IIF RESEARCH NOTE

Capital Flows to Emerging Market Economies

September 25, 2011

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

Kristina Morkunaite

RESEARCH ASSISTANT
Global Macroeconomic Analysis

1-202-857-3640
kmorkunaite@iif.com

Emre Tiftik

RESEARCH ASSISTANT
Global Macroeconomic Analysis

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

- **Net private capital flows to emerging economies are projected to be $1,053 billion in 2011, up from $1,009 billion in 2010 and our June forecast of $1,041 billion**
- **Current market turbulence will likely dampen flows in the near term, especially portfolio equity flows**
- **In the medium term, however, strong relative fundamentals of emerging markets vis-à-vis mature economies provide a positive backdrop for capital inflows**
- **Factors promoting flows include low rates in mature economies; growth prospects in EMs; and the likelihood of more relative shifts in sovereign ratings**
- **Investment and lending from emerging market economies to other countries is becoming increasingly important**

Private capital flows to emerging economies have been subject to conflicting forces in recent months. On the one hand, rising fragilities and uncertainties surrounding the global economic outlook have dampened overall flows, as is typical in such adverse periods. This factor appears to have intensified in the past two weeks if recent market developments are any guide. On the other hand, however, the fact that global economic worries are concentrated in mature economies, and that interest rates and bond yields in those economies have been cut to the bone means that the relative attractiveness of emerging markets generally continues to improve, which should promote net flows to emerging economies. In our projections, these two developments broadly offset each other. Net private flows to

Rising fragilities and uncertainties surrounding the global economic outlook have dampened overall flows

Chart 1
Emerging Market Private Capital Inflows, Net

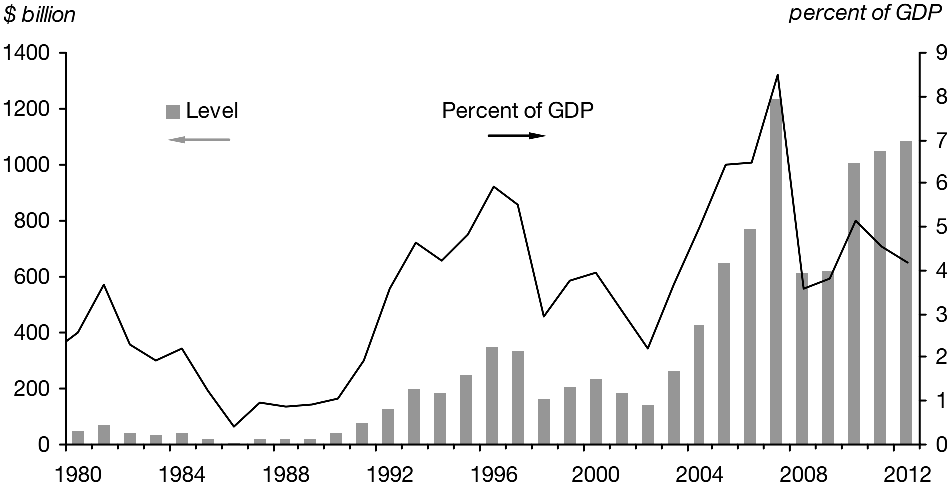


Table 1
Emerging Market Economies: Capital Flows
$ billion

	2009	2010	2011f	2012f
Capital Inflows				
Total Inflows, Net:	*690*	*1078*	*1089*	*1125*
Private Inflows, Net	623	1009	1053	1084
Equity Investment, Net	472	534	526	577
Direct Investment, Net	348	359	431	448
Portfolio Investment, Net	124	174	95	129
Private Creditors, Net	151	475	528	506
Commercial Banks, Net	0	162	198	215
Nonbanks, Net	151	313	329	291
Official Inflows, Net	67	69	36	41
International Financial Institutions	47	32	21	13
Bilateral Creditors	21	38	15	28
Capital Outflows				
Total Outflows, Net	*-1050*	*-1453*	*-1474*	*-1385*
Private Outflows, Net	-430	-646	-568	-640
Equity Investment Abroad, Net	-259	-259	-288	-323
Resident Lending/Other, Net	-171	-386	-279	-318
Reserves (- = Increase)	-620	-807	-906	-745
Memo:				
Current Account Balance	*359*	*374*	*385*	*260*

emerging economies are forecast to be $1.053 trillion in 2011, which is roughly in line with the outcome in 2010. They are projected to remain at about this level in 2012. Expressed as a share of emerging market GDP, however, these net inflows would be steadily lower in 2011-12 than in 2010 (thanks to the rise in emerging market GDP in nominal dollar terms; Chart 1, front page). They would also remain well below the previous peak of 2007, both in absolute terms and, especially, relative to GDP.

Inflows should be about evenly split between debt and equity flows in 2011-12

Inflows should be about evenly split between debt and equity flows in 2011-12 (Table 1 and Chart 2). Within the equity component, direct investment flows can be expected to rise steadily, as corporate investment levels are increased (helped by retained profits). Portfolio equity flows are understandably more volatile and will be much weaker this year than last. Some reacceleration in these flows seems likely in 2012. Debt flows are importantly bolstered by high interest differentials in favor of emerging markets. This will especially boost nonbank related credit flows, notably portfolio bond flows into local currency markets. (Borrowers in emerging economies will also be attracted to issuing more bonds denominated in low-yielding currencies). Net inflows from banks will remain relatively subdued compared to the levels seen in 2006-08, but should rise steadily, as global banks look to shift the geographic allocation of their assets more towards emerging economies.

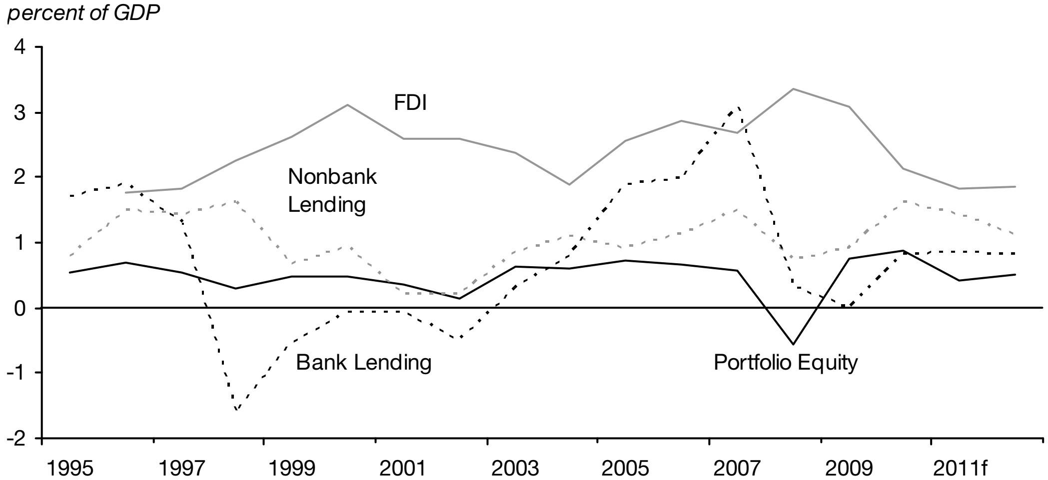
By region, flows to Emerging Asia will amount to about half of total flows in 2011-12 (about $492 billion and $476 billion, respectively), with China accounting for $271 billion and $268 billion, respectively. For China, inward direct investment inflows have now been far exceeded by other flows from portfolio investors (both bond and equity investors) and banks.

