capital due to diversification by the private sector, along with greater outward direct investment. The latter reflects the move to secure natural resource supplies along with the setting up of global marketing and production operations.

EMERGING EUROPE: EURO AREA CRISIS TO WEIGH ON CAPITAL FLOWS

The uncertainty surrounding the European sovereign debt crisis and the deteriorated global growth outlook caused private capital inflows to Emerging Europe to slow sharply or reverse in some countries after July. Portfolio equity inflows have reversed, and IPOs and bond issues have been postponed. Sharply intensified funding constraints, including by foreign parents, have led domestic banks to repay external debt in most countries. Nonresident purchases of local currency-denominated bonds have fallen sharply. These developments largely offset a steady, even if moderate, increase in capital inflows through July, leaving the full-year total at \$208 billion, only slightly higher than the \$201 billion reported in 2010. The increase from 2010 mainly reflected a rise in foreign direct equity investment, the bulk of which represented reinvested earnings as foreign-invested companies increased their

The deteriorated global growth outlook has caused private capital inflows to Emerging Europe to slow sharply since August

Capital Flows to Emerging Market Economies

profits. Borrowing from banks was higher for the year as a whole, mainly thanks to smaller repayments by Hungary and net borrowing by Russia through July.

With financial market pressures likely to remain elevated and risk aversion high this year as European banks strive to meet additional capital requirements mandated by the recent EBA stress test, capital inflows to Emerging Europe look set to slow by one-third to \$146 billion. Except for direct equity investment, which is likely to remain little changed from last year, all other types of inflows are likely to register steep declines. Borrowing from banks is likely to suffer the most, with the region as a whole making net repayments for the first time since 2009. Borrowing by foreign-owned domestic banks from their offshore parents will be cut as well, as the latter are forced by their home regulators to cut exposures. Borrowing from nonbank creditors is likely to decline sharply as well, by more than 30 percent from last year, thanks to smaller Eurobond issues and reduced foreign purchases of local currency-denominated government bonds. Portfolio equity inflows will be smaller as well (Table 7).

While capital inflows will be smaller across the region, countries deemed to have weaker fundamentals and those with large external borrowing needs will be hit the hardest. Ukraine and Hungary stand out as most vulnerable in the region. Turkey, with its outsized current account deficit and large external borrowing needs, could come under pressure as well.

Ukraine is probably the country most at risk of a major financial disruption in the region.

Capital inflows look set to slow even more sharply this year because of increased risk aversion and pressures among European banks to deleverage

Countries deemed to have weaker fundamentals are likely to be hit the hardest

Table 7
Emerging Europe: Capital Flows

\$ billion

	2010	2011e	2012f	2013f
Capital Inflows				
<i>Total Inflows, Net:</i>	<u>224.1</u>	<u>214.0</u>	<u>145.6</u>	<u>211.9</u>
Private Inflows, Net	200.8	207.8	146.1	216.9
Equity Investment, Net	71.9	77.3	76.4	94.6
Direct Investment, Net	65.2	73.1	72.8	82.0
Portfolio Investment, Net	6.8	4.2	3.7	12.6
Private Creditors, Net	128.9	130.5	69.7	122.3
Commercial Banks, Net	13.0	18.8	-7.1	22.5
Nonbanks, Net	115.9	111.7	76.8	99.7
Official Inflows, Net	23.3	6.2	-0.6	-5.0
International Financial Institutions	15.6	10.4	1.6	-2.4
Bilateral Creditors	7.7	-4.1	-2.1	-2.6
Capital Outflows				
<i>Total Outflows, Net</i>	<u>-224.1</u>	<u>-206.3</u>	<u>-119.8</u>	<u>-118.7</u>
Private Outflows, Net	-140.1	-190.9	-126.6	-125.8
Equity Investment Abroad, Net	-47.7	-48.8	-52.3	-63.7
Resident Lending/Other, Net	-92.4	-142.1	-74.3	-62.1
Reserves (- = Increase)	-84.1	-15.4	6.8	7.1
<i>Memo:</i>				
<i>Current Account Balance</i>	<u>0.0</u>	<u>-7.8</u>	<u>-25.8</u>	<u>-93.1</u>

