Capital Flows to Emerging Market Economies

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Overview

Modest Improvement in Private Capital Flows

Capital flows to emerging markets are expected to increase in 2003 from last year's meager levels (the lowest in more than 10 years), but will remain subdued. The global economic recovery continues to be tepid while the outlook is clouded by the risk of war in the Middle East and its implications for oil prices and global terrorism. Although investors' risk aversion appears to have eased a bit in the wake of elections in Brazil, whether this marks the beginning of a trend with increasing capital flows remains uncertain.

Against this background, net private capital flows to emerging markets are projected to rise modestly this year to about $137 billion from about $113 billion last year, as the global economic recovery begins to pick up in the second half of the year (Table 1). This year's projected increase, however, largely reflects the cessation of private capital outflows from crisis countries that occurred in 2002 and the year before, rather than an improvement in inflows into emerging market countries. Despite the expected increase, this year's level will be well below the average of around $185 billion over the past 10 years.

Recent weakness in capital flows to emerging markets reflects both cyclical (short-term) and structural (long-term) problems. The cyclical factors reflect the downturn in the world economy since 2001 and the heightened sensitivity to market risk. The latter stems from a confluence of negative developments including the bursting of the stock market bubble, corporate governance scandals, the aftermath of the September 11 terrorist attacks, as well as the potential war with Iraq. Among the structural factors, one of the most important is the gradual loss of investor appetite for emerging markets as an asset class caused by a series of severe financial crises and consequent huge investor losses. The universe of dedicated emerging market investors has dwindled, and crossover investors have become much more cautious. The modest recovery in net capital inflows projected for 2003 is primarily due to some improvement in the cyclical environment and not an amelioration of structural problems.

In terms of the composition of external financing in 2003, net direct equity investment is likely to continue to dominate overall flows. But while direct equity investment is expected to remain stable this year at about $108 billion, this and last year's levels will be the lowest since 1996 as multinational corporations continue to be cautious about investment spending, investors remain concerned about the global economic outlook, and the pace of structural reform and privatization continues to be slow in many countries. Although

Table 1
Emerging Market Economies' External Financing
(billions of dollars)

	1999	*2000*	*2001*	*2002e*	*2003f*
Current account balance	**30.1**	**47.9**	**32.8**	**51.8**	**33.6**
External financing, net:					
Private flows, net	**148.2**	**185.6**	**125.7**	**112.5**	**137.1**
Equity investment, net	**164.1**	**149.9**	**144.5**	**101.9**	**116.6**
Direct investment, net	**149.1**	**135.6**	**134.3**	**106.6**	**107.7**
Portfolio investment, net	**15.0**	**14.3**	**10.2**	**-4.7**	**8.9**
Private creditors, net	**-15.9**	**35.7**	**-18.8**	**10.5**	**20.5**
Commercial banks, net	**-51.6**	**-4.4**	**-26.3**	**-4.8**	**-2.6**
Nonbanks, net	**35.8**	**40.1**	**7.5**	**15.3**	**23.1**
Official flows, net	**12.4**	**-3.0**	**14.7**	**12.2**	**10.4**
IFIs	**2.4**	**3.3**	**24.3**	**19.8**	**19.6**
Bilateral creditors	**10.0**	**-6.2**	**-9.6**	**-7.6**	**-9.2**
Resident lending/other, net[1]	**-135.4**	**-159.5**	**-85.7**	**-35.6**	**-60.6**
Reserves (- = increase)	**-55.3**	**-71.1**	**-87.5**	**-140.8**	**-120.6**

e = estimate, f = IIF forecast

[1] Including net lending, monetary gold, and errors and omissions.

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nonbank credit flows, mostly bonds, are likely to increase slightly this year, they also remain relatively weak compared to levels in previous years (see box on page 14 entitled *"Bond Flows to Emerging Markets: Is There a Recovery in Sight?"*). Net repayments to commercial banks are expected to continue to decline this year, as new lending is expected to rise slightly while repayments level off.

Our baseline forecast for capital flows to emerging markets rests on expectations of continued global recovery this year (albeit a modest one), some progress toward stabilization in Latin American crisis countries, and an easing in oil prices in the second half of the year, after an uptick in the first half, as tensions in the Middle East are expected to subside. It also takes account of a lower-than-expected outturn for 2002; our estimate for last year's net private capital flows to emerging markets was revised down by about $10 billion, reflecting weaker-than-expected portfolio and direct equity investment that was only partially offset by greater-than-expected net nonbank private credit flows that came in the fourth quarter. Accordingly, while the extent of the increase now projected for 2003 is broadly similar to that envisaged in our last report issued September 2002, the resulting level for 2003 now being projected is some $12 billion less than the level earlier foreseen (Chart 1, Table 2).

A major downside risk for emerging markets in 2003 is that the global economy does not gather momentum in the course of the year. A key factor in this regard is whether robust U.S. consumer spending can persist without a revival of confidence based on a sustained increase in profits and job recovery. On the positive side, U.S. monetary and fiscal policies are expansionary and their impact has yet to fully work through the economy. Still, weak manufacturing growth, low consumer confidence and higher oil prices pose a risk that the recovery will be slower than expected.

Outside the United States, Japan's economy remains anemic despite a strong recovery in exports last year, while the outlook for this year has become cloudier as a result of recent yen appreciation. Meanwhile, Europe's hopes of a stronger recovery have been dampened as domestic demand remains weak with business investment low and consumer confidence faltering. Like Japan, European growth next year will rely heavily on external demand, which still remains at risk. In the event of a retrenchment in G7 growth, emerging market exports and capital flows would be certain to suffer (Chart 2).

Second, the prospect of war against Iraq and heightened security concerns over the potential for terrorism is constraining global investment and putting upward pressure on oil prices. Since the end of November 2002, the prospect of war with Iraq, together with the shut down of Venezuela's oil, have boosted oil prices almost 20 percent to levels that are now about 40 percent higher than a year ago. Although higher oil prices are unlikely to be sustained after the resolution of the standoff with Iraq, protracted upward pressure on prices could further impair the global recovery

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Chart 1: Private Capital Flows to Emerging Markets (billions of U.S. Dollars)

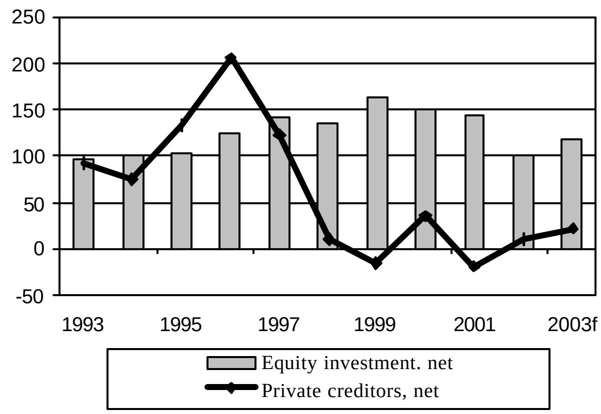

Table 2
Financial Flows to Emerging Market Economies by Region, Net
(billions of dollars)

	1999	2000	2001	2002e	2003f
Private flows	**148.2**	**185.6**	**125.7**	**112.5**	**137.1**
Latin America	**69.7**	**62.6**	**47.8**	**25.2**	**35.5**
Europe	**38.3**	**42.2**	**17.0**	**21.7**	**31.0**
Africa/Middle East	**10.2**	**4.7**	**9.3**	**3.8**	**8.1**
Asia/Pacific	**30.1**	**76.2**	**51.6**	**61.8**	**62.5**
Five Asian economies[1]	**-5.8**	**17.2**	**7.1**	**2.9**	**5.7**
Official flows	**12.4**	**-3.0**	**14.7**	**12.2**	**10.4**
Latin America	**7.9**	**-6.7**	**22.4**	**14.0**	**17.7**
Europe	**0.2**	**2.0**	**1.4**	**5.0**	**-0.1**
Africa/Middle East	**-1.7**	**-0.5**	**-4.0**	**-2.0**	**-2.0**
Asia/Pacific	**6.0**	**2.3**	**-5.0**	**-4.8**	**-5.2**
Five Asian economies[1]	**1.9**	**2.9**	**-4.6**	**-3.9**	**-4.9**

e = estimate, f = IIF forecast
[1] South Korea, Indonesia, Malaysia, Thailand, Philippines.

or possibly reverse it. Also, an actual war with Iraq, short as it may prove to be, would contribute to already high concerns about global terrorism and add to the persistence of risk aversion.