Our sample of 30 major emerging economies remain significant net capital exporters, however, reflecting their combined status as current account surplus economies. In aggregate, net capital *outflows* from our sample of emerging economies will total about $1.4 trillion per year in 2011-12. Although official reserve accumulation continues to account for the lion's share of these flows, net private outflows are on the rise (especially FDI). The significance of this development is that some net *private* capital outflows from emerging economies are likely to end up as flows into other emerging economies, and will thus also count as net *inflows* in our dataset, at least in principle. Chinese FDI outflows, for example, will amount to around $85 billion, net, in 2011 and $105 billion, net, in 2012, and a significant portion of this will be allocated to other emerging economies. This increasing tendency for emerging economies to invest in each other is one factor that can explain why some high frequency indicators of capital flows (such as illustrated in Chart 5, page 6) may be understating overall inflows in 2011. These high frequency measures typically identify only net flows from investors in mature economies to recipients in emerging economies.

Official reserve accumulation still accounts for the lion's share of capital outflows, but private outflows are on the rise

While we project broad stability in net flows amid a phase of growing global turbulence, we have also entered a phase when investors are liable to begin to differentiate more between emerging economies. Countries with more obvious risk characteristics are apt to come under more pressure. For example, countries with high and rising external borrowing requirements will probably find themselves unable to attract flows on quite the same favorable terms as has been the case in recent years, extremely low rates in mature economies notwithstanding. For example, Turkey's current account deficit has approached 10% of GDP in recent months (see Chart 13, page 10), which will make it more challenging for Turkey to attract the necessary net debt inflows without seeing a rise in yields, a weaker currency or some combination of these two effects.

Chart 2
Emerging Market Private Capital Inflows, Net
percent of GDP



China accounts for most of the net upward revision in our capital flows forecasts, with an additional $8 billion and $31 billion of inflows projected for 2011 and 2012, respectively

BOX 1: REVISIONS TO IIF FORECASTS

Since our June 2011 report, we have made modest upward revisions to our projections of net private capital inflows to EMs in 2011 and 2012 (Table 2). In addition, inflows in 2010 are now estimated to have exceeded the $1 trillion dollar mark for the first time since 2007. There are important regional and country-specific differences, however. China accounts for most of the net upward revision, with an additional $8 billion and $31 billion of inflows projected for 2011 and 2012, respectively. In both years, inflows to the troubled Africa/Middle East region are projected to be lower than previously estimated. Inflows to EM Europe were revised up $8 billion for this year, but we cut our forecast for next year, owing to a less favorable outlook for Turkey.

Table 2
Revisions to IIF Net Private Capital Inflows
$ billion

	2008	2009	2010	2011f	2012f
IIF Capital Flows					
September 2011	616	623	1,009	1,053	1,084
June 2011	620	644	990	1,041	1,056
Difference	-4	-21	19	12	28
Revisions by Region					
Latin America	-5.7	-7.6	-6.1	2.1	15.7
Emerging Europe	1.4	3.8	50.7	7.7	-10.7
Africa/Middle East	-1.0	-11.1	-4.3	-5.0	-7.3
Emerging Asia	0.8	-6.1	-21.2	7.6	29.8

We now project more debt and less equity inflows into emerging markets in 2011. Our forecast for portfolio equity investment inflows was cut by $56 billion, while nonbank lending has been revised up by the same amount. Direct equity investment and bank lending are projected to be slightly higher than we expected before (Chart 3).

Chart 3
Revisions to Private Capital Inflow Estimates for 2011 by Component
$ billion, change between June 2011 and latest (September 2011) estimates

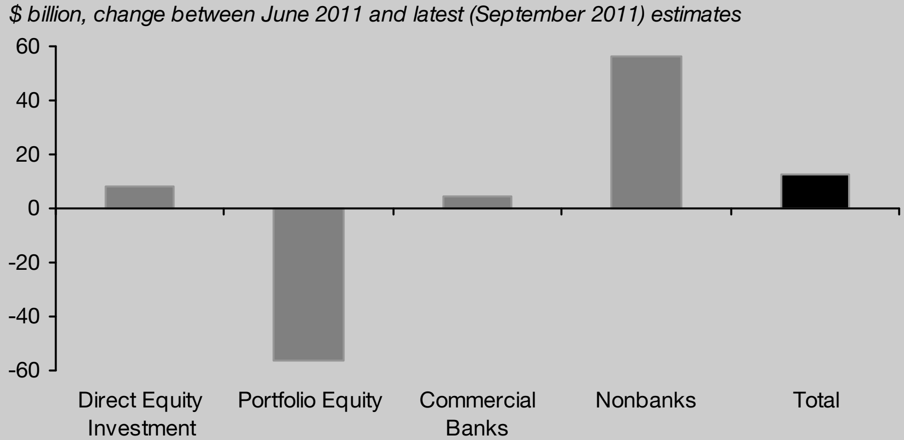


Table 3
Global Output Growth
percent change over previous year

	2009	2010	2011f	2012f
Mature Economies	**-4.2**	**2.7**	**1.4**	**1.8**
United States	-3.5	3.0	1.6	1.8
Euro Area	-4.2	1.7	1.7	1.3
Japan	-6.3	4.0	-0.3	2.8
Other Mature Economies	-3.3	2.4	1.7	2.2
Emerging Economies	**1.6**	**7.3**	**6.3**	**6.0**
Latin America	-2.4	6.2	4.2	3.7
Argentina	-2.6	9.2	6.5	4.4
Brazil	-0.6	7.5	3.5	3.3
Mexico	-6.1	5.4	3.9	3.6
Emerging Europe	-5.8	4.5	4.5	3.7
Russia	-7.8	4.0	4.2	4.0
Turkey	-4.8	9.0	7.5	4.0
Asia/Pacific	6.8	9.4	8.0	7.9
China	9.2	10.8	9.5	9.0
India	8.0	8.5	7.8	8.2
Africa/Middle East	0.9	4.3	4.6	4.1
South Africa	-1.7	2.8	3.5	3.9
World	**-2.2**	**4.4**	**3.4**	**3.6**

GLOBAL OUTLOOK: MARKET TURBULENCE TWISTS PROSPECTS FOR FLOWS

Downside risks to our baseline forecast of a sluggish expansion in mature economies have increased

Our baseline macroeconomic forecast is for a sluggish expansion in the mature economies, while emerging markets are settling down closer to trend growth. We project mature economies to grow by 1.4% this year and 1.8% in 2012, compared to 6.3% and 6.0% in emerging markets, respectively (Table 3). Downside risks to this forecast have increased, however. The interaction of sovereign debt concerns and weak growth in the Euro Area and a painfully slow recovery in the U.S. labor and housing markets have prompted fears of another recession. Financial markets have become increasingly shaky in recent weeks. Global stock markets have lost 24% since late July and risk indicators have spiked (Chart 4, next page). We believe that market volatility will subside only gradually, especially given that there is no easy way out of subdued growth prospects and sovereign debt challenges.