Capital Flows to Emerging Market Economies

With IMF lending halted, access to markets lost since October, and a current account deficit of more than 5 percent of GDP, financing pressures are likely to intensify further. Mindful of next year's parliamentary election, the government has been unwilling to advance the measures needed to restart IMF lending or let the hryvnia adjust, counting instead on obtaining a larger discount on the import price of Russian natural gas. Even with a sizable price cut, external financing pressures would remain strong and the hryvnia under pressure, with market access unlikely to be restored unless the IMF program is brought on track.

In **Hungary**, delays on a new IMF-EU program have kept the forint under downward pressure. Hungary needs official financing on the order of €15 billion, €10 billion of which from the IMF. Agreeing on a program would be difficult, however, unless the government makes amendments to the much-criticized financial stability and central bank laws. More importantly, a new program should provide more stable and predictable economic policies, helping to reassure foreign investors. Until agreement is reached, market confidence will not improve, leaving the forint under downward pressure even though the current account surplus looks set to widen to 5.6 percent of GDP from about 3.4 percent last year.

In **Turkey**, the outsized current account deficit and the central bank's reluctance to explicitly tighten monetary policy are likely to increase vulnerability to shifts in market sentiment. A slowdown in foreign capital outflows since August has sharply intensified downward pressure on the lira. The central bank, in response, has sold nearly \$15 billion to the market since August, reducing foreign exchange reserves from \$93 billion to \$78 billion by December. With the current account deficit likely to narrow only slightly in 2012 from 10% of GDP likely in 2011, external financing needs will remain large, leaving Turkey vulnerable if increased risk aversion causes capital inflows to diminish in 2012.

In **Russia**, capital inflows have fallen sharply since August, with most banks and corporations having lost access to foreign markets since October. Large external debt repayments have caused foreign capital inflows to reverse and combine with large resident outflows to weaken the ruble. More importantly, resident capital outflows jumped to as much as \$140 billion on the back of sharply intensified political uncertainty since the December Duma election and the subsequent protests. With uncertainty likely to persist at least until the March presidential election, capital outflows will remain large. Foreign inflows are likely to remain constrained as well, both by the adverse investment climate and pressures on foreign banks to deleverage, continuing to weigh on the ruble.

LATIN AMERICA: HOLDING THE FORT

Net private capital inflows to Latin America are projected to decline to about \$250 billion in 2012, down from almost \$260 billion in 2011, before strengthening to over \$270 billion in 2013 (Table 8, page 22). The underlying capital flow dynamics in 2012 reflect: (1) a moderate recovery of portfolio equity inflows following a sharp drop last year, (2) a reduction of net trade financing as regional real GDP growth weakens, and (3) flat net inflows by commercial banks. We expect the accumulation of international reserves to slow this year as current account deficits widen and risk aversion remains relatively high. Reserves increased more

Large external financing needs will leave Turkey vulnerable if increased risk aversion causes capital inflows to diminish in 2012

Tension in global financial markets has, thus far, put moderate upward pressure on bank dollar interest rates, but they remain well below the levels of the 2008 global crisis