Third, there are risks that Turkey and several countries in Latin America may continue to face financing problems and market volatility. In our baseline scenario, we assume that these countries will navigate the political and economic challenges with relative success, but a great deal of uncertainty remains. Argentina has shown tentative signs of bottoming out, but a recovery has yet to take hold and policies remain in a state of flux. Brazil's economic situation appears to be improving, but uncertainty remains about economic policy and structural reform implementation. Turkey's new government, which commands a strong majority in parliament, was initially successful in turning around negative market sentiment prevailing prior to the November election, but recent vacillation over policy has reversed some of the gains. Moreover, Venezuela's political and economic situation remains bleak. Should volatility substantially increase in one or more of these economies, it could have substantial repercussions well beyond country borders.

Finally, although structural reform and privatization continue in a number of emerging markets, the momentum has slowed. While the loss of pace may, in part, be due to the substantial progress made in recent years, lack of popular support and the slow global recovery may also be factors. Last year's volatility in Latin America, combined with disregard for investor rights as well as ongoing intense debate on approaches to the restructuring of unsustainable sovereign debt, has increased perceived long-term risks to investing in emerging markets.

Despite the considerable downside risks to emerging market capital flows, there are some positive elements that provide grounds for guarded optimism. Increased economic and financial volatility in Latin America has not had a substantial impact on financial markets in Asia or emerging Europe. Most of Asia and Europe have continued to experience solid growth and attract capital at favorable rates, despite volatility in other markets. While these markets have undoubtedly suffered from the global economic slowdown and heightened sense of risk aversion, on the whole investors are more willing today than some years ago to discriminate between individual country risks. Moreover, those countries with successful economic liberalization and market deepening policies have been the most apt to maintain or increase capital inflows in the midst of the recent market turbulence.

Factors Influencing Capital Flows

1. Economic Growth: **Continued recovery**

Emerging market real GDP is projected to grow by 4.5 percent this year (Chart 3), which is roughly one percentage point higher than last year's estimated growth of 3.3 percent. While last year's growth was severely constrained by weak industrial country

Chart 2: Industrial Country Real GDP Growth (percent change from previous year)

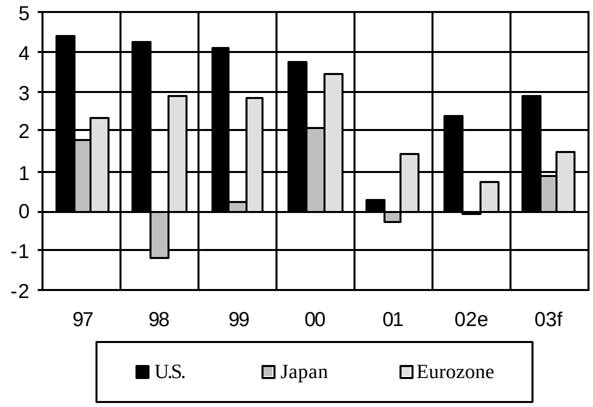

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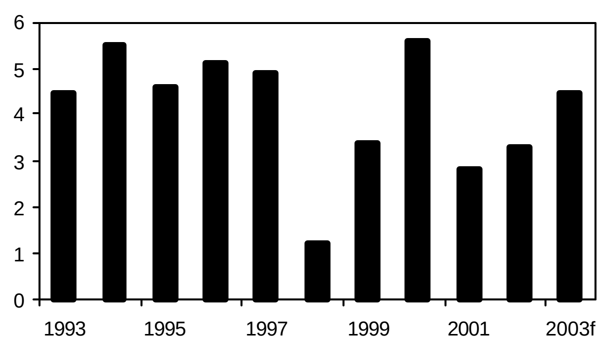
Chart 3: Emerging Market Economies' Real GDP Growth (percent change from previous year)



economic conditions and a broad-based slowdown in Latin America, this year's growth should benefit from improving G7 economic conditions (Table 3). Nonetheless, should G7 growth slow, oil prices rise faster than expected in the context of escalating conflict in the Middle East, or Latin America fails to stabilize, emerging markets may experience another year of subpar growth.

A gradual, if modest, recovery in industrial countries during 2003 should help emerging market exports recover from their weakness over the last two years and increase about 11.5 percent this year (in value terms) compared to 8.5 percent last year and a fall of 2.3 percent in 2001.

- The U.S. is expected to grow 3 percent this year, up from last year's estimated 2.4 percent.
- Growth in the rest of the G7 is also expected to pick up, albeit modestly. The Eurozone economies are expected to grow only 1.5 percent in 2003, while the United Kingdom is likely to grow about 2.5 percent and Canada is projected to grow over 3 percent.
- The outlook for the Japanese economy remains poor and uncertain. The economy is expected to expand by less than 1 percent in 2003 after contracting by 0.1 percent in 2002.

Within emerging markets, both Asia and emerging Europe are likely to expand output at nearly the same pace this year as last, with Asian growth of just above 6 percent continuing to far outpace other regions. Output in Latin America is expected to grow 2.4 percent this year after 2002's extremely poor performance—which marked the first fall in regional aggregate output since 1983. The trajectory of Latin America, however, is still quite uncertain as Argentina is only showing tentative signs of bottoming out and as economic and political uncertainty still plagues Venezuela. Even Brazil's situation is not without major vulnerabilities despite a favorable market response to the new government.

- Asia's expected growth of over 6 percent this year will be nearly unchanged from last year and continues to be led by the strong performance of China, India, and South Korea, with growth rates ranging from 5 to 7.5 percent. Growth in the rest of Asia is expected to be more moderate, in the range of 3.5-4.5 percent, though still strong compared to other regions.
- After growing an estimated 3.8 percent in 2002, emerging Europe is likely to see a slightly slower pace of 3.4 percent growth in 2003. Last year, Turkey began to recover from its 2001 crisis by growing an estimated 6.5 percent, after contracting by 7.4 percent in 2001. In 2003, Turkey's growth is expected to slow to 3.5 percent, while Russia and Slovakia are also projected to see slightly weaker growth compared to about 4 percent last year.

Table 3
Emerging Market Economies' Output
(billions of dollars)

	1999	*2000*	*2001*	*2002e*	*2003f*
Real GDP	**3.4**	**5.6**	**2.8**	**3.3**	**4.5**
Latin America	**0.0**	**3.9**	**0.1**	**-1.5**	**2.4**
Europe	**1.9**	**6.3**	**1.1**	**3.8**	**3.4**
Africa/Middle East	**3.3**	**3.6**	**3.4**	**2.8**	**3.8**
Asia/Pacific	**6.8**	**7.0**	**5.3**	**6.4**	**6.3**
Five Asian economies[1]	**7.0**	**7.3**	**2.7**	**5.1**	**4.6**

e = estimate, f = IIF forecast
[1] South Korea, Indonesia, Malaysia, Thailand, Philippines.

"This year's output should benefit from improving global conditions and export growth. Nonetheless, should G7 growth slow, oil prices rise faster than expected in the context of escalating conflict in the Middle East, or Latin America fails to stabilize, emerging markets may experience another year of subpar growth."

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- The collapse of the Argentine economy and its impact on Uruguay, as well as economic weakness and political uncertainty in Brazil and escalating conflict in Venezuela, generated a contraction of perhaps 1.3 percent in Latin America's combined real GDP last year, the first decline in regional output since 1983. While Argentina is expected to stabilize from its estimated 13 percent output contraction in 2002, the economy is unlikely to stage a material recovery in 2003. Most other countries in the region that saw exceptional volatility last year, including Brazil, Venezuela, and Uruguay, are projected to stabilize during 2003, but are also unlikely to experience a robust recovery. By contrast, other countries that escaped the brunt of Latin volatility in 2002 will likely see expansion this year as long as the global recovery solidifies and regional stability resumes.

- Growth in the Africa/Middle East region is likely to increase this year to about 4 percent, from less than 3 percent last year, but security concerns pose a major downside risk to the region.

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2. *Current Account Balances:* Surpluses narrow

With the modest rise in the rate of emerging market growth, the combined current account surplus is expected to fall by about $18 billion this year to around $34 billion (0.6 percent of combined GDP, compared to an estimated 0.9 percent in 2002) (Table 4). Exports this year will be helped by the strengthening global recovery and are expected to rise by about 12 percent in value terms for emerging markets as a group.

Emerging market imports, however, are projected to grow about 13 percent this year, after growing about 7 percent in 2002, as demand strengthens and a slight weakening in the region's terms of trade is probable. Interest payments are also expected to increase slightly this year, to about $109 billion from an estimated $103 billion last year.