The recent deterioration in the outlook in mature economies will impact capital flows through multiple channels. First, the spike in global risk aversion increases investors' home bias and their demand for "safe" assets. Thus, investors in mature economies tend to sell EM holdings and invest in assets like domestic government bonds or gold. This has a direct and sharp negative impact on capital flows to emerging economies. In the past, investors' "flight to quality" response has often led to precipitated withdrawals of equity and bond inflows from emerging markets (Chart 5, next page). The impact was particularly sharp during the fall of 2008 (Lehman Brothers), but was also notable in February this year, when turmoil erupted in the MENA region. In recent weeks, jitters in financial markets have once again prompted investors to dump EM assets. This is also reflected in EM currencies, which have

Chart 4
U.S. Equity Volatility and EM Sovereign Bond Spreads
index *basis points over UST*

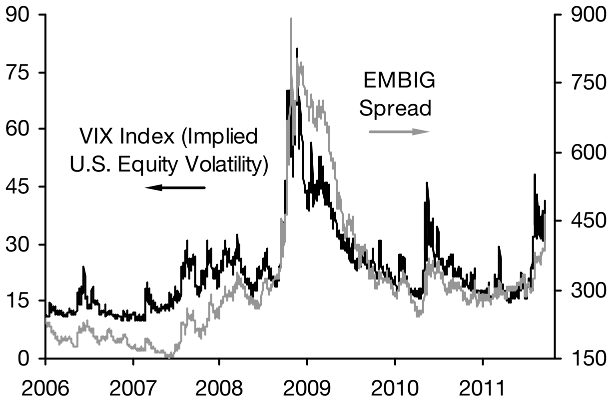
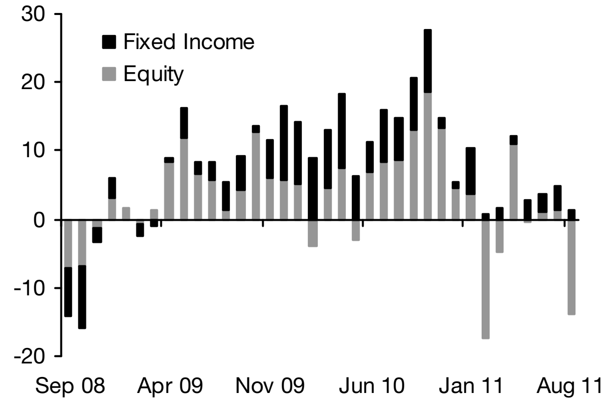


Chart 5
Emerging Market Funds: Debt and Equity Net Flows
$ billions



plummeted over the past weeks (Chart 6). In this environment of high risk aversion, there is a chance that spillovers to emerging markets may produce a more severe economic slowdown. In most emerging economies, however, there is ample policy space (both fiscal and monetary) to counteract such destabilizing forces.

But there are other channels through which the recent deterioration in the outlook for mature economies may *increase* capital flows to emerging markets over the medium term. One way would be through wider interest rate differentials in favor of emerging markets (Chart 7). A weaker-than-expected growth outlook in the mature economies means that macroeconomic policies need to be even more supportive. This will likely delay the monetary tightening cycle in some countries (U.S., U.K.) and may even reverse policy hikes implemented in others (Euro Area, Sweden, Norway). This should lead to wider (expected) interest rate differentials between mature and emerging markets than would otherwise be the case. Higher relative yields should help attract global investors once market volatility subsides.

Monetary easing in mature economies should widen interest rate differentials to emerging markets

Relative fundamentals of emerging economies continue to improve—both due to stronger domestic conditions and because of weakening fundamentals in mature countries. In 2010,

Chart 6
Selected Emerging Market Currencies
index, Jan 1, 2009=100, increase=EM currency appreciation

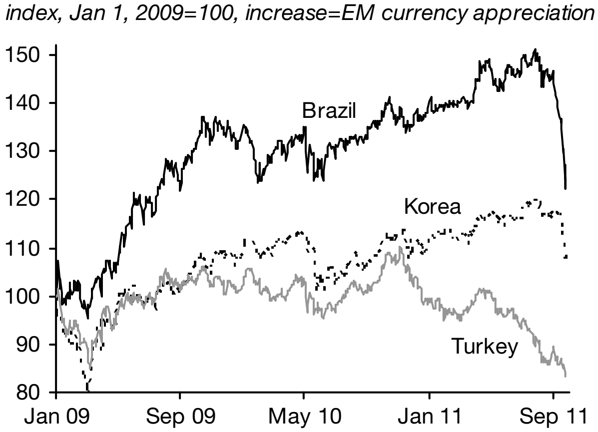


Chart 7
Trends in Official Interest Rates
percent per annum, GDP-weighted averages

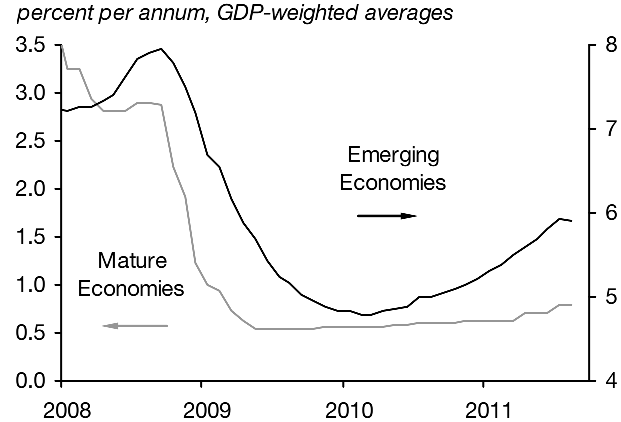


Chart 8
IIF30: Contributions to World GDP Growth
percent

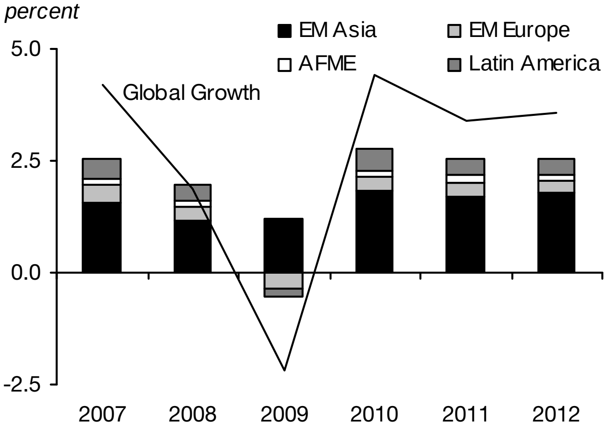
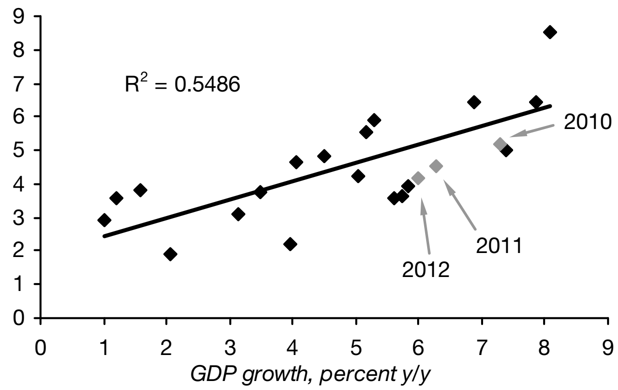


Chart 9
Private Capital Inflows and EM Real GDP Growth
net private capital inflows, percent of GDP, 1991-2012



emerging markets accounted for 62% of global output growth (Chart 8). Better growth prospects make emerging markets a more promising investment destination. Indeed, GDP growth is one of the key driving forces behind capital flows. Stronger growth prospects reflect better earnings potential for businesses and a more dynamic environment for financing profitable investments. Chart 9 shows the correlation between annual GDP growth and net private capital inflows. The regression line shows a good fit, with an R^2 of 0.55. This suggests that output growth explains about 55% of the variation in net inflows (although other factors may account for some of this relationship).