Capital Flows to Emerging Market Economies

Chart 23
Brazil: 3-Month Onshore Dollar Spread over LIBOR

basis points

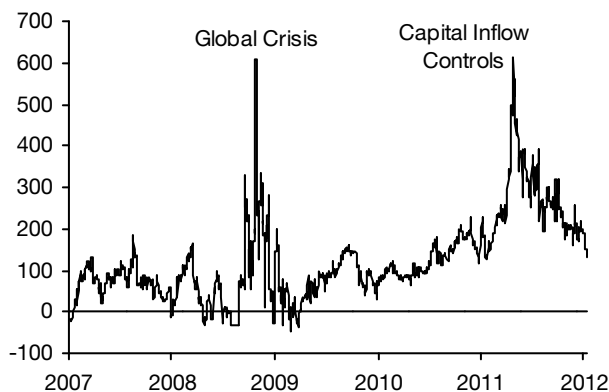
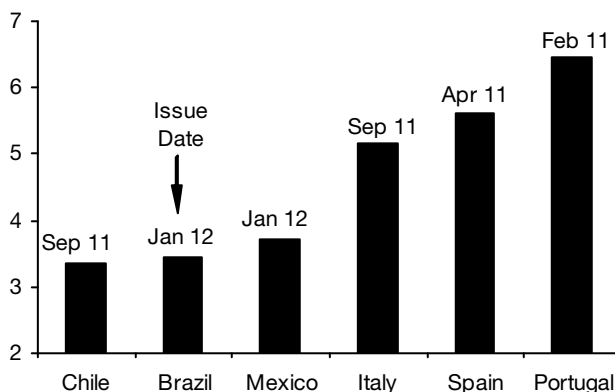


Chart 24
Yields on Recent Sovereign Bond Issuances*

percent per annum



* Most recent bond issuances with maturities between 5 and 15 years.

than \$100 billion in 2011 driven by carry trade and equity investment inflows; we expect them to rise about \$25 billion in 2012.

Tension in global financial markets has, thus far, put moderate upward pressure on bank dollar interest rates, but they remain well below the levels of the 2008 global crisis. In **Brazil**, the spread between the 90-day onshore dollar lending rate and LIBOR was 130 bp in mid-January, down from a spike of about 500 bp last May, when capital inflow controls drained dollar liquidity (Chart 23). The increase in dollar spreads has also been relatively subdued in other countries such as **Chile**. The moderate rise in spreads reflects strong foreign currency positions by the major countries and increased precautionary borrowing abroad at longer maturities.

Several factors have supported capital flows to the region notwithstanding persistent global uncertainty:

1. **Prospects of limited contagion from European bank deleveraging:** In Latin America, bank subsidiaries fund themselves mostly locally via deposits rather than via cross-border borrowing. The possible sources of contagion are twofold: the sale of equity and liquidity transfers. The impact of the former is limited by the presence of well-capitalized domestic banks that can replace foreign institutions. For example, in 2011 the Chilean bank CorpBanca acquired Banco Santander Colombia for \$1.2 billion. Strong banking regulation, on the other hand, has helped prevent unrestricted capital transfers to parent banks.
2. **A favorable return-to-risk assessment:** Despite heightened global risk aversion, Latin American sovereigns have been able to raise resources abroad at relatively favorable terms (Chart 24). Bond issuance in the midst of global tension highlights the gradual emergence of the region as a more mature asset class. In January 2012, three countries tapped capital markets: (i) **Brazil** raised \$0.8 billion at a spread of 150 bp over U.S. Treasuries by reopening its 2021 global bond; (ii) **Mexico** issued a 10-year bond (Global 2022) for \$2.0 billion at a spread of 175 bp over U.S. Treasuries; and (iii) **Colombia**

Capital Flows to Emerging Market Economies

BOX 3: CHILE - THE LOCAL MARKET STABILIZER

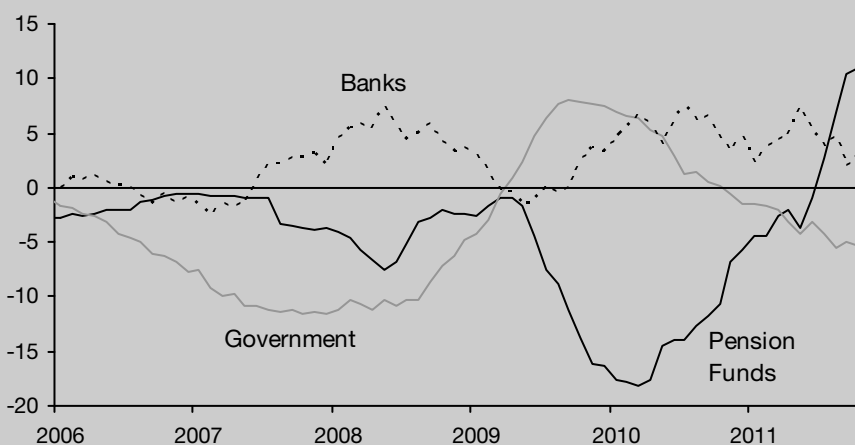
The Chilean economy continues to prove resilient to contagion from global turbulence despite significant trade openness and financial integration. This resilience stems from widely recognized macroeconomic strengths, including a truly floating exchange rate regime, a credible inflation targeting system and solid external and fiscal positions. A less known but important source of strength is a well functioning local capital market (See IIF Research Note: “The Local Market Stabilizer”).