Table 4
Emerging Market Economies' Current Account Balance
(billions of dollars)

	1999	*2000*	*2001*	*2002e*	*2003f*
Current account balance	**30.1**	**47.9**	**32.8**	**51.8**	**33.6**
Latin America	**-48.4**	**-40.5**	**-46.7**	**-18.2**	**-17.8**
Europe	**1.8**	**18.0**	**19.9**	**7.5**	**-2.9**
Africa/Middle East	**-3.0**	**6.1**	**7.3**	**5.2**	**4.0**
Asia/Pacific	**79.6**	**64.4**	**52.3**	**57.3**	**50.4**
Five Asian economies[1]	**63.2**	**46.4**	**33.6**	**30.8**	**26.0**
			(percent GDP)		
Current account balance	**0.6**	**0.9**	**0.6**	**0.9**	**0.6**
Latin America	**-2.9**	**-2.2**	**-2.7**	**-1.2**	**-1.2**
Europe	**0.3**	**2.3**	**2.4**	**0.8**	**-0.3**
Africa/Middle East	**-0.9**	**1.8**	**2.3**	**1.7**	**1.2**
Asia/Pacific	**3.5**	**2.6**	**2.1**	**2.1**	**1.7**
Five Asian economies[1]	**7.7**	**5.2**	**4.0**	**3.3**	**2.5**

e = estimate, f = IIF forecast
[1] South Korea, Indonesia, Malaysia, Thailand, Philippines.

- The combined current account balance of emerging Europe is expected to shift to a $3 billion deficit in 2003 from a $7.5 billion surplus in 2002 and a $20 billion surplus in 2001, as the trade surplus narrows and the services deficit widens.

- Economic weakness and currency depreciation in Latin America have depressed the region's demand for imports and will likely keep the current account deficit at just above 1 percent of GDP in 2003, about the same as last year, but lower than the 2.7 percent of GDP deficit recorded in 2001. Argentina's imports last year are estimated to have shrunk to less than half their level in 2001. Exports from the region are projected to increase slightly this year, due largely to a moderate global recovery and the expected stabilization in Argentina and Brazil in the second half of 2003.

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- The current account surplus of Asia is expected to continue its steady decline throughout 2003, as the pace of import growth, particularly services, outstrips that of exports. Without exception, exports across the region are expected to increase, with particularly strong growth forecast for China.

Outlook for Major Components of Capital Flows

1. Net Equity Investment: **Continued weakness**

Net equity flows are expected to rise marginally to about $117 billion this year from last year's meager flows of $102 billion after averaging over $150 billion from 1999 to 2001 (Chart 4). This year's continued weakness in net equity investment is primarily due to subdued direct investment, while net portfolio investment is expected to see modest gains. This contrasts with the experience of the past few years when stability in net equity flows reflected increases in direct investment that offset declines in portfolio flows. Still, direct equity investment continues to dominate overall private capital flows to emerging markets, representing an estimated 95 percent of total net private capital flows to emerging markets in 2002, and a projected 80 percent this year.

In past years, privatization, structural reform, and the easing of restrictions on foreign investment facilitated a growing presence of direct foreign ownership and less portfolio equity investment. Much of last year's relative weakness in direct investment, however, is attributable to generally depressed global economic conditions, a jump in overall market uncertainty, and policy reversals in a number of countries. This year's improving, but generally tepid, global economic conditions are likely to be accompanied by little increase in net direct equity investment and modest gains in portfolio equity investment in most regions of the world.

Direct Investment: Net direct investment is expected to remain at the relatively depressed level of $108 billion in 2003, nearly unchanged from last year's level of $107 billion. (Chart 5). Weak net direct equity investment flows reflect our baseline assumptions of a sluggish global recovery, lingering concerns over the return of profitability of emerging market companies, and limited privatizations. The momentum of structural reform in many markets appears to have waned due to the recent economic slowdown, weakness in the global technology and telecommunications sector, and a greater market perception of the risk associated with cross-border investment.

Argentina's policy reversals on key issues of property rights and contracts, as well as a political shift toward more populist candidates in several emerging market countries last year, have caused investors to reevaluate the long-term risks to direct investment in emerging markets. But emerging market direct investment flows have also been affected by the sharp drop in global mergers and acquisitions activity which is related more to the general increase in financial market uncertainty and global economic slowdown than to specific concerns about emerging

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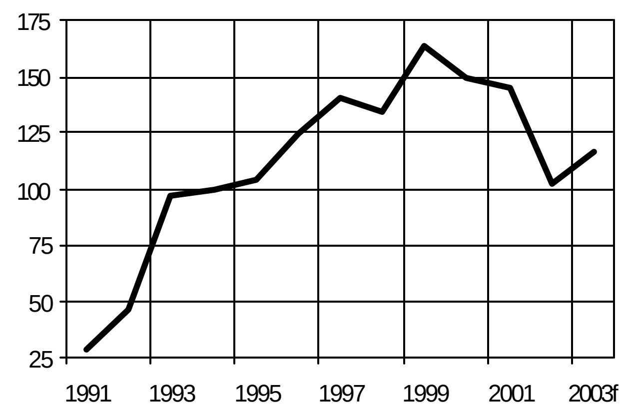
Chart 4: Net Equity Investment (billions of U.S. dollars)



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Emerging Europe

Net inflows of private capital to emerging Europe are set to increase further to $31 billion in 2003 after rising to about $22 billion last year from $17 billion in 2001. This year's gain reflects a small positive net inflow for Turkey, which made net repayments to private creditors of $2.6 billion in 2002 and more than $15 billion in 2001.

- Increased international bond issuance combined with stepped-up nonresident buying of local currency government bonds should boost net private credit disbursements to $14 billion from about $6 billion last year. Foreign bond issues should rise as governments in Turkey, Hungary and Romania borrow more abroad than in 2002. Borrowing by Russian oil companies should also increase further.

- Nonresident purchases of domestic bonds should grow as investors look to gain from currency appreciation and a decrease in yields to EU levels in several central European countries during the run up to EU accession in 2004 and Eurozone entry after 2006.
- Fewer large privatizations and continued weakness in global investment are likely to cause net inflows of direct equity investment to decrease to $16 billion from $17 billion in 2003. Optimism about further increases in equity prices is likely to shift portfolio equity investment to a net inflow from net outflow last year, raising overall equity inflows marginally to $17 billion in net terms.

Table 5
Europe: External Financing
(billions of dollars)

	1999	*2000*	*2001*	*2002e*	*2003f*
Current account balance	1.8	18.0	19.9	7.5	-2.9
External financing, net:					
Private flows, net	38.3	42.2	17.0	21.7	31.0
Equity investment, net	16.1	15.5	16.6	16.1	16.8
Direct investment, net	16.4	17.9	14.9	16.8	15.6
Portfolio investment, net	-0.3	-2.4	1.6	-0.7	1.2
Private creditors, net	22.2	26.7	0.4	5.6	14.2
Commercial banks, net	8.9	12.4	-7.4	-2.7	0.9
Nonbanks, net	13.3	14.3	7.8	8.4	13.4
Official flows, net	0.2	2.0	1.4	5.0	-0.1
IFIs	-2.2	2.5	7.4	7.9	1.5
Bilateral creditors	2.4	-0.5	-6.0	-2.8	-1.6
Resident lending/other, net[1]	-27.3	-41.1	-29.6	-3.1	-12.7
Reserves (- = increase)	-12.9	-21.0	-8.6	-31.1	-15.3

e = estimate, f = IIF forecast
[1] *Including net lending, monetary gold, and errors and omissions.*

Asia/Pacific

Net private capital inflows strengthened with growth in the region from around $52 billion in 2001 to almost $62 billion in 2002 and are likely to be sustained at close to that level in 2003. Part of the recent pickup reflects renewed net lending by foreign banks after several years of retrenchment triggered by the 1997 financial crisis. Last year's small outflows due to foreign investors selling domestic equities also appears to have run its course, while an upturn in new commitments suggests that inflows of foreign direct investment into China will remain large.

- Real GDP is likely to expand more than 6 percent in 2003, sustaining the momentum from a rebound in exports and a firming in domestic demand that lifted GDP growth from about 5 percent in 2001.

- After contracting 5 percent in 2001 with the sharp retrenchment in global IT investment, regional exports rebounded more than 12 percent in 2002 with the recovery in shipments of electronic products. Export growth of more than 14 percent is expected for 2003 with the firming in global growth.

- Given the outlook for the continued large balance of payments surplus for the leading Asian emerging markets, official foreign exchange reserves would rise to $675 billion by the end of 2003 from $597 billion at the end of 2002.