GDP growth is one of the key driving forces behind capital flows

The correlation between output growth and foreign capital inflows also holds across different EM regions. In 2010, Emerging Asia accounted for 41% of global output growth. As one would expect, the region was the recipient of nearly half of net private capital inflows to emerging markets last year (Chart 10). China alone accounts for over 27% of net private inflows to our sample of 30 major EM countries. Chinese growth of around 8-9% is impressive by itself, but seems truly spectacular when compared to mature market growth

Chart 10
Emerging Market Private Capital Inflows, Net
$ billion

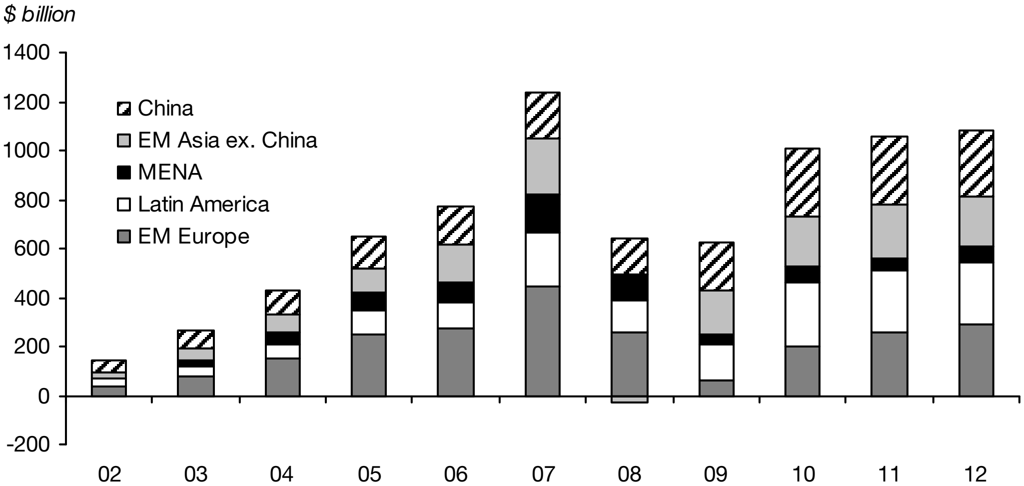


Chart 11
Sovereign Credit Ratings on Long-Term Debt
average of Moody's S&P, and Fitch long-term ratings

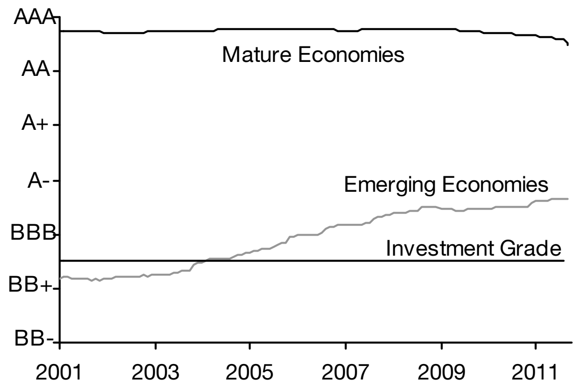


Table 4
Recent Sovereign Rating Changes
rating changes for long-term foreign currency debt

	Upgrades			Downgrades		
September	Israel	A+	S&P	Slovenia	Aa3	Moody's
				Italy	A	S&P
August	Peru	BBB-	S&P	U.S.	AA+	S&P
	Czech	AA-	S&P	Japan	Aa3	Moody's
	Estonia	AA-	S&P			
July	Uruguay	BBB-	S&P	Greece	CC	S&P
	Bulgaria	Baa2	Moody's	Portugal	Ba2	Moody's
	Angola	BB-	S&P	Spain	Aa2-	Moody's
				Ireland	Ba1	S&P
June	Brazil	Baa2	Moody's			
May	Colombia	Baa3	Moody's			

rates of 1.5-2%. It seems unlikely that the disruptions to financial markets seen in recent weeks will do much to change the secular trend of faster growth and increasing capital inflows to EMs.

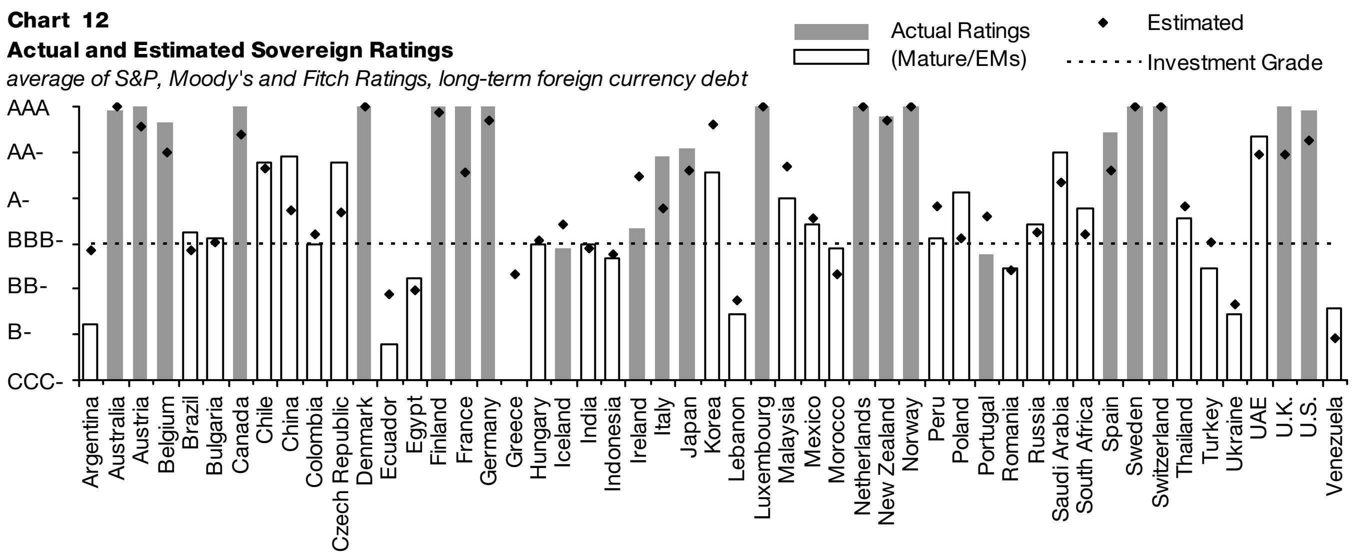
RE-RATING EMERGING ECONOMIES

Another set of factors that could promote net inflows to emerging economies amid a gloomier environment in mature economies is the strong likelihood that the recent trends toward rating *upgrades* in emerging economies and rating *downgrades* in mature economies will continue (Chart 11 and Table 4).

Recent trends toward rating *upgrades* in emerging economies and rating *downgrades* in mature economies will likely continue

There would appear to be two reasons why these relative rating shifts seem likely to persist. First, underlying fundamentals of the variables driving sovereign ratings are liable to

Chart 12
Actual and Estimated Sovereign Ratings
average of S&P, Moody's and Fitch Ratings, long-term foreign currency debt



deteriorate more quickly in mature economies than in emerging economies. Second, what would appear to be a systematic bias against emerging market economies in the ratings process seems quite likely to be corrected in coming years.

We illustrate these points by estimating a regression model of sovereign ratings, using a pooled sample of data. The dependent variable in the model is the average rating assigned to the country by the major agencies (their letter scale is converted to a numerical scale for regression purposes). We use a number of factors that are commonly thought to affect country ratings as a series of independent variables. These include income levels, growth, and measures of debts and deficits (see Table 5). The model does a fairly good job of explaining ratings (Chart 12, previous page). It accounts for about three quarters of the variation in ratings. Chart 12 shows where ratings should be according to the model (the dot) and where they actually are. (Note that this estimation of where ratings "should" be is derived from the pooled sample of data). As the evolution of the variables in the model moves against mature economies and in favor of emerging economies, so the model would predict a downgrade of mature ratings relative to emerging ratings.

It should be noted, however, that there is an additional variable in the model: a dummy variable that takes the value of 1 for mature economies and 0 for emerging economies. This variable is highly statistically significant and takes a value of almost 4 in the model. What this tells us is that the current rating structure gives mature economies, on average, almost a 4-notch advantage over emerging economies, once other key rating determinants are controlled for. Note that this variable is part of the estimated value in the chart. Historically, this may have made sense: emerging economies' tendency to suffer regular debt crises and loss in creditor confidence made them more vulnerable to an investor run. Recent experience, however, suggests that this relative bias may no longer be fully warranted. This does not necessarily mean that emerging economies should be upgraded; rather, it is more plausible that more high income countries could be vulnerable to downgrades.

