Capital Flows to Emerging Market Economies

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Overview

The outlook for private capital flows to emerging economies has deteriorated significantly in recent months. Net flows are now projected to be just $165 billion in 2009, down from $466 billion in 2008 (Table 1). This estimate for capital flows in 2009 is an unambiguously weak one, and a decline of 82 percent from the boom year of 2007 ($929 billion). It is also down substantially from our estimate for 2009 made just four months ago. Then, we projected net flows for the year to be $562 billion. To an extent, this sharp downward revision for 2009 is a reflection of a very tough environment for capital flows that became increasingly evident as 2008Q4 progressed. As a result, our estimate of the outturn for 2008 has been revised down sharply, from $619 billion, net, in October 2008 to a current estimate of $466 billion. It is also consistent with the much weaker global growth outlook that we now envisage for 2009, which both reduces the supply of external finance, as lenders and investors turn more risk averse, as well as the demand for external finance for both consumption and investment spending.

While all components of net private capital inflows have recently weakened, it is not surprising that the most significant drop in prospect is for net bank lending, which is forecast to shift from a net inflow of $167 billion in 2008, to a net outflow of $61 billion in 2009, a $227 billion negative swing. This would be a dramatic reversal from the peak year of banking sector net flows, of $410 billion in 2007.

The region most directly affected by the slump in capital flows is Emerging Europe, which had been heavily dependent on external finance. Among our sample of countries from the region, strains have been most evident in Russia and Ukraine, although some smaller countries in the region (not in our sample) have been hit harder.

While external financing difficulties have hit home hardest in Emerging Europe, other regions have also been severely affected by the global growth weakening that has accompanied the credit crisis in the mature economies. Latin American borrowers have suffered a set back in their terms of trade, and Ecuador has chosen the course of selective external debt default. Asian manufacturers have been harder hit by the drop off in global demand than they were during the depth of the 1997-98 regional financial crisis, but domestic financial systems in the region are in far better shape today than they were in that previous episode.

Many of these difficulties seem likely to linger, as least through the first half of 2009. The economic outlook could turn somewhat positive in the second half of the year, and this would help stabilize a number of difficult emerging market situations. Moreover, years of steady policy reform and institutional strengthening in many key emerging economies have left them in much better shape to handle the current global downturn, severe as it is. Most have some—albeit limited—latitude to run counter-cyclical fiscal and, especially, monetary policies in the months ahead.

Significant vulnerabilities remain, however, especially for large emerging market corporate borrowers with sizeable roll over needs. Private sector borrowers have at least $100 billion of debt service for market-based borrowing falling due in the first half of 2009. At the current level of market access, borrowers seem able to issue not much more than half this total. Policy makers in both mature and emerging markets would be well advised to address this refinancing problem head on in the weeks and months ahead.

Table 1
Emerging Market Economies' External Financing
billions of U.S. dollars

	2006	2007	2008e	2009f
Current account balance	383.9	434.0	387.4	322.8
External financing, net:				
Private flows, net	564.9	928.6	465.8	165.3
Equity investment, net	222.3	296.1	174.1	194.8
Direct investment, net	170.9	304.1	263.4	197.5
Portfolio investment, net	51.5	-8.0	-89.3	-2.7
Private creditors, net	342.6	632.4	291.7	-29.5
Commercial banks, net	211.9	410.3	166.6	-60.6
Nonbanks, net	130.7	222.2	125.1	31.1
Official flows, net	-57.5	11.4	41.0	29.4
IFIs	-30.4	2.7	16.6	31.0
Bilateral creditors	-27.1	8.7	24.3	-1.6
Resident lending/other, net[1]	-336.5	-425.3	-449.8	-271.6
Reserves (- = increase)	-554.8	-948.7	-444.3	-245.9

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

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Box 1: Expanding the IIF Sample to include Gulf countries

The standard IIF sample of countries used to monitor capital flows to emerging economies includes countries that have typically been major borrowers in international markets. With capital flows *from* emerging economies having grown to outweigh capital flows *to* emerging economies, and the oil producing countries of the Gulf Cooperation Council (GCC) being particularly important in this intermediation process, we have extended our standard sample of 28 countries to include the 6 GCC countries. The external financing picture for this full group of 34 countries is shown in Table 2 below. The main difference between the two samples is the degree of current account adjustment for the sample (including the oil-exporting GCC countries inevitably means a larger decline in the overall current account surplus for emerging economies). In turn, this means less capital to export in 2009 versus 2008, whether in the form of outward portfolio equity investment (about $168 billion less), resident net lending (about $350 billion less), or official reserve accumulation (about $324 billion less).