The presence of a relatively deep local capital market has mitigated financial contagion from external shocks in several ways:

- 1) **Inducing countercyclical capital flow shifts:** A strong institutional investor base, dominated by pension funds, has helped to stabilize net capital flows. Pension funds tend to move capital onshore when global uncertainty rises, offsetting nonresident outflows. By contrast, when global conditions improve, they move capital offshore (Chart 25).
- 2) **Enhancing financing flexibility:** The local capital market has allowed corporations and banks to increase reliance on domestic funding in the face of tightened external conditions. In the aftermath of the 2008 global crisis, Chilean corporations sharply increased local financing. Something similar is happening now, although the slow unfolding of the European debt crisis has allowed banks and corporations to engage in precautionary external financing ahead of an expected worsening of global conditions.
- 3) **Reducing foreign currency financing dependency:** Increased reliance on local currency lending has helped to shield banks and corporations from foreign exchange volatility.

The Chilean economy continues to prove resilient to contagion from global turbulence despite significant trade openness and financial integration

Chart 25
Chile: Net Private Outflows
 \$ billion



Capital Flows to Emerging Market Economies

Table 8
Latin America: Capital Flows

\$ billion

	2010	2011e	2012f	2013f
Capital Inflows				
<i>Total Inflows, Net:</i>	<u>280.7</u>	<u>284.1</u>	<u>269.7</u>	<u>296.5</u>
Private Inflows, Net	260.5	257.9	249.2	272.1
Equity Investment, Net	136.0	142.5	146.6	162.5
Direct Investment, Net	92.8	125.7	118.2	126.4
Portfolio Investment, Net	43.2	16.8	28.4	36.1
Private Creditors, Net	124.5	115.4	102.5	109.6
Commercial Banks, Net	29.2	19.9	22.8	32.2
Nonbanks, Net	95.3	95.4	79.8	77.4
Official Inflows, Net	20.2	26.2	20.6	24.3
International Financial Institutions	6.1	4.4	3.8	6.1
Bilateral Creditors	14.1	21.9	16.7	18.2
Capital Outflows				
<i>Total Outflows, Net</i>	<u>-233.2</u>	<u>-240.9</u>	<u>-182.1</u>	<u>-199.2</u>
Private Outflows, Net	-150.1	-132.9	-153.3	-151.1
Equity Investment Abroad, Net	-65.6	-37.1	-50.0	-58.7
Resident Lending/Other, Net	-84.6	-95.8	-103.4	-92.4
Reserves (- = Increase)	-83.1	-108.0	-28.8	-48.1
<i>Memo:</i>				
<i>Current Account Balance</i>	<u>-47.5</u>	<u>-43.2</u>	<u>-87.6</u>	<u>-97.2</u>

raised \$1.5 billion in order to buy back more expensive debt (2041 global bond).