Table 6
Asia/Pacific: External Financing
(billions of dollars)

	1999	*2000*	*2001*	*2002e*	*2003f*
Current account balance	79.6	64.4	52.3	57.3	50.4
External financing, net:					
Private flows, net	30.1	76.2	51.6	61.8	62.5
Equity investment, net	73.5	74.4	63.2	49.6	60.4
Direct investment, net	55.3	53.2	50.2	51.5	55.2
Portfolio investment, net	18.1	21.2	13.0	-1.9	5.3
Private creditors, net	-43.4	1.7	-11.6	12.2	2.1
Commercial banks, net	-43.8	-16.2	-9.5	5.3	0.9
Nonbanks, net	0.4	18.0	-2.0	6.9	1.2
Official flows, net	6.0	2.3	-5.0	-4.8	-5.2
IFIs	-3.2	3.7	-5.5	-2.1	-0.2
Bilateral creditors	9.2	-1.4	0.5	-2.7	-4.9
Resident lending/other, net[1]	-64.0	-97.6	-28.5	-8.3	-26.5
Reserves (- = increase)	-51.7	-45.2	-70.3	-106.0	-81.2

e = estimate, f = IIF forecast
[1] *Including net lending, monetary gold, and errors and omissions.*

Latin America

Net private capital flows to Latin America are projected to increase moderately in 2003 to about $35 billion from $25 billion last year as political and economic conditions in a number of countries begins to improve. Resumption of growth throughout the region is expected to gain momentum in the second half of the year as uncertainty falls and financial difficulties in key countries begins to ease.

- Following two difficult years, we project regional growth of 2.4 percent in 2003. Growth will be led primarily by Chile and Mexico, which have maintained solid fundamentals through fiscal discipline.
- Brazil has undertaken important fiscal and external adjustments that will have to be deepened and sustained if it is to fully recover. Reforms aimed at reducing the ratio of public sector debt to GDP are essential for achieving this. While fiscal and monetary conditions will have to remain tight this year, there are hopeful signs—albeit not fully tested—that the new government is moving toward credible polices that will generate a virtuous cycle of fiscal improvement, lower interest rates, and higher growth.
- The region's current account deficit is projected to remain at about the same low level as last year despite a modest recovery. Improved external conditions, enhanced export performance, and a moderate increase in private capital flows should allow most countries to replenish their international reserves in 2003.

Table 7
Latin America: External Financing
(billions of dollars)

	1999	*2000*	*2001*	*2002e*	*2003f*
Current account balance	**-48.4**	**-40.5**	**-46.7**	**-18.2**	**-17.8**
External financing, net:					
Private flows, net	**69.7**	**62.6**	**47.8**	**25.2**	**35.5**
Equity investment, net	**67.7**	**54.4**	**54.7**	**33.8**	**34.1**
Direct investment, net	**75.3**	**60.6**	**54.0**	**35.6**	**33.7**
Portfolio investment, net	**-7.6**	**-6.2**	**0.7**	**-1.8**	**0.4**
Private creditors, net	**2.0**	**8.2**	**-6.9**	**-8.6**	**1.4**
Commercial banks, net	**-15.7**	**1.0**	**-10.1**	**-7.5**	**-4.7**
Nonbanks, net	**17.7**	**7.3**	**3.2**	**-1.2**	**6.2**
Official flows, net	**7.9**	**-6.7**	**22.4**	**14.0**	**17.7**
IFIs	**6.5**	**-2.8**	**22.1**	**13.7**	**17.7**
Bilateral creditors	**1.5**	**-3.9**	**0.3**	**0.3**	**0.0**
Resident lending/other, net[1]	**-37.9**	**-13.7**	**-23.9**	**-22.8**	**-17.2**
Reserves (- = increase)	**8.6**	**-1.7**	**0.4**	**1.9**	**-18.2**

e = estimate, f = IIF forecast
[1] *Including net lending, monetary gold, and errors and omissions.*

Africa/Middle East

Net private flows to the region are likely to rise to $8 billion in 2003 from around $4 billion last year. The increase largely reflects a projected recovery in private flows to South Africa as a result of the anticipated privatization of Telkom and a pickup in nonresident purchases of equities and fixed income securities.

- The region's combined current account surplus is likely to continue to shrink in 2003. While the surplus on services, income and transfers should strengthen as a result of a projected recovery in tourism receipts, this will be more than offset by a deterioration in the trade balance on account of strong import growth. The rise in import payments reflects stronger anticipated demand for capital goods.
- While the potential for military action against Iraq clouds the outlook, growth in most of the countries of the Africa/Middle East region is projected to rise in 2003 as global economic conditions start to improve. A recovery in tourism should help strengthen growth in countries like Tunisia, Morocco, and Egypt, while prospects for Algeria should also improve barring any significant disruption to oil and gas markets. In South Africa, the pickup in global economic activity this year should help offset the negative effect on exports of a stronger rand, and growth may be similar to the estimated 3 percent in 2002.

Table 8
Africa/Middle East: External Financing
(billions of dollars)

	1999	*2000*	*2001*	*2002e*	*2003f*
Current account balance	**-3.0**	**6.1**	**7.3**	**5.2**	**4.0**
External financing, net:					
Private flows, net	**10.2**	**4.7**	**9.3**	**3.8**	**8.1**
Equity investment, net	**6.8**	**5.6**	**10.1**	**2.5**	**5.4**
Direct investment, net	**2.1**	**3.9**	**15.1**	**2.8**	**3.3**
Portfolio investment, net	**4.7**	**1.7**	**-5.1**	**-0.3**	**2.1**
Private creditors, net	**3.3**	**-1.0**	**-0.8**	**1.3**	**2.7**
Commercial banks, net	**-1.0**	**-1.5**	**0.7**	**0.2**	**0.4**
Nonbanks, net	**4.4**	**0.6**	**-1.5**	**1.2**	**2.3**
Official flows, net	**-1.7**	**-0.5**	**-4.0**	**-2.0**	**-2.0**
IFIs	**1.3**	**-0.1**	**0.3**	**0.4**	**0.6**
Bilateral creditors	**-3.0**	**-0.4**	**-4.3**	**-2.4**	**-2.6**
Resident lending/other, net[1]	**-6.2**	**-7.2**	**-3.6**	**-1.4**	**-4.1**
Reserves (- = increase)	**0.7**	**-3.1**	**-8.9**	**-5.6**	**-5.9**

e = estimate, f = IIF forecast
[1] *Including net lending, monetary gold, and errors and omissions.*

markets *per se*. According to data produced by Thomson Financial, global mergers and acquisitions rose steadily during the 1990s from less than $500 billion in 1993 to nearly $3.5 trillion in 2000; but since then, deals have fallen back to just $1.7 trillion in 2002.

On a regional basis, the slowdown in net direct equity investment last year was concentrated in Latin America and Africa/ Middle East as flows into Asia and emerging Europe are estimated to have increased slightly. This year, we expect net flows into Latin America to continue to flag while flows into Africa/Middle East, Asia and emerging Europe are expected to remain about the same or increase slightly (Chart 5).

- Net direct investment in Latin America is expected to fall to less than $34 billion this year from about $36 billion last year and nearly $55 billion in 2001. The weakness in direct equity investment is likely to be seen across the region, but only Brazil, Ecuador, and Uruguay would experience actual declines. In Brazil, net direct investment is expected to fall to about $13 billion, which is less than half the levels seen in 2000, as investors remain cautious about the new administration's economic policies, at least in the first half of the year. In Ecuador, the falloff is due mainly to a return to more normal inflows after two years of strong foreign investment in the country's oil sector.

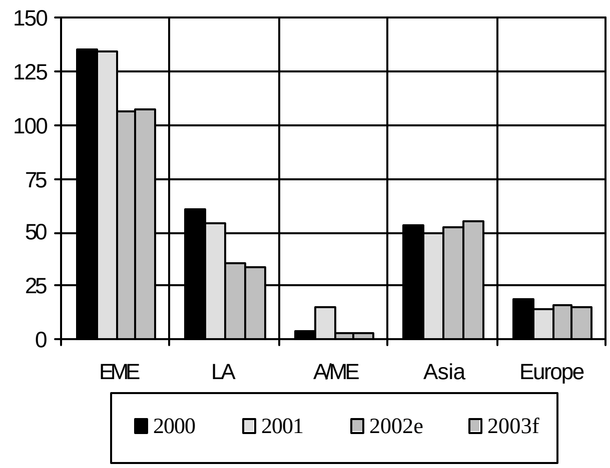
- Accounting for over 85 percent of net direct investment in the Asia/Pacific region, China experienced a strong WTO-related increase in direct investment last year that is expected to continue into 2003. Last year, South Korea experienced slight net outflows of direct investment (as South Korean companies stepped up investment abroad that was only partially offset by increased inward investment), but the country is expected to see a return to net inflows in 2003. Overall, net direct investment in the region is likely to increase marginally to around $55 billion this year from around $52 billion in 2002.