Table 2
Emerging Market Economies' External Financing (incl. GCC)
billions of U.S. dollars

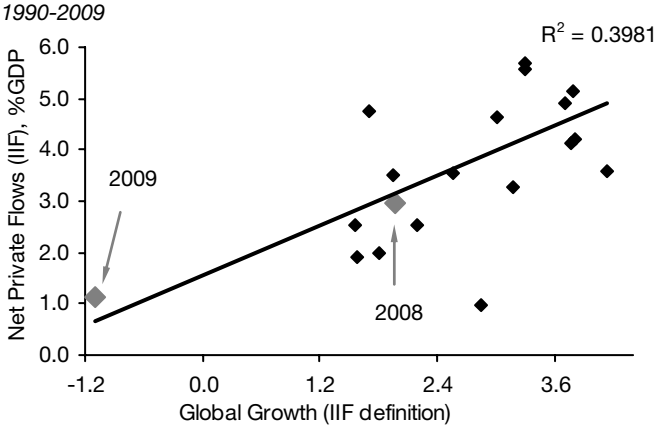
	2006	2007	2008e	2009f
Current account balance	594.6	640.1	703.0	343.4
External financing, net:				
Private flows, net	572.9	1009.6	411.4	109.6
Equity investment, net	121.6	211.6	44.8	143.9
Direct investment, net	172.6	305.1	263.3	193.9
Portfolio investment, net	-50.9	-93.6	-218.5	-50.0
Private creditors, net	451.3	798.0	366.6	-34.3
Commercial banks, net	298.7	570.0	235.0	-70.5
Nonbanks, net	152.5	228.0	131.6	36.3
Official flows, net	-57.7	10.8	43.1	29.6
Resident lending/other, net[1]	-472.0	-569.3	-585.9	-234.9
Reserves (- = increase)	-637.7	-1091.2	-571.6	-247.6

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

The Global Financial Crisis Worsens

Significantly reduced capital flows to emerging economies are part of the broader financial and confidence crisis that has swept through the global economy in recent months. Historically, there is a positive correlation between global growth and our measure of net private capital flows to emerging economies, with a 1 percentage point change in growth typically corresponding to a change in net capital flows of about 0.9 percent of emerging economies' combined GDP (Chart 1). Based on this relationship, our current estimate of an overall global contraction of about 1.1 percent in 2009 is fully consistent with the projected slide in private capital flows to just 1.1 percent of emerging market GDP (or $165 billion). Of course, the softness in capital flows is both the result of, and a contributor to, weak global growth.

Chart 1: Global Growth and Net Private Flows
1990-2009

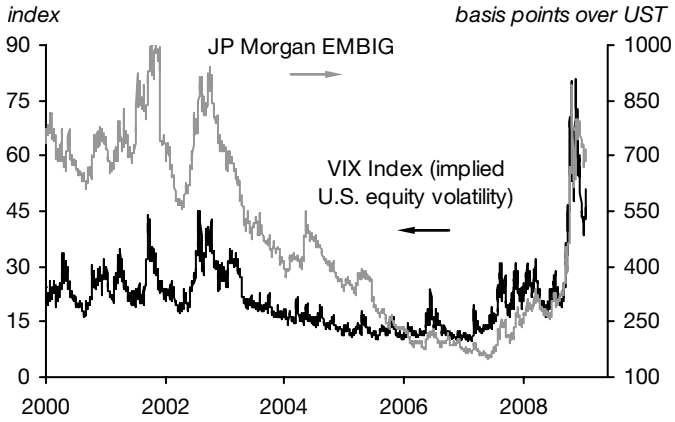


Emerging economies had exhibited remarkable resilience through the first year of the current phase of global turmoil. They were certainly affected by the slowing in the U.S. economy that became evident as 2007 progressed, particularly in the form of lost export markets. Moreover, net private sector flows to emerging economies—which had soared to remarkably high levels in 2007—began to fall steadily in 2008. Through the middle of 2008, however, the underlying economic performance of emerging economies was quite robust—sufficient, indeed, to provide an important global offset to U.S. economic weakness.