3. **Strong investment momentum:** Despite the economic downturn, long-term foreign direct investment (FDI) drivers have continued to support inflows. These include: (1) comparatively stronger growth prospects; (2) abundant and well-diversified commodity export bases; (3) relatively sounder macroeconomic policies; (4) low political risk; (5) a favorable business climate in most economies; and (6) a rising middle class. **Argentina** and **Venezuela**, nonetheless, have not benefited from global appetite for regional assets because of their unsustainable policies and anti-business climates. We estimate that net FDI inflows to the region increased more than 30% y/y in 2011. Following a flattening out this year, we expect them to regain strength in 2013.
4. **Countercyclical capital shifts by capital exporters:** In **Chile**, for example, a strong institutional investor base, dominated by pension funds, has helped to stabilize net capital flows (Box 3, previous page).

In Chile a strong institutional investor base, dominated by pension funds, has helped to stabilize net capital flows

Capital Flows to Emerging Market Economies

AFRICA AND MIDDLE EAST: DIVERGENCE ACROSS THE REGION

Aggregated capital flows in 2011 and 2012 to the seven Africa/Middle East countries included in our capital flows report disguise some sharp differences in both the economic performance and financing requirements of individual countries as well as the composition of the aggregated flows (Box 4, page 24). High oil prices have boosted oil exporting countries (Saudi Arabia, the UAE and Nigeria), ongoing political uncertainty continues to adversely affect some MENA economies (Egypt and to a lesser extent Lebanon and Morocco), and global capital market developments and the crisis in Europe have tended to impact the more mature economies (especially South Africa).

The current account surplus for the region as a whole rose sharply in 2011 on the back of higher oil prices and is estimated to have reached a record \$185 billion, equivalent to 9.2% of GDP. A similarly large surplus is forecast for 2012 followed by some moderation in 2013 as oil earnings level off and imports continue to rise. A projected combined surplus of \$205 billion in the oil exporting countries in 2012 comfortably offsets relatively modest deficits in South Africa (\$16 billion), Lebanon (\$8 billion), Morocco (\$4 billion) and Egypt (\$3 billion).

Net private capital inflows to the region are projected to slow for the second consecutive year, from an estimated \$72.5 billion in 2011 to \$63.7 billion in 2012. The slowdown is mainly due to lower, but still robust, inflows into South Africa whose capital markets are more integrated into the global economy. Direct equity investment continues to account for the bulk of the flows (around 60% of the total) and these flows are likely to remain fairly steady at about \$45 billion a year on average through 2013. Portfolio equity flows, which dropped sharply in 2011 due to capital flight from Egypt, are forecast to recover this year and next as prospects in the region gradually improve (Table 9, page 25).

In contrast to private flows, official flows to the region are forecast to be the highest in over a decade. The projected \$9.9 billion of net inflows in 2012 compares with \$5.5 billion in net repayments last year, and assumes that multilateral institutions and bilateral creditors rally to support countries in transition such as Egypt (and Tunisia) that are experiencing growing

Direct equity investment continues to account for the bulk of the flows

Chart 26
Egypt: Foreign Holdings of Treasury Bills

LE billion

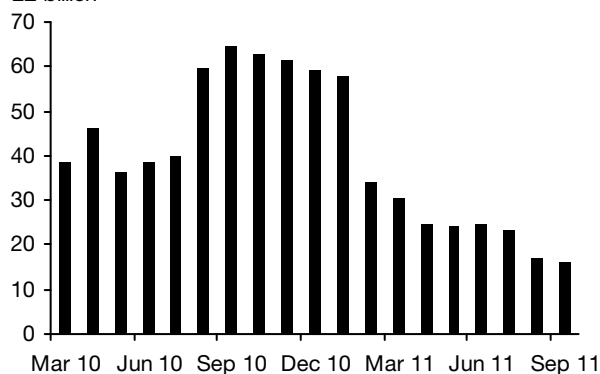
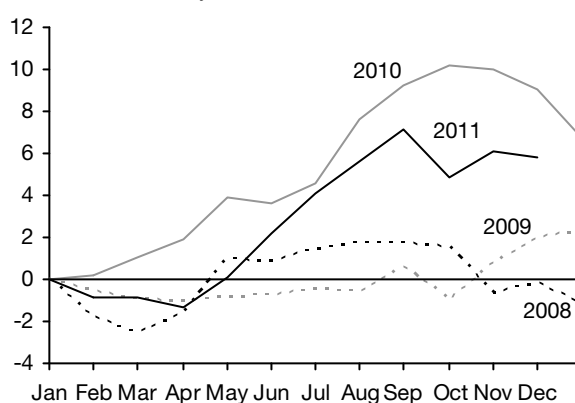


Chart 27
South Africa: Nonresidents' Net Purchases of Bonds
\$ billion, cumulative year-to-date



Capital Flows to Emerging Market Economies

financing difficulties.