- Stepped-up privatization boosted net inflows of direct equity investment to emerging Europe to nearly $17 billion last year from about $15 billion in 2001. In 2003, net direct equity investment inflows are likely to be slightly lower at about $16 billion. While in 2002, the Slovak Republic added about $4 billion to the region's net direct equity investment, primarily due to privatization in the energy sector, similar large sales are not expected in 2003. Several other countries in the region are expected to see modest gains next year, particularly the Czech Republic and Poland, due to a push for further privatizations.

Portfolio Investment: Emerging market net portfolio equity investment is expected to rise modestly this year to around $9 billion from last year's net outflows of nearly $5 billion (Chart 6). Over half of the total net inflows this year will be accounted for by the Asia/Pacific region, but all regions are expected to see gains. Inflows are projected to come mostly in the second half of the year as the global recovery gains momentum and uncertainty in the oil

"This year, we expect net direct equity flows into Latin America to continue to flag while flows into Africa/Middle East, Asia and emerging Europe are expected to remain about the same or increase slightly."

Chart 5: Net Direct Investment by Region
(billions of U.S. dollars)



"Accounting for over 85 percent of net direct investment in the Asia/Pacific region, China experienced a strong WTO-related increase in direct investment last year that is expected to continue into 2003."

markets is expected to wane. Nonetheless, flows to emerging markets may be restrained if the risk/return profile in industrial country equity markets improves relative to that in emerging markets during the global recovery. Over the last year, emerging equity markets have fallen only about 5 percent in dollar terms (MSCI Emerging Market Index), while most industrial country equity markets have declined in excess of 20 percent (Chart 7). The bounce-back in industrial country markets may be stronger and, hence, weaken the growth in portfolio flows to emerging markets.

- Net portfolio equity investment in Asia is expected to rise to over $5 billion in 2003, from net outflows of about $2 billion last year. Last year's outflows were primarily the result of declining portfolio equity investment in South Korea as foreign investors sold shares after Korea's 35 percent stock market surge from December 2001 to mid-April 2002. This year, South Korea is expected to see modest net inflows as is China. Partly due to the liberalization of rules on foreign ownership of Chinese domestic "A-shares" last year, the country is likely to see an increase in portfolio inflows. However, stringent restrictions remain on foreign ownership of stocks, and investors remain cautious about corporate governance issues and weak minority shareholder protection.

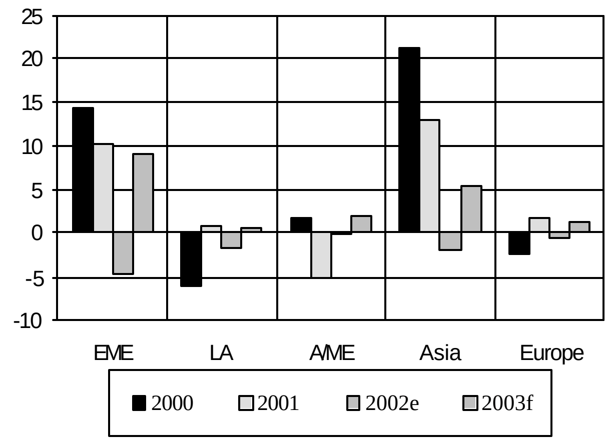
- Latin America's portfolio equity investment is expected to rise from net outflows of about $2 billion in 2002 to net inflows of around $400 million in 2003, as last year's withdrawals from Argentina, Brazil, Colombia, and Venezuela are expected to slow, and a pickup in net inflows to Chile and Mexico is likely. Still, portfolio inflows will likely remain quite modest for the region as a whole this year as investors await clear signals that stabilization is under way.

- A modest increase in net portfolio equity investment of around $1.2 billion in emerging Europe is expected this year, from last year's $700 million outflow. While most markets are likely to see a slight inflow this year, Poland's turnaround from an estimated $1.3 billion outflow over the past two years (due to the bursting of the stock market bubble) to this year's modest inflow of $150 million is the largest contributor to the change in net portfolio equity investment.

- South Africa's net portfolio equity inflows are expected to be nearly $2 billion this year after net outflows of about $5 billion during 2001 and $400 million in 2002. Outflows in 2001 were primarily due to the buyout of the minority shareholders in De Beers by Anglo American (a nonresident company listed in London), which caused a decline in portfolio investment and a jump in direct investment. Nonresidents have continued to be strong buyers on the Johannesburg Stock Exchange and this buying is expected to continue this year.

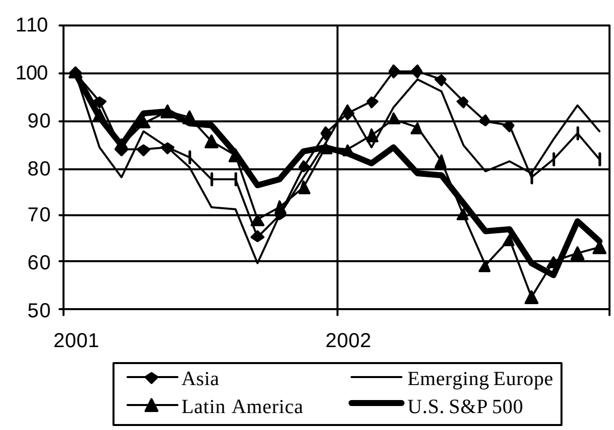
Weaker confidence in the global recovery as well as uncertainty in Latin America led to a nearly 25 percent drop (in dollar terms) in the MSCI Free Emerging Market Index from April through

Chart 6: Net Portfolio Investment by Region
(billions of U.S. dollars)



"Emerging market net portfolio equity investment is expected to rise modestly this year to around $9 billion from last year's net outflows of nearly $5 billion. Over half of the total net inflows this year will be accounted for by the Asia/Pacific region, but all regions are expected to see gains. "

Chart 7: Emerging Market Equities
(January 2001 = 100, US$ terms)

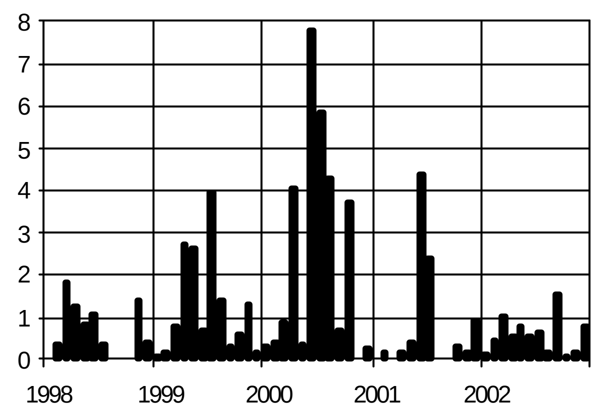


September 2002, while industrial country equity markets suffered similar, if not larger, declines in dollar terms. The U.S. S&P 500 Index fell 24 percent, Germany's DAX fell 45 percent, and Japan's Nikkei fell 18 percent, as concerns over weak corporate profits and corporate governance issues, particularly in the United States, dampened investor sentiment. While emerging markets have recovered from September's lows to close the year down just under 5 percent, industrial countries suffered their third year of declines—for the U.S. it was the worst three-year period in 61 years—with most markets falling in excess of 20 percent during 2002.

"While emerging markets have recovered from September's lows to close the year down just under 5 percent, industrial countries suffered their third year of declines—for the U.S. it was the worst three-year period in 61 years—with most markets falling in excess of 20 percent during 2002."

Particularly hard hit during 2002 were equities in Latin America, which dropped close to 26 percent in dollar terms, as the crisis in Argentina and volatility in Brazil and Venezuela shook confidence. Asia's markets fared relatively better, ending the year nearly unchanged, while Europe and Africa/Middle East were able to produce gains of nearly 9 and 17 percent, respectively, according to the MSCI regional indexes.

Chart 8: Emerging Market Equity Issues
(billions of U.S. dollars)



Total equity issuance in 2002 by the emerging market economies covered in this report was the lowest of any year since 1995, reflecting market volatility, the global economic slowdown, and weak investor appetite for higher-risk assets. Those countries that were able to increase their equity issuance last year were few and far between and included countries such as Malaysia, Mexico, Russia, South Africa and Thailand.

Emerging market equity placements had been growing quite steadily up until 2000 and became an increasingly important component of external financing (Chart 8). Privatization, particularly in the technology, media and telecommunications (TMT) sector, garnered a major share of those equity placements, but since the bursting of the TMT asset price bubbles, these equity placements slowed to a trickle. Total equity placements were only $6.7 billion in 2002, compared to the peak of $28.5 billion in 2000[1]; nearly a third of these flows were to China which sold a few of its large public enterprises. Equity issuance is unlikely to reach the levels seen in 2000 for quite some time as most of the easy privatization sales have already taken place and the market appetite for new issuance remains quite weak.