These developments changed conspicuously in 2008Q3, since which time the overall global economy has been in recession, economic growth in emerging markets has slowed precipitously, while private capital flows to emerging markets have slumped. Three factors seem responsible for this sudden shift in business cycle conditions. First, the progressive tightening in monetary policy in most emerging economies—put in place in 2007 and the first half of 2008 in order to

temper rising headline inflation—began to bite in those economies. Second, the spike in oil prices, which reached a peak in July, acted as a huge drag on global manufacturing activity, and a tax on oil consumers, that became fully evident in August. Third, and most significantly, the renewed flare up in global financial turmoil that came on the heels of the U.S. government's taking Fannie Mae and Freddie Mac into its conservatorship and the failure of Lehman Brothers in September had an immediate and severe impact across emerging economies and markets (Chart 2).

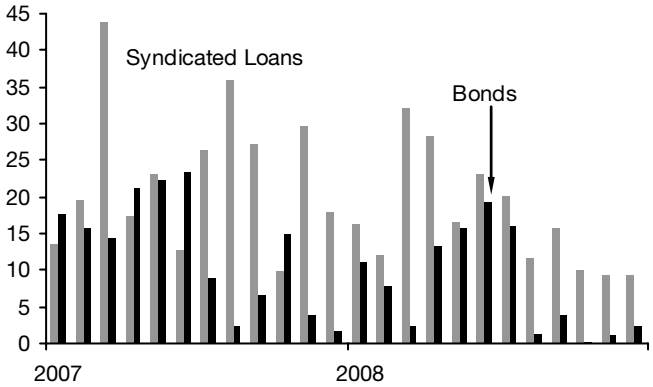
Chart 2: U.S. Equity Volatility and EM Bond Spreads



The volume of international syndicated lending to borrowers domiciled in our 28 country sample had been little affected through the first year or so of the current crisis. In the first six months of 2007, loan volume had averaged $21 billion per month (Chart 3). Between July 2007 and July 2008, the pace actually rose slightly, to $22 billion per month. Since August 2008, however, the average monthly loan volume has been halved to about $11 billion. The slump in bond issuance by emerging market borrowers has been even more extreme. In the first half of 2007, monthly bond issuance had averaged about $19 billion per month. Between July 2007 and July 2008, it fell to $10 billion per month. Since August 2008, however, it has averaged less than $2 billion per month.

Chart 3: International Issuance by Emerging Economies

$ billion, monthly, not seasonally adjusted



At first sight, it is not obvious why emerging economies and markets should have been so affected by the post-Lehman turmoil, especially given how well they had survived previous episodes of acute mature market weakness in August and December 2007 and March 2008 (Bear Stearns). In retrospect, three factors seem particularly important in explaining this rapid and severe contagion:

- The near seizure of global interbank markets in the weeks following the collapse of Lehman Brothers delivered a sharp blow to global activity, as access to short-term financing for production and trade dried up. The result was a global scramble to preserve liquidity among banks, non-financial business and households. Ironically, many banks in emerging economies found themselves with severe funding difficulties even though their exposures to troubled assets in the United States were limited. Despite holding substantial foreign currency reserves, their own central banks were either unable or unwilling to supply banks with dollars, leading to significant dislocations, and forcing many banks in emerging market economies to suddenly turn very restrictive in their own lending activities. Some of these tensions were eased after the Federal Reserve established swap lines with central banks in Brazil, Mexico, Korea and Singapore on October 29th. By that time, however, six weeks of damage had been done.