A large current account surplus and continued robust inflows of foreign capital implies a further sizable increase in foreign assets. Our projections suggest that official reserves, excluding gold, will rise from \$757 billion at the end of 2011 to \$957 billion by the end of 2013, equivalent to more than 15 months of imports. We also expect a large increase in non-reserve assets (about \$140 billion a year in both 2012 and 2013) as sovereign wealth funds, investment companies and private individuals invest abroad.

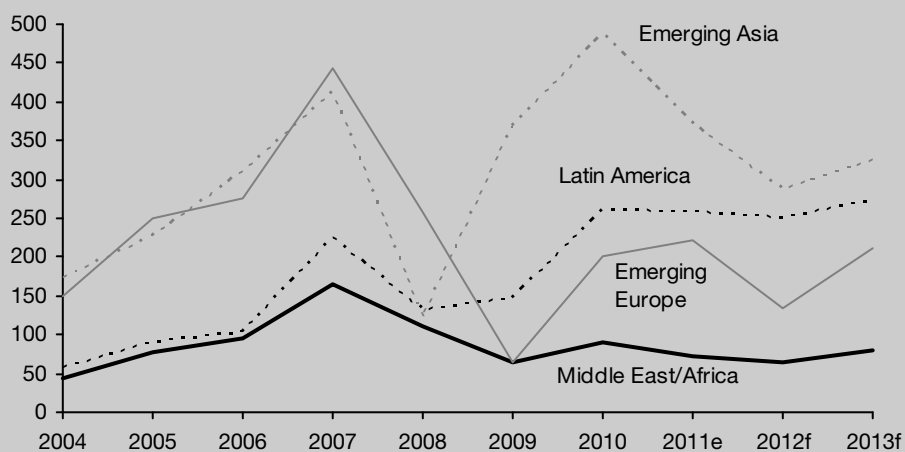
In **Egypt**, the balance of payments has come under intense pressure amidst political uncertainty and policy drift. Since the overthrow of the Mubarak regime nearly a year ago, FDI has fallen and nonresidents have sharply reduced their holdings of Egyptian treasury bills (Chart 26, previous page) and sold equities. As a result, there was a net outflow of private capital in FY 2010/11 following a large inflow the previous year. Official reserves excluding gold, meanwhile, dropped from \$32.6 billion at the end of January 2011 to \$15.4 billion in December. The authorities received assistance from the Arab Monetary Fund late last year and have reopened negotiations with the IMF on a \$3 billion loan. If agreed, this could trigger

In Egypt, there was a net outflow of private capital in FY 2010/11 following a large inflow the previous year

BOX 4: WHY HAVE FLOWS TO THE MIDDLE EAST REMAINED LOW?

Capital flows into Middle East are still well below their 2007 levels (Chart 28). While international capital flows have bounced back in Latin America and Emerging Asia in the past two years, they remained weak in Middle East and North Africa (MENA). The continued low volumes of inflow to MENA countries is explained by the following factors: (i) tight supply conditions related to lower risk appetite following the Dubai debt crisis in late 2009; (ii) corrections in real estate market in some countries; (iii) the regional political turmoil in early 2011; and (iv) relatively undeveloped bond and capital market. The share of bonds in total financing in the region is less than 5%, the lowest among emerging economies.