"Equity issuance is unlikely to reach the levels seen in 2000 for quite some time as most of the easy privatization sales have already taken place and the market appetite for new issuance remains quite weak."

2. *Nonbank Private Sector Lending:* Slight increase next year

Excluding the ongoing accumulation of interest arrears in Argentina (about $7 billion), which are counted as a capital inflow in balance of payments data, nonbank private creditors are expected to provide a modest increase in net financing to emerging markets this year—to about $16 billion from only $12 billion in 2002. Despite this increase, net nonbank private lending remains substantially less than the yearly average of over $50 billion during

[1]This is for the 29 economies listed at the end of this report to which the capital flows aggregate refer. Using a broader definition, including some smaller economies as well as Hong Kong and Taiwan, issuance in 2002 was about $10.3 billion compared to $43.1 billion in 2000.

the 1990s (Chart 9). Also, our baseline forecast is highly dependent on stabilization and modest recovery in Latin America, which—although tentative signs suggest it is beginning—has yet to gain solid footing.

Nonbank flows, primarily bond purchases, but also suppliers' credits, nonresident deposits in domestic banks, and nonresident purchases of local government securities, were severely depressed during the past two years as perceptions of increased risk, the global economic slowdown, and emerging market political and economic uncertainty persisted. While nonbank flows were down for most emerging markets in the aggregate, markets were bifurcated last year with Latin America, particularly Argentina and Brazil, suffering the greatest decline in flows and largest widening in yield spreads, while some high-grade credits, particularly those in Asia, were able to attract greater nonbank credit inflows at favorable rates (Chart 10).

Reflecting the divergence in market spreads, Latin America's bond issuance at $19.5 billion last year was the lowest since before the Mexican peso crisis in 1995, and less than half the amount issued in 2001, while Asia's, at $18.7 billion was the highest since its crisis in 1997. Europe also had increased issuance last year, but Africa/Middle East saw a decline after four years of growth (Chart 11).[2]

Of the 15 changes to emerging market sovereign credit ratings by Standard and Poor's since January 2002, about three-quarters have been upgrades or improvements to the outlook. The upgrades included three important emerging capital markets—Mexico, South Korea, and Russia. Mexico now has an investment-grade sovereign rating from Moody's and Standard and Poor's, which expands its market for its high-grade corporate debt to large institutional investors. South Korea's S&P upgrade moved the sovereign debt rating from BBB+ to A-, and is now out of the EMBI+ universe, which is limited to debt instruments of BBB+ or lower. Russia's rating improved twice last year, moving from B+ at the start of the year to BB by December 2002.

Despite Asia's gains in nonbank net inflows last year, the region is expected to see a slight decline in net inflows this year as the relative attractiveness of Asian markets is unlikely to improve. Conditions in the region are not projected to deteriorate in 2003, but after two years of steady gains and tight spreads, other markets may become relatively more appealing.

Assuming that Latin America stabilizes this year, net nonbank financing in the region is expected to see a return to some modest inflows after suffering four years of sustained declines. Although

[2]This pertains to the 29 economies listed at the end of this report to which the capital flows aggregates refer. Using a broader definition, including some smaller economies as well as Hong Kong and Taiwan, issuance was about $56.5 billion, down from over $68.3 billion in 2001. Note that the gross issuance figures do not include Argentina's $30 billion megaswap in June 2001.

Chart 9: Net Nonbank Lending by Region
(billions of U.S. dollars, adjusted for interest arrears)

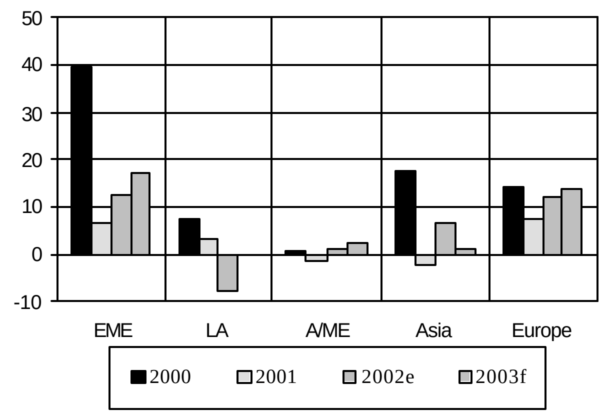


Chart 10: EMBI+ Spreads
(basis points)

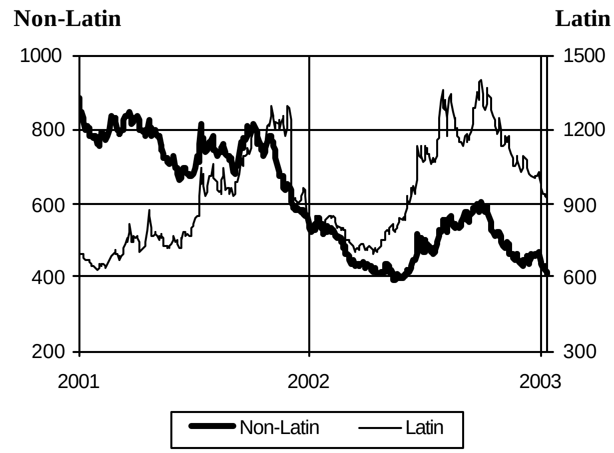
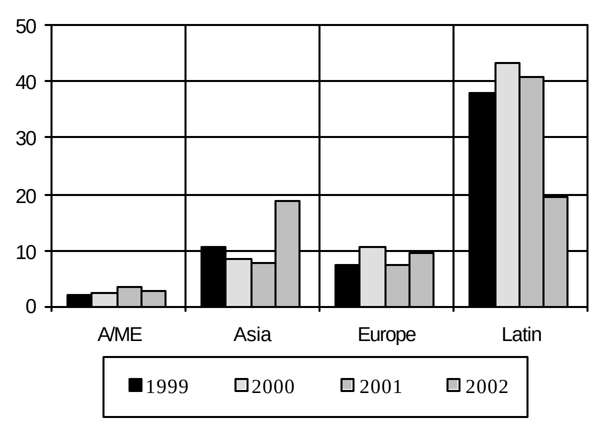


Chart 11: Bond Issues by Region
(billions of U.S. dollars)



Argentina is still unlikely to contribute to those inflows this year (as political uncertainty remains quite high and other markets are likely to be relatively more attractive), Brazil may see a modest $400 million net inflow this year following 2002's nearly $5 billion outflow. Turkey is expected to see slight net inflows this year as well following two years of sustained outflows totaling some $4.5 billion.

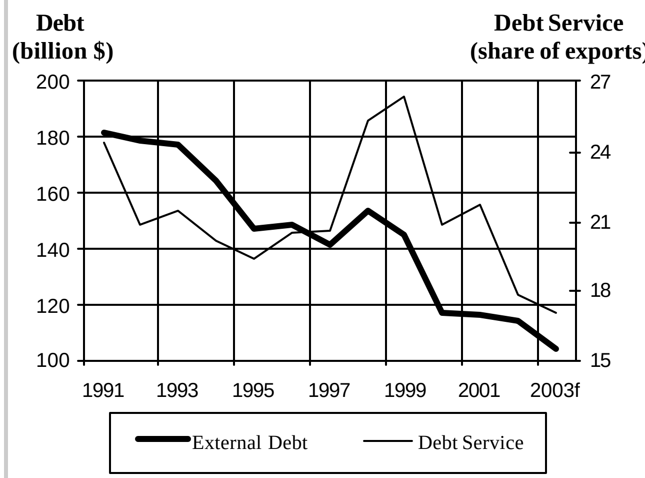
Nonetheless, while conditions are expected to improve over the coming year, credit flows are still unlikely to reach the levels seen prior to the recent downturn in 2001. Despite signs of potential investor appeal in certain markets and the scope for narrowing in bond spreads for some borrowers, other markets face formidable challenges in attracting foreign capital due to weak economic fundamentals in some countries as well as policy drift. For some countries, there is scant evidence that capital inflows will pick up from their prolonged stagnation as the field of emerging market investment opportunities has widened and foreign investors have become more discriminating. Moreover, in all regions net private credit flows remain depressed and, on average, have been near zero during 1998-2002. The capacity for emerging markets to absorb more debt, however, has improved as the ratios of overall external debt and debt service to exports have fallen (Chart 12).