- Second, although most emerging market governments had been restrained in their borrowing through the latest expansion, borrowing by both financial and non-financial private companies—in both local and foreign currency—had been relatively heavy. Banks in emerging markets—especially (but not exclusively) in Emerging Europe—had borrowed abroad in term debt markets (as well a short-term interbank markets) in order to fund aggressive rates of local lending growth. On the investor side, hedge funds had been important investors in emerging market corporate debt, and the post-Lehman squeeze on them added to the difficulties in emerging markets. Conditions in emerging corporate debt markets had been deteriorating before September, but took a severe turn for the worse through Q4. Refunding pressure for private sector borrowers in the first half of 2009 looks to be significant (Table 3). Debt falling due totals about $17 billion per month, well ahead of the recent pace of issuance.

- Third, the collapse in commodity prices—especially oil prices—after September has hit many emerging market borrowers hard. Many resource-based companies had increased borrowing in order to finance ambitious production expansion schemes. The greatest strains have come in parts of Latin America (Ecuador, Argentina and Venezuela) and Emerging Europe (Russia and Ukraine).

Table 3
Estimated Amortization Payments of Market-Based Borrowings
billions of U.S. dollars, nsa

	2009			
	Q1	Q2	Q3	Q4
Emerging Asia	26.3	24.8	30.1	23.7
China	1.2	1.7	4.1	2.0
India	8.1	8.0	6.7	5.7
Korea	10.4	8.1	10.8	10.6
Latin America	7.6	10.0	18.0	9.5
Brazil	3.0	4.1	12.2	3.7
Mexico	3.8	2.1	3.9	4.0
Emerging Europe	10.5	18.0	20.5	14.0
Poland	0.1	0.2	0.0	1.8
Hungary	1.3	1.4	0.1	0.8
Russia	6.2	8.1	13.4	8.7
Africa/Middle East	2.5	2.1	3.5	2.2
Total [1]	**46.9**	**54.9**	**72.1**	**49.4**

[1] Non-government bonds and syndicated loans in all currencies. Regional composition is presented on the back cover of the report.

Global Economy Likely to Decline in 2009: A First in Modern History

The global economy has recently weakened decisively. Through much of 2007 and early 2008, the U.S. economy had slowed, but demand growth elsewhere was holding up quite well. This pattern of relative strength shifted after mid-year, and the most extreme, synchronized downturn of the whole post-war period has taken hold in recent months (Chart 5).

The result is that output in the three largest mature economies—the United States, Euro area and Japan—is likely to fall by 2.1 percent in 2009, while growth in emerging markets will slow very sharply, to just 2.7 percent, half the pace of 2008 (Table 4). All emerging regions will slow. In Emerging Asia, the moderation will be substantial, with Chinese growth slowing to 6.5 percent and growth in the region as a whole moderating to 5.4 percent. In Latin America, Mexico will experience a recession, and regional growth will slip below 1.0 percent. Recession will be more widespread across Emerging Europe and the region will be the weakest among emerging economies. The contraction will be especially acute in Ukraine.

We also expect the year ahead to be something of a tale of two halves. Output contractions across all economies are currently severe, and this is likely to persist through the first few months of 2009. By mid-year, however, the combination of easier monetary and fiscal policies—including the fiscal program of the new U.S. Administration—should begin to provide a net lift. In consequence, we expect the second half of 2009 to produce better outcomes.

Box 2: IIF Capital Flow Forecasting Errors Tend to be Procyclical

For the past 12 years, the IIF has published a forecast of capital flows in the year ahead. Projecting flows in the year ahead is a challenge at the best of times, but has become more difficult during the last few years, as swings in flows have become more extreme. Not surprisingly, our forecasting errors (measured on the vertical scale, as the difference between the forecast for year *t* made in October of year *t-1*, and the latest available estimate of the outturn for flows in year *t*) tend to be positively related to the realized change in flows between years *t-1* and *t*. Our tendency is evidently to assume that flows will mean-revert, when they typically are serially-correlated. Years 2007 and 2008 represent the two extremes of the spectrum (with associated relatively large forecasting errors). If our recent forecast revisions are anything to go by, this year is shaping up to follow this pattern. The 2009 observation in Chart 4 below is derived by comparing our current estimate for 2009 relative to our initial estimate last October, against the current estimate for flows in 2009 versus 2008.