Chart 28
EM Regions: Net Private Capital Inflows
\$ billion



Capital Flows to Emerging Market Economies

Table 9
Africa and Middle East: Capital Flows

\$ billion

	2010	2011e	2012f	2013f
Capital Inflows				
<i>Total Inflows, Net:</i>	<u>90.7</u>	<u>66.9</u>	<u>73.6</u>	<u>83.2</u>
Private Inflows, Net	91.3	72.5	63.7	80.2
Equity Investment, Net	60.8	45.4	50.9	60.4
Direct Investment, Net	44.0	43.1	42.9	46.7
Portfolio Investment, Net	16.8	2.3	8.1	13.7
Private Creditors, Net	30.5	27.1	12.8	19.8
Commercial Banks, Net	7.1	3.8	1.1	7.3
Nonbanks, Net	23.4	23.3	11.8	12.5
Official Inflows, Net	-0.7	-5.5	9.9	3.0
International Financial Institutions	3.6	2.2	8.1	3.4
Bilateral Creditors	-4.2	-7.8	1.8	-0.4
Capital Outflows				
<i>Total Outflows, Net</i>	<u>-157.0</u>	<u>-251.6</u>	<u>-252.6</u>	<u>-231.4</u>
Private Outflows, Net	-114.7	-144.1	-143.5	-140.7
Equity Investment Abroad, Net	-37.8	-50.9	-59.1	-62.9
Resident Lending/Other, Net	-76.9	-93.1	-84.4	-77.7
Reserves (- = Increase)	-42.3	-107.5	-109.1	-90.7
<i>Memo:</i>				
<i>Current Account Balance</i>	<u>66.3</u>	<u>184.7</u>	<u>179.1</u>	<u>148.1</u>

additional support from other multilateral institutions and bilateral creditors, and may result in up to \$7 billion in official inflows in 2011/12, helping offset the net outflow of private capital.

In **South Africa**, we expect net private flows to slow from an estimated \$18.4 billion in 2011 to \$12.2 billion in 2012. This reflects both weaker inflows into the local bond market as well as a slowdown in FDI, which was boosted last year by some large acquisitions in the retail and mining sectors. In the first eight months of 2011, nonresidents purchased \$7.2 billion worth of high-yielding government bonds, but in the three subsequent months they sold \$1.3 billion reflecting increased global risk aversion (Chart 27, page 23). Going forward, we expect foreign investors to exercise more caution in the carry trade as increased currency risk starts to outweigh the benefits of a relatively large interest rate differential.

While FDI has declined, total net private capital inflows to **Lebanon** are estimated to have increased from \$4.6 billion in 2010 to \$7.8 billion in 2011 (equivalent to 19% of GDP). This is explained mainly by the increase in nonresident deposits in domestic banks, which rose to \$6.5 billion at end-November 2011 from \$4.5 billion at end-2010, partly reflecting outflows from the more troubled countries in the region. We expect private capital flows to decline in 2012 to \$5.4 billion.

Private capital flows into **Morocco** have also increased to \$3.6 billion in 2011 (equivalent to about 4% of GDP) from \$1.8 billion in 2010. Morocco has weathered the upheavals in the

Capital Flows to Emerging Market Economies

Arab world by implementing constitutional reforms. We expect net FDI to almost double to \$1.8 billion in 2012 because Renault (a major French car company) has recently opened a subsidiary in Morocco. Such a large increase in FDI will help offset a moderation in other capital inflows. As a result, net private capital inflows will remain around \$3.5 billion in 2012 and 2013.

Oil exporters in the region continue to benefit from high oil prices, which have provided a boost to economic activity. Improved external account balances will allow **Saudi Arabia** and the **UAE** to strengthen their investment positions abroad. The buildup in their foreign assets (including through foreign reserves and sovereign wealth funds) has accelerated to reach \$1.2 trillion in 2011 from about \$1 trillion in 2010, and is projected to increase further to about \$1.5 trillion by end-2013. In addition to providing foreign investment flows to the rest of the world, the oil exporters of the region will continue to be a source of positive spillovers both within and outside the Middle East, through imports and outward remittances.

High oil prices have provided a boost to economic activity in oil-exporting countries

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