Table 5
Determinants of Sovereign Credit Ratings

Explanatory Variable	Coefficient
ln(GDP per capita)	1.17*
	(1.78)
GDP Growth (%)	0.27**
	(1.88)
Inflation (%)	-0.14
	(-1.20)
General Government Balance (% GDP)	-0.05
	(-0.67)
General Government Gross Debt (%GDP)	-0.03**
	(-2.16)
Current Account Balance (%GDP)	0.25***
	(3.05)
Index of Economic Freedom	0.14***
	(2.23)
Dummy (Mature=1, Emerging=0)	3.74***
	(3.47)
Intercept	-7.70
	(-1.21)
Number of Observations	51
Adjusted R-Squared	0.757

Notes: Annual data, t-statistics are in parentheses. Dependent variable: average ratings from S&P, Moody's and Fitch Ratings converted into a numerical system ranging from 1 for CC to 20 for AAA data as of September 2011
* Significant at 10 percent level
** Significant at 5 percent level
***Significant at 1 percent level

BOX 2: BRAZIL AND TURKEY — DIFFERENT MONETARY APPROACHES

Divergences among emerging economies have become more important in recent quarters. One interesting contrast is between two countries that have often suffered from volatility in external flows: Brazil and Turkey.

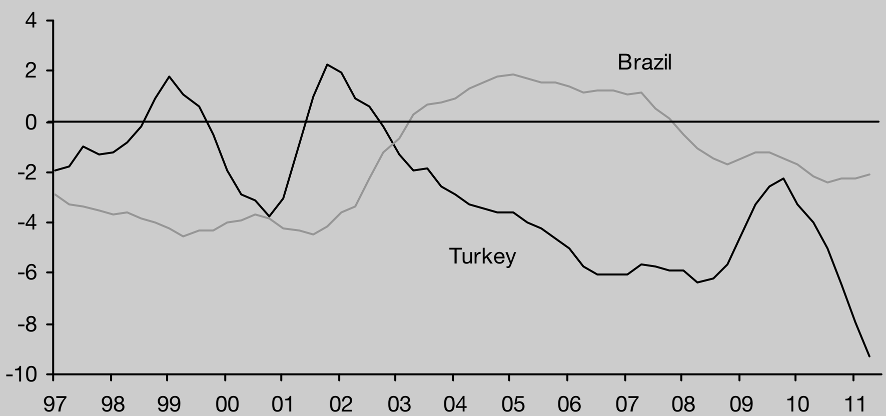
For much of the 1990s, Turkey's external balance was much stronger than Brazil's (Chart 13). In part, this was because Turkey maintained the lira at more competitive levels. It also reflected terms of trade developments which were more favorable for Turkey than Brazil. Since 2003, however, there has been a significant reversal of these relative trends, with Brazil's external balance being far more solid than Turkey's. The main factor supporting this development has been the strength of commodity prices, which has been a major support to Brazil, but which has tended to work against Turkey.

In the past year, however, another difference has developed. Brazil was willing to tighten monetary policy. Although this caused BRL to strengthen, it did have the beneficial impact of tempering domestic credit expansion. This contributed to moderating the incipient deterioration in the external deficit. By contrast, Turkey preferred to reduce policy interest rates, in part to stem currency appreciation. In addition, the central bank attempted to use other policies — mainly increased reserve requirements — to dampen domestic credit expansion. In retrospect, this strategy does not seem to have worked very well, at least judging by the evolution of the external deficit.

Brazil was willing to tighten monetary policy, while Turkey preferred to reduce policy interest rates, in part to stem currency appreciation

The spike in Turkey's current account deficit raises some concerns that less favorable external conditions could cause a more abrupt adjustment in coming quarters than might have been the case had rates been raised earlier.

Chart 13
Brazil and Turkey: Current Account Balance
percent of GDP, 4-quarter moving average



EMERGING ASIA: RETURNING TO TREND

Relatively strong economic performance and ample global liquidity are bolstering private capital flows to the region, although the renewed global financial turmoil is a dampening factor. Real GDP growth for our sample of seven countries constituting Emerging Asia is set to moderate to 8% this year and next after rebounding to 9.4% in 2010 from an eight-year low of 6.8% in 2009. While the region is resuming more normal trends after recovering from the global crisis, growth will continue to outperform the rest of the world. In 2012, China and India will lead again with growth of around 9% and 8% respectively, followed by Indonesia at nearly 7%.

The share of Emerging Asia in total private capital flows to emerging markets should continue to be greater than 40%

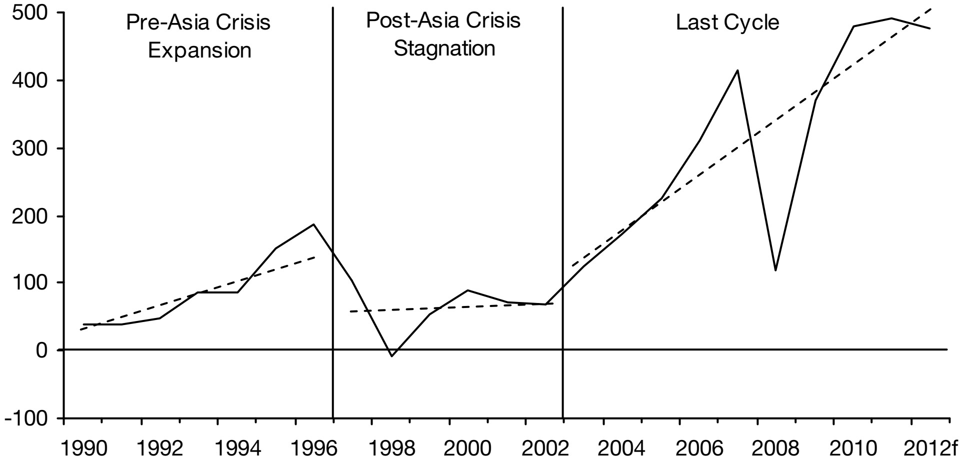
Private capital inflows to Emerging Asia are set to rise further to over $490 billion in 2011 from $480 billion in 2010 and a five-year low of only $120 billion in 2008, before returning to last year's level in 2012 (Table 6). This reflects the broad trend witnessed after the region emerged from five years of stagnation in the aftermath of the 1997 Asian financial crisis (Chart 14, next page). The share of Emerging Asia in total private capital flows to emerging markets should continue to be greater than 40%.

Inflows of foreign direct investment are once again on the rise and should be $175-185 billion a year, but below the pre-crisis peak of $218 billion in 2008. China will continue

Table 6
Emerging Asia: Capital Flows
$ billion

	2009	2010	2011f	2012f
Capital Inflows				
Total Inflows, Net:	*388.7*	*503.5*	*502.1*	*485.2*
Private Inflows, Net	371.4	478.3	491.7	475.8
Equity Investment, Net	254.5	286.3	252.8	264.8
Direct Investment, Net	168.4	159.5	182.2	175.7
Portfolio Investment, Net	86.0	126.8	70.6	89.1
Private Creditors, Net	116.9	192.0	238.9	211.1
Commercial Banks, Net	72.0	110.9	125.6	117.4
Nonbanks, Net	44.9	81.1	113.4	93.7
Official Inflows, Net	17.4	25.2	10.4	9.4
International Financial Institutions	5.4	4.8	2.6	2.0
Bilateral Creditors	12.0	20.4	7.7	7.4
Capital Outflows				
Total Outflows, Net	*-717.9*	*-849.6*	*-822.6*	*-827.1*
Private Outflows, Net	-136.5	-253.1	-211.1	-259.4
Equity Investment Abroad, Net	-157.5	-135.2	-168.2	-193.9
Resident Lending/Other, Net	21.1	-117.9	-42.9	-65.5
Reserves (- = Increase)	-581.5	-596.5	-611.5	-567.8
Memo:				
Current Account Balance	*329.2*	*346.1*	*320.5*	*342.1*

Chart 14
Net Private Capital Inflows to Emerging Asia
$ billion



to account for slightly more than $100 billion a year, reflecting its manufacturing strength and more recently foreign participation in services. Foreign direct investment to India is set to revive to $40 billion a year after falling to a recent low of $23 billion in 2010 from $37 billion in 2008. This reflects in part foreign interest in India's home market and export base as well as liberalization. In addition, driven by the commodity boom and efforts to improve the business environment, foreign direct investment to Indonesia, which surged from $5 billion in 2009 to $12 billion in 2010, should rise further to $20 billion in 2012.