- After reaching a peak of nearly 1400 basis points prior to Brazil's elections in late September 2002, Latin America's EMBI+ spreads narrowed to 918 basis points in the second week of January 2003. Issuance for the region fell to about $20 billion during 2002, from nearly $41 billion in 2001. While issuance was down for the year, it picked up in December 2002 as Chile, Colombia, Mexico, and Peru accessed markets and issued over $3 billion of sovereign and corporate bonds at relatively modest spreads. Mexico and Chile continue to enjoy relatively low spreads of between 200-300 basis points, but Brazil's spreads remain above 1200 basis points and Argentina's spreads are still near 6000 basis points.
- Asia was the second-largest source of bond issuance in 2002, placing nearly $19 billion of debt at relatively low spreads. The EMBI+ spread for Asia fell to a low of 238 basis points in May 2002 from 356 basis points at the beginning of the year, but is currently around 400 basis points. South Korea and Malaysia were the largest issuers, placing almost $8 billion and $6 billion, respectively, but the Philippines was also an active borrower, placing around $4 billion of bonds on international markets.
- Emerging Europe's bond issuance rose slightly in 2002 to just over $9 billion from a total of $7.3 billion in 2001. Russia accessed markets issuing a total of $2.4 billion at spreads in the range of 450-850 basis points. Turkey placed about $2.8 billion of debt last year, at spreads that ranged from around 500 basis points in May 2002 to around 780 basis points in November 2002. Reflecting positive trends, Europe's EMBI+ spreads fell to a record low 411 basis points at the end of the second week of January 2003.

"While conditions are expected to improve over the coming year, credit flows are still unlikely to reach even the levels seen prior to the recent downturn in 2001."

"Despite signs of potential investor appeal in certain markets and the scope for narrowing in bond spreads for some borrowers, other markets face formidable challenges in attracting foreign capital due to weak economic fundamentals in some countries as well as policy drift."

Chart 12: Emerging Market Debt and Debt Service as a Share of Exports



"Mexico and Chile continue to enjoy relatively low spreads of between 200-300 basis points, but Brazil's spreads remain above 1200 basis points and Argentina's spreads are still near 6000 basis points."

Bond Flows to Emerging Markets: Is there a recovery in sight?

Medium- to long-term net nonbank lending to emerging markets (primarily bond flows) has experienced a wide swing over the last decade. Overall net nonbank lending to emerging markets rose to a peak of $88 billion in 1997, from less than $23 billion in 1990, but has since fallen back to about $12 billion in 2002 and is not expected to rise appreciably this year.[*] Indeed, this and last year's estimated net inflows will be lower than anytime since 1990 as new disbursements have fallen relative to repayments (Chart 13). Although credit flows are unlikely to experience a sustained retrenchment, and are projected to pick up as the global economy gains momentum, it could be several years before emerging market bond inflows return to their levels seen in the mid-1990s.

Undoubtedly, a nontrivial portion of the jump in emerging market bond inflows during the early 1990s was driven by overoptimistic expectations and bandwagon effects, but significant reforms and prudent monetary and fiscal policy in many emerging market countries set the foundation for much of these flows as well. The early 1990s also saw the end of the decade-long debt crisis, the so-called "lost decade" of economic development. In fact, much of the increase in emerging market bond flows was driven by the development of "Brady Bonds," which allowed for the securitization of the large stock of existing bank loans and provided the impetus for the development of deeper and more liquid emerging bond markets.

Although reforms, improved policies, and more liquidity stimulated emerging market credit inflows during the mid-1990s—and continues to be sustained in a number of countries—there have been reversals and periodic setbacks in others. Mexico's peso crisis in 1995, the Asian crisis in 1997, Russia's default in 1998, Argentina's current problems, and debt problems in other countries have increased the perceived risks to investing in emerging market bonds. Moreover, despite advances on the economic front, it is also now generally recognized that political systems and institutions were not mature enough.

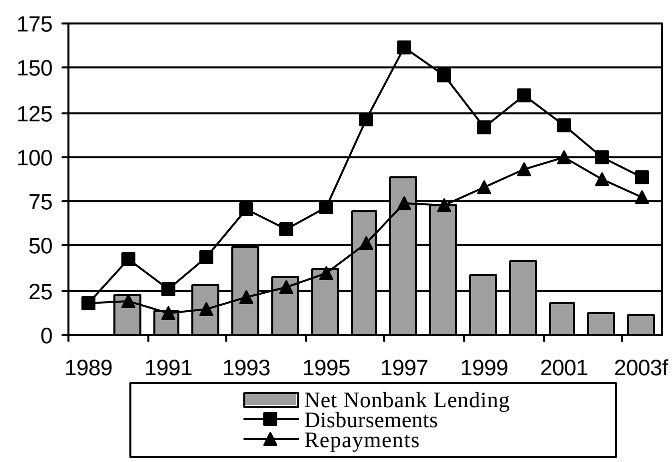
What was once thought to be an immutable march forward for emerging market bonds has, in fact, been marked by episodes of instability and this has led to the realization that development takes time. As a result, crossover investors, who contributed to strong emerging market bond flows during the first half of the 1990s, have reduced their exposure to the asset class, while the universe of dedicated emerging market investors has dwindled. Recent official proposals for a formal sovereign debt restructuring mechanism, which are viewed in some quarters as increasing the likelihood of future debt restructurings, have also generated more uncertainty.

The situation was exacerbated over the last year and a half by the cyclical weakening of the global economy and the sharp increase in risk aversion affecting all higher-risk asset classes caused by the bursting of the stock market bubble, corporate governance scandals, and the aftermath of the September 11 terrorist attacks. Capital flows into emerging markets fell markedly, with bond inflows declining to very low levels.

Despite recent setbacks, not all has gone wrong. Over the past few years, some markets—particularly those in Asia and Eastern Europe—have increased bond issuance at favorable spreads. On the whole, investors are more willing today than some years ago to discriminate between individual country risks.

Nonetheless, the medium-term prospects for net bond flows to emerging markets as a whole remain subdued. Until investors are sufficiently convinced that the likelihood of financial crises has meaningfully declined, through enhanced institutional infrastructure as well as improved economic policies, they are likely to continue to be hesitant about investing in emerging bond markets.

Chart 13: Medium- to Long-Term Nonbank Lending to Emerging Markets[†]
(billions of U.S. dollars)



[†]Excludes short-term net credits, interest rate arrears, and discounted debt transactions.

[*]As opposed to figures shown in the other portions of this report, the net nonbank lending figures discussed here exclude short-term net credits, interest rate arrears, and discounted debt transactions. This is done to provide a better picture of underlying trends in nonbank—particularly bond—credit flows.

3. *Commercial Bank Lending:* To remain close to zero

Net repayments to commercial banks are expected to continue this year, though their size will be less than that seen in the last few years (at about $3 billion this year, compared with $5 billion last year and $26 billion in 2001; see Chart 14).

While net repayments have been declining in recent years, this primarily reflects a fall in amortizations, rather than an increase in new loans. This year, however, loan disbursements are expected to rise slightly, while amortizations are beginning to level off. One reason for the downward trend in borrowing over the last few years is that domestic banks and corporations are continuing to refinance their external obligations with local currency domestic borrowing. Greater exchange rate flexibility in several markets has increased the perceived risk in borrowing in foreign exchange and current account financing requirements are expected to remain relatively low (for emerging markets as a whole, the current account balance is likely to be a surplus of around 0.6 percent of GDP this year).

Another reason is that internationally active commercial banks have continued to shift from new lending for their own balance sheets to fee-based activities, in part due to improved risk management methods. Moreover, international commercial banks are also taking an increasingly active role in local currency lending rather than external financing. Indeed, local currency lending by BIS reporting banks to the emerging market countries covered in this report increased from $5.5 billion in 1992 to nearly $85 billion at the end of 2001—a fifteenfold increase.

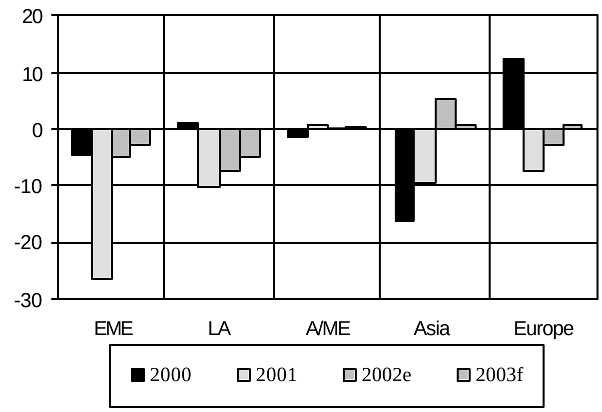
- While net commercial bank lending to Asia is expected to fall to about $1 billion this year from last year's estimated $5.3 billion, the region still accounts for most of the bank lending to emerging markets. In 2002, as growth in the region was the highest among emerging markets, most countries—especially South Korea—sought to take advantage of low foreign interest rates and borrowed from abroad. This year, however, net lending into the region is expected to slow as overseas interest rates are likely to rise and the demand for additional credit wanes.