The adverse impact of the recent global financial turmoil is most evident in portfolio equity flows to the region

In contrast, the adverse impact of the recent global financial turmoil is most evident in portfolio equity flows to the region. There was a dramatic turnaround from foreign portfolio equity net outflows of $54 billion in 2008 to record net inflows of $127 billion in 2010 as Asian corporate performance rebounded, accompanied by asset reallocation towards emerging markets. With the reappraisal of the global outlook and valuations, foreign portfolio equity investments will slip to $71 billion in 2011 before edging up to around $90 billion in 2012. China, India and Korea will continue to dominate these flows.

Low global borrowing costs, search for yields and the rise in domestic interest rates to combat inflation should continue to sustain net inflows from commercial banks and nonbanks. These inflows rebounded to $190 billion in 2010 from net repayments of $40 billion in 2008. These are set to rise further to $240 billion in 2011 before edging down somewhat to $210 billion in 2012, which is in line with the dissipation of the positive factors and negative impact of tighter global banking regulations.

While capital inflows remain sizable, the aggregate current account surplus of Emerging Asia appears to have stabilized at around $320-340 billion a year. This is primarily because China's current account surplus will rise further to $335 billion in 2012 from $300 billion last year and this year. Excluding China and India, the aggregate current account surplus of the other countries falls from $85 billion in 2010 to $50 billion in 2012. India is the only country in the region to be running a fairly large current account deficit of $45-50 billion a year, which is more than covered by capital inflows.

Although official foreign exchange reserves for Emerging Asia should rise somewhat more slowly from around $570 billion in 2010 to $600 billion in 2012, the increase reflects the regional bias for limiting currency gains, led by China. The region also remains a major exporter of capital due to efforts to mitigate pressures from the external surplus as well as diversification by the private sector.

EM EUROPE: INCREASED RISK AVERSION TO SLOW INFLOWS IN 2011H2

Heightened global uncertainties have caused capital inflows to slow or reverse since July in much of the region. The slowdown appears to have been centered in short-term and portfolio capital that has affected mainly those countries with macroeconomic fundamentals considered to be problematic in one or more ways. These countries include Turkey, Poland, Hungary and Ukraine. Inflows of portfolio equity have either stopped or even reversed. Foreign holdings of local currency-denominated government bonds have leveled off or been sold down after large purchases during the first half of the year. Macroprudential tightening and signs of weakening economic expansion led domestic banks to borrow less from abroad, especially in Turkey. The recent slowdown in foreign capital inflows has been accompanied by a marked acceleration of resident capital outflows (Table 7). This has

Heightened global uncertainty has caused capital inflows to Emerging Europe to slow or reverse since July

Table 7
Emerging Europe: Capital Flows
$ billion

	2009	2010	2011f	2012f
Capital Inflows				
Total Inflows, Net:	*83.1*	*224.5*	*260.4*	*291.1*
Private Inflows, Net	59.8	199.1	254.3	289.4
Equity Investment, Net	61.9	70.4	97.6	118.8
Direct Investment, Net	52.9	63.6	82.7	104.2
Portfolio Investment, Net	9.0	6.7	14.9	14.5
Private Creditors, Net	-2.1	128.7	156.6	170.6
Commercial Banks, Net	-70.2	14.7	39.6	56.3
Nonbanks, Net	68.1	114.0	117.0	114.3
Official Inflows, Net	23.3	25.4	6.2	1.8
International Financial Institutions	29.0	17.6	10.3	1.7
Bilateral Creditors	-5.7	7.8	-4.2	0.1
Capital Outflows				
Total Outflows, Net	*-104.2*	*-225.1*	*-210.7*	*-186.8*
Private Outflows, Net	-82.3	-141.6	-146.1	-157.4
Equity Investment Abroad, Net	-46.6	-47.6	-58.6	-66.5
Resident Lending/Other, Net	-35.7	-94.0	-87.5	-90.8
Reserves (- = Increase)	-22.0	-83.6	-64.6	-29.4
Memo:				
Current Account Balance	*21.1*	*0.6*	*-49.7*	*-104.4*

mostly been due to outflows from Russia, where political uncertainty has grown amid indications of increasing tension in the run-up the presidential election early next year.

The recent slowdown followed a robust and broad-based recovery in private sector capital inflows during the first half of 2011. Stepped-up equity investment accounted for roughly one half of the increment from a year before during January-June. FDI was supported mainly by an increase in reinvested earnings rather than new inward investments. Poland was an exception, with privatization proceeds boosting inflows. Borrowing from foreign banks gained momentum as well, especially where bank lending has recovered. Domestic banks continued making net repayments, by contrast, in Bulgaria and the Czech Republic, where growth in deposits exceeded that in bank lending. Hungarian banks repaid foreign lenders as well, with the heavy "crisis tax" levied on banks continuing to constrain banks' ability to lend. Foreign purchases of local currency-denominated government bonds were supported by low foreign interest rates during the first half and were especially large in Turkey and Hungary. Global risk appetite contributed to these inflows as well, but has weakened sharply since midyear. Eurobond issues were somewhat smaller, by contrast, as narrower fiscal deficits and increased reliance on local currency borrowing enabled government to scale back foreign-currency bond issuance.

The recent slowdown followed a robust and broad-based recovery in private sector capital inflows during the first half

Assuming some recovery in market sentiment, capital inflows should pick up again later this year. Net inflows of foreign capital would increase to $254 billion from $199 billion. Capital inflows would surpass the pre-crisis 2008 level only in 2012. Increases in foreign capital inflows should be driven this year and next by ongoing recoveries of FDI and borrowing from foreign banks. At $56 billion in 2012, the latter will still remain well below the 2005-2008 average. Borrowing from foreign banks will be constrained in part by the need for further deleveraging of banks in Western Europe. Nonresident purchases of local currency government bonds should recover as market sentiment improves and with foreign interest rates low, but are likely to remain subject to substantial volatility.

Assuming market sentiment improves, capital inflows should recover later in the year

With the IMF program still on hold, Ukraine will remain the country most vulnerable to shifts in market sentiment. Financing pressures are likely to intensify next year, even if IMF lending resumes. Large repayments to the IMF will commence. The current account deficit looks set to widen markedly as FDI remains constrained by lagging reforms. Downside risks have increased sharply in Turkey as well, with the current account deficit on course to exceed 10 percent of GDP this year. Reliance on short-term capital inflows has increased, fiscal policy has eased in underlying terms and monetary policy has been focused on keeping interest rates low to help sustain output growth amid increased uncertainty about foreign and domestic demand. In central Europe, Hungary will remain most at risk of a reversal of capital inflows, given its high government debt, large temporary taxes on banks and other mainly foreign-invested sectors, and moves to shift the burden of the increase of servicing of Swiss Franc–denominated loans to domestic banks. Vulnerability to shifts in market sentiment has also increased in Poland, where the large fiscal deficit remains a source of concern. In Romania, the approach of next year's local and parliamentary elections will test the cohesion of the ruling coalition and its resolve to sustain the fiscal adjustment that has helped ease market worries this year.

Ukraine will remain the country most vulnerable to shifts in market sentiment

The Euro Area debt crisis and weakening growth prospects in Europe remain the main downside risks for the region. A deepening of the crisis would hit countries such as Hungary, Poland and Romania, which are more vulnerable to increased financial pressures because of their large government deficits and high levels of public debt. Turkey's outsized current account deficit and its growing reliance on short-term capital inflows would leave the lira vulnerable to further depreciation and domestic borrowing costs at risk of sizable increases. Decreases in commodity prices, even moderate ones, would be likely to have substantial adverse effects on the external balances and fiscal positions of Russia and Ukraine, especially.

The Euro Area debt crisis and weakening growth prospects in Europe remain the main downside risks for the region

LATIN AMERICA: A RISING ASSET CLASS

Capital inflows to Latin America have shown resilience despite renewed concerns over the global economy and heightened risk aversion. Global appetite for regional assets has remained relatively robust, supported by the market's favorable return-to-risk assessment vis-à-vis mature economies. This shift in market perceptions has partly offset the dragging effect of the recent global equity weakness on inflows. We project net private capital inflows to the region to remain broadly unchanged in 2011 from a year ago at about $257 billion and to decrease marginally next year (Table 8). The key driver is foreign direct investment (FDI), which has gained strength due to: (1) comparatively stronger real GDP growth prospects, (2) abundant and well diversified commodity-export bases, (3) sound macroeconomic policies;

A favorable shift in market perceptions has partly offset the dragging effect of the recent global equity weakness on inflows

Table 8
Latin America: Capital Flows
$ billion

	2009	2010	2011f	2012f
Capital Inflows				
Total Inflows, Net:	*171.3*	*277.9*	*280.3*	*276.2*
Private Inflows, Net	147.9	258.8	256.8	254.2
Equity Investment, Net	108.6	134.6	145.7	152.2
Direct Investment, Net	62.4	91.4	120.8	119.5
Portfolio Investment, Net	46.2	43.2	24.9	32.7
Private Creditors, Net	39.3	124.2	111.1	102.0
Commercial Banks, Net	0.0	29.2	29.9	36.6
Nonbanks, Net	39.3	95.0	81.2	65.4
Official Inflows, Net	23.4	19.1	23.5	22.0
International Financial Institutions	8.8	6.1	4.4	4.0
Bilateral Creditors	14.5	13.0	19.1	18.0
Capital Outflows				
Total Outflows, Net	*-158.5*	*-232.8*	*-232.3*	*-188.6*
Private Outflows, Net	-118.4	-148.3	-110.7	-122.9
Equity Investment Abroad, Net	-43.9	-67.0	-47.0	-48.4
Resident Lending/Other, Net	-74.5	-81.3	-63.7	-74.5
Reserves (- = Increase)	-40.1	-84.5	-121.7	-65.8
Memo:				
Current Account Balance	*-12.7*	*-45.1*	*-48.0*	*-87.5*

(4) declining political risk, and (5) a favorable business climate in the major economies. Nonresident demand for fixed-income securities, on the other hand, has been supported by relatively high domestic interest rates and increasingly liquid local capital markets. Portfolio equity and debt inflows have declined from last year's peak because of a plunge of global stock markets and controls on capital inflows in Brazil.

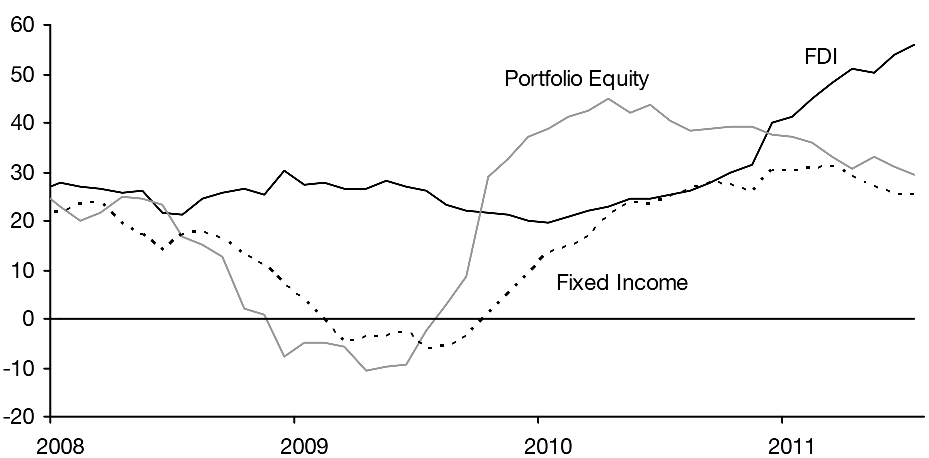
FDI inflows to the region are forecast to increase more than 30% in 2011 to $120 billion, of which about half will go to Brazil. As a result of wide interest rate differentials, carry trade inflows remain significant, but they are set to lose prominence in 2012 as major economies in the region are poised to ease monetary policy to stem economic deceleration. With authorities fully committed to forestalling further currency appreciation, we expect the region to accumulate about $120 billion in international reserves in 2011, with Brazil accounting for the bulk of the increase. Reserve accumulation should moderate next year as net private capital inflows stabilize.

Due to wide interest rate differentials, carry trade inflows remain significant

In Brazil, controls on capital inflows have reduced their volatility by discouraging outflows (reentering the local market requires payment of the IOF tax), reducing short-term borrowing from abroad and reducing the composition of inflows (Chart 15). The 6% IOF tax on resident short-term borrowing abroad (at below-two year maturities) and nonresident portfolio fixed-income inflows have reduced external debt and amplified FDI inflows as some companies appear to have set up shop in the local market to avoid controls. Short-term external debt declined to $50 billion in July from $57 billion in December; in the same period, medium- and long-term external liabilities increased by $50 billion. FDI inflows, mostly growth and commodity driven, rose to $56 billion (2.7% of GDP) in the twelve months to July, up from $25 billion (1.5% of GDP) a year ago. Given the government's concerns over deindustrialization, we expect capital inflow controls to remain at the core of Brazil's efforts to prevent further *real* appreciation.

In Mexico, a sound policy mix, lack of capital controls and the country's inclusion in the

Chart 15
Brazil: Net Private Capital Inflows
$ billion, 12-month rolling sum



BOX 4: ARGENTINA - EXTERNAL ACCOUNTS UNDER PRESSURE

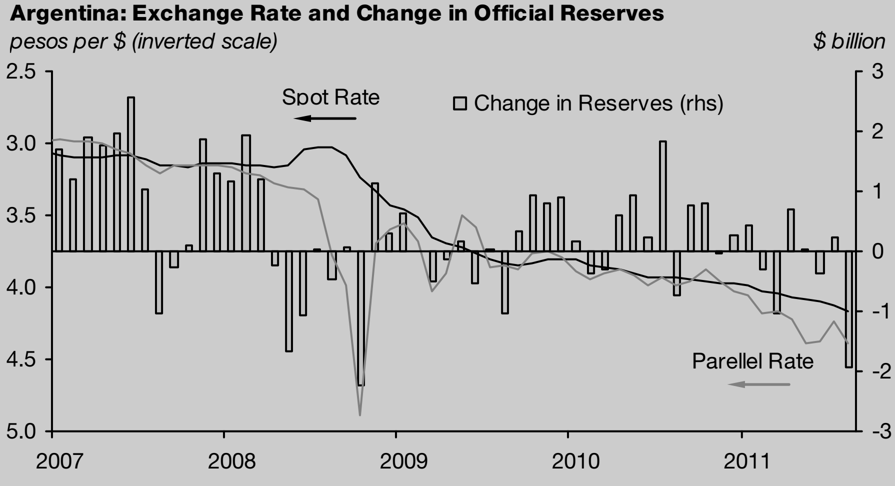
Two factors have begun to put downward pressure on international reserves: a rapidly shrinking trade surplus driven by the appreciation of the real exchange rate and accelerating capital flight in the run-up to the October 23 presidential election. This is exacerbating the already strong chronic forces fueling the movement of capital offshore by residents. These include:

- An overly expansionary monetary policy. This is reflected in negative real interest rates and entrenchment of inflation at a high level (about 25% according to private sector estimates).
- A procyclical fiscal policy. Heavy spending ahead of the election has further weakened the fiscal position. As a result, the central government balance is projected to shift from a surplus of 0.2% of GDP in 2010 to a deficit of 1.3% of GDP this year.
- Heterodox public sector financing. The government is increasingly relying on transfers from the social security system and central bank financing, thereby increasing uncertainty regarding the sustainability of public finances.
- Interventionist policies. Export taxes and other financial restrictions have contributed to undermine the trade balance and the development of a parallel foreign exchange market (Chart 16).