- After experiencing net repayments to commercial banks over the last two years of about $10 billion, emerging Europe is expected to see a modest net inflow of nearly $900 million in 2003. Most of the turnaround, however, is expected to come from a swing in Turkey's net flows, moving from net repayments in 2002 to slight net inflows this year, as amortization of previous loans falls and new disbursements remain relatively stable.

- Commercial bank outflows this year are expected to be concentrated in Latin America, accounting for $4.7 billion of total net repayments. Although this year's expected repayments

"Net repayments to commercial banks are expected to continue this year, though their size will be less than that seen in the last few years."

Chart 14: Net Commercial Bank Lending by Region (billions of U.S. dollars)



"While net repayments have been declining in recent years, this primarily reflects a fall in amortizations, rather than an increase in new loans. This year, however, loan disbursements are expected to rise slightly, while amortizations are beginning to level off."

"Internationally active commercial banks have continued to shift from new lending for their own balance sheets to fee-based activities, in part due to improved risk management methods."

are lower than those in 2001 and 2002, continuing uncertainty is likely to depress new lending to the region.

- The Africa/Middle East region is projected to see slightly higher net commercial bank lending of about $400 million this year, compared to an estimated $200 million last year, primarily due to the improving economic climate in South Africa.

4. *Official Flows:* To fall slightly

Net official flows to emerging markets are projected to fall marginally to about $10 billion this year, from around $12 billion in 2002 and nearly $15 billion in 2001 (Chart 15). In 2003, increased official disbursements to Latin America are expected to be more than offset by increased repayments from Asia and Europe.

This year's official flows will likely be dominated by a jump in lending to Brazil and Colombia that will more than offset the decline in official lending to Turkey and large planned repayments by Thailand. Turkey's net official inflows, which were $9 billion in 2002 following $10 billion in 2001, are expected to drop to less than $3 billion 2003 as disbursements from the IMF taper off. However, in the event of financial market contagion as a result of war with Iraq, Turkey may attain additional official support this year and next.

Argentina has yet to negotiate an agreement with the IMF, but is shortly expected to conclude a short-term arrangement with the Fund to roll over payments coming due through August. However, a longer-term agreement with the Fund is not foreseen before a new administration takes office following the presidential election in April 2003. Since October 2002, Argentina has failed to make payments on loans from the World Bank as well as on a $250 million tranche of a $1.5 billion sovereign global bond, whose payment was guaranteed, on a rolling basis, by the World Bank. Since Argentina defaulted on payments, it has not been allowed to receive scheduled disbursements from existing World Bank loans, nor can it receive any new loans from the Bank. Until it negotiates a longer-term arrangement with the Fund, Argentina is unlikely to receive additional support from the World Bank or other official creditors.

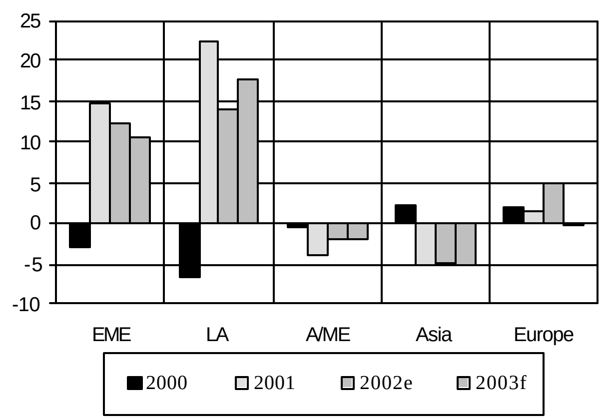
Argentina's failure to make its scheduled payment on its sovereign global bond, and the subsequent exercise of its one-time rolling payment guarantee by the World Bank (which made the remaining two tranches of the bond subject to pure sovereign risk without any guarantee) has had the effect of downgrading other World Bank rolling guarantee issues and partial credit guarantee programs from other multilateral organizations like the Andean development bank, CAF. Peru, for example, recently opted against a CAF guarantee on a new sovereign bond offering after the market was unwilling to favorably price the risk.

- In Asia, net repayments on official sector loans are expected to remain relatively unchanged from last year's net repayments of

"In 2003, increased official disbursements to Latin America are expected to be more than offset by increased repayments from Asia and Europe."

"This year's official flows will likely be dominated by a jump in lending to Brazil and Colombia that will more than offset the decline in official lending to Turkey and large planned repayments by Thailand."

Chart 15: Net Official Lending by Region
(billions of U.S. dollars)



"Since Argentina defaulted on payments, it has not been allowed to receive scheduled disbursements from existing World Bank loans, nor can it receive any new loans from the Bank".

about $5 billion. A major contributor to last year's outflows was Thailand's $3.7 billion net repayment on its obligations to official creditors. This year, Thailand's central bank plans to repay all of its remaining obligations under its current IMF-supported programs amounting to nearly $5 billion.

- In Latin America, official net lending is expected to rise to nearly $18 billion from last year's $14 billion based largely on inflows into Brazil, but also increased flows into Colombia. In August 2002, Brazil negotiated a $30 billion IMF package with the bulk of disbursements ($24 billion) coming in 2003 and Colombia is expected to receive some $3 billion from official creditors during 2003.
- Net repayments to official creditors from central and eastern Europe are expected to be about $3 billion this year following over $4 billion last year. This year's slight decline is mostly accounted for by an ongoing fall in repayments from Russia.

5. Resident Net Lending Abroad and International Reserves:
Pace of reserve accumulation likely to moderate

Net lending abroad by emerging market residents is expected to rise to about $61 billion this year, following last year's drop to $36 billion from nearly $86 billion in 2001 (Chart 16). The decline in resident lending last year was concentrated primarily in Asia and emerging Europe where relative economic stability and declining overseas interest rates relative to domestic rates prompted residents to shift to domestic assets. However, this year's projected ongoing recovery in the G7 may reverse the trends and lead to greater resident net lending abroad.

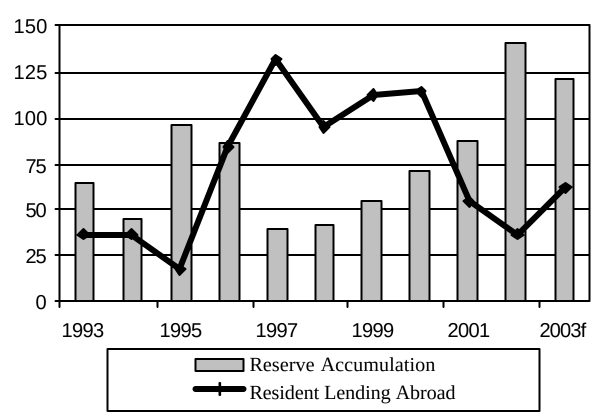
The expected rise in resident net lending abroad, combined with a slight fall in the aggregate current account surplus of emerging markets, and only a moderate increase in capital inflows in 2003, implies a decline in reserve accumulation to about $121 billion in 2003 from slightly over $140 billion in 2002.

- Overall, Asia is expected to account for two-thirds of total emerging market reserve accumulation this year, following slightly higher levels in 2002. Together, China and South Korea are expected to account for most of the region's reserve accumulation of over $81 billion this year.
- Emerging Europe is projected to see a slowing in reserve accumulation this year to about $15 billion following a $31 billion increase last year as most countries in the region are expected to see financing needs increase.
- As official lending steps up and economic volatility subsides, Latin America's reserves are likely to grow by $18 billion this year, after two years of reserve decumulation of about $2 billion due to the weak capital inflows and economic uncertainty.

"Argentina's failure to make its scheduled payment on its sovereign global bond, and the subsequent exercise of its one-time rolling payment guarantee by the World Bank has had the effect of downgrading other World Bank rolling guarantee issues."

"The expected rise in resident net lending abroad, combined with a slight fall in the aggregate current account surplus of emerging markets, and only a moderate increase in capital inflows in 2003, implies a decline in reserve accumulation to about $121 billion in 2003 from slightly over $140 billion in 2002."

Chart 16: International Reserves and Resident Net Lending (billions of U.S. dollars)



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Asia/Pacific	**Latin America**	**Europe**	**Africa/Middle East**
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India	Brazil	Czech Republic	Egypt
Indonesia	Chile	Hungary	Morocco
Malaysia	Colombia	Poland	South Africa
Philippines	Ecuador	Romania	Tunisia
South Korea	Mexico	Russian Federation	
Thailand	Peru	Slovakia	
	Uruguay	Turkey	
	Venezuela		