The projected shifting of the current account from a small surplus in 2011 to a deficit next year and a surge in capital flight are expected to reduce international reserves by about $4.0 billion in 2012, bolstering devaluation expectations and adding to growing imbalances. This is likely to intensify anti-market policies by the government.

International reserves are expected to fall by about $4.0 billion in 2012, bolstering devaluation expectations and adding to growing imbalances

Chart 16
Argentina: Exchange Rate and Change in Official Reserves



world government bond index (WGBI) in 2010 have led to a structural increase of portfolio debt inflows. Fixed-income inflows totaled almost $15 billion in the first half of 2011, broadly unchanged from a year earlier, but up from minus $2.0 billion in the same period of 2009. In Argentina by contrast, heightened uncertainty ahead of the October 2011 presidential election has accelerated capital flight by residents. Capital flight has become chronic due to unsustainable expansionary fiscal and monetary policies, rising inflation and a tightly managed nominal exchange rate. Accelerating capital outflows and shifting of the current account from a small surplus in 2011 to a deficit next year will put increased pressure on international reserves. This is likely to intensify anti-market policies by the government.

Risks of a renewed global downturn have increased the likelihood of monetary easing across the region. If implemented, this should ease upward pressure on local currencies. In August, the central bank of Brazil cut its benchmark Selic policy rate 50 bps to 12%. We expect further cuts in the months ahead. Unlike 2009, when economic growth was mainly supported by countercyclical fiscal and quasi-fiscal expansions, this time Brazil's policy response to global weakness will most likely rely heavily on monetary easing in order to accelerate convergence of interest rates to those in mature economies. Depending upon how the global economy and commodity prices evolve, other inflation targeting countries such as, Mexico, Chile and Peru could follow suit.

In Brazil, we expect further policy rate cuts in the months ahead

AFRICA AND MIDDLE EAST: STABLE BUT DIFFERENTIATED INFLOWS

Capital flows to Africa and the Middle East remain relatively small as a share of their total GDP, expected at 2.5% in 2011, and as compared to other regions. There are also significant differences between (1) the oil exporting countries (Nigeria, Saudi Arabia, and the UAE) and (2) the oil importers facing political turmoil (Egypt and Lebanon), and (3) countries with more mature capital markets (South Africa), whose fortunes are more closely tied to developments in the global economy.

Real GDP growth for our sample of seven main countries in Africa and the Middle East is set to stabilize at around 4% this year and next. Stronger growth will be recorded by the oil exporters while oil importing countries will show weakness. Net private capital inflows are projected to rise to nearly $65 billion in 2012 from $51 billion in 2011 and $73 billion in 2010 (Table 9). The increase in 2012 reflects mainly the expected recovery of inflows to Egypt as a relatively peaceful transition paves the way for a gradual recovery. Net foreign direct investment to Emerging Africa and the Middle East, while slightly increasing to around $49 billion in 2012, and directed largely to the oil producing states, will remain well below the level reached in 2008 of $64 billion. Portfolio equity flows to the region remain small.

In Egypt, a relatively peaceful transition should pave the way for a gradual recovery

The aggregate current account surplus of African and Middle Eastern countries in the sample remains sizeable, at $162 billion in 2011 and $110 billion in 2012. This largely reflects the surpluses in Saudi Arabia and the UAE. Official exchange reserves (excluding SWFs) are expected to continue rising, from $758 billion in 2011 to $837 billion in 2012, led by Saudi Arabia. The accumulation of foreign assets will show up as a large outflow in the form of resident lending abroad. In addition, we expect the surplus countries in the GCC to provide

Table 9
Africa and Middle East: Capital Flows
$ billion

	2009	2010	2011f	2012f
Capital Inflows				
Total Inflows, Net:	46.9	72.1	46.2	72.1
Private Inflows, Net	43.5	72.7	50.7	64.5
Equity Investment, Net	46.8	42.3	29.7	41.8
Direct Investment, Net	64.5	44.8	45.0	48.6
Portfolio Investment, Net	-17.7	-2.6	-15.3	-6.8
Private Creditors, Net	-3.3	30.4	20.9	22.8
Commercial Banks, Net	-1.7	7.1	3.3	5.1
Nonbanks, Net	-1.6	23.3	17.6	17.7
Official Inflows, Net	3.4	-0.6	-4.4	7.6
International Financial Institutions	3.6	3.1	3.3	5.0
Bilateral Creditors	-0.2	-3.7	-7.7	2.5
Capital Outflows				
Total Outflows, Net	-69.2	-145.0	-208.1	-182.4
Private Outflows, Net	-92.9	-102.7	-99.7	-100.8
Equity Investment Abroad, Net	-11.1	-9.4	-14.5	-13.8
Resident Lending/Other, Net	-81.8	-93.3	-85.2	-87.0
Reserves (- = Increase)	23.6	-42.3	-108.4	-81.6
Memo:				
Current Account Balance	21.6	72.0	161.9	109.8

financial support to other countries in the region in 2012 (particularly to Egypt, Jordan, Morocco, and Tunisia) whose balance of payments have come under pressure as a result of higher oil import bills or a drop in foreign exchange earnings from exports of goods, tourism, remittances, and FDI as a result of the social unrest.

Political uncertainty and continued sporadic protests have led to large capital outflows from Egypt in the first eight months of this year. We expect a modest recovery in inflows next year once parliamentary elections (now scheduled for November 2011) and presidential elections (most likely in early 2012) are out of the way. Official reserves dropped sharply in 2011 H1 as FDI was cut back and as nonresidents reduced their holdings of treasury bonds and sold equities. However, the external position has stabilized recently, and foreign exchange reserves, which stood at $21.6 billion in July, may level off in the second half of the year. The authorities are in discussions to secure possible financial assistance from multilateral development banks and oil-rich countries in the region. This will help compensate for a drop in private inflows, which have turned negative this year. The bulk of the assistance is likely to come in 2012.

South Africa is likely to continue to benefit from robust private capital inflows

South Africa is likely to continue to benefit from robust private capital inflows, which will remain at around $20 billion this year and in 2012. Although South Africa has attracted a steady flow of FDI over the past decade ($2.7 billion per annum, on average, which is equivalent to about 1% of GDP), it lags behind other leading emerging markets and has consisted mostly of acquisitions, as opposed to greenfield investment. Political meddling, bureaucratic red tape, policy uncertainty and corruption are the main obstacles for larger capital inflows. The capital account has been bolstered this year by continued strong inflows into the local bond market, which is providing substantially better yields than international markets. In the first six months of this year nonresidents bought $4.1 billion of fixed income securities, which followed a record inflow of $6.7 billion in 2010. With yields likely to remain at record lows in the United States, where the Fed recently announced that short-term rates would be held steady through the middle of 2013, the differential between South African and U.S. yields will remain substantial for some time. Although South Africa will be competing against other high-yielding emerging markets, we expect foreigners to continue to invest in the rand carry trade.

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