Chart 4: IIF Net Private Capital Forecasting Errors and the Trend in Private Flows
Realized Error in Year Ahead IIF Flow Forecasts ($ billion)

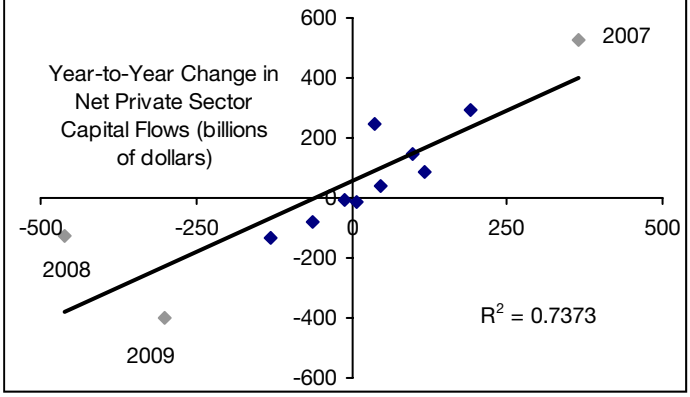


Chart 5: Global Manufacturing Production
percent, 3m/3m saar, both scales

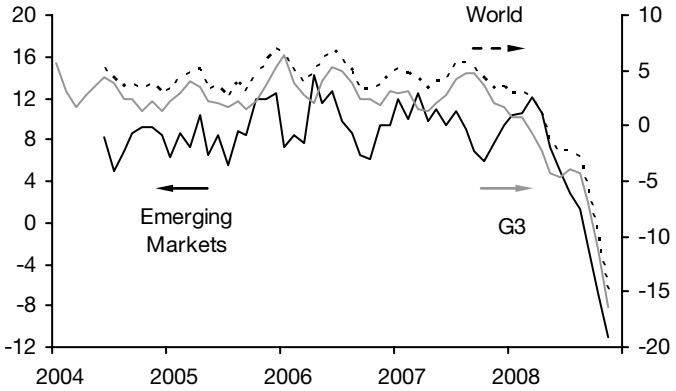


Table 4
Global Output Growth
percent change from previous year

	2006	2007	2008e	2009f
Mature Economies	2.7	2.3	0.9	-2.1
United States	2.8	2.0	1.2	-2.1
Euro area	3.0	2.7	1.0	-2.1
Japan	2.0	2.4	-0.1	-2.3
Emerging Markets	7.5	7.5	5.7	2.7
Latin America	5.3	5.4	4.3	0.5
Brazil	3.8	5.4	5.5	0.8
Mexico	4.9	3.2	1.8	-0.5
Emerging Europe	6.9	6.5	4.6	-1.1
Russia	7.3	8.1	5.9	-1.5
Turkey	6.9	4.5	1.9	-1.3
Ukraine	7.1	7.6	2.0	-12.0
Africa/Middle East	5.3	5.3	4.8	3.7
Emerging Asia	9.2	9.4	7.0	5.4
China	11.6	11.9	9.0	6.5
India	9.6	9.0	6.2	5.0
World	3.8	3.5	2.0	-1.1

e = estimate, f = IIF forecast

Low commodity prices and suddenly weak global demand have pushed goods price inflation rates down sharply, and this is allowing central banks across the world to run easier monetary policies. Federal Reserve and Bank of Japan official policy rates are now close to zero, and rates will be cut below 2 percent by the European Central Bank and Bank of England in coming months. Low G7 short-term interest rates typically form a very favorable backdrop in promoting capital flows to emerging economies. Falling headline inflation is also giving central banks in emerging economies the scope to ease policy, especially in Emerging Asia, but increasingly so now in Latin America and Emerging Europe.

The tumbling oil price is also playing an important role in shifting income (and saving) from oil producers to oil consumers (Table 5). The loss in income (as reflected in a declining current account balance) is most evident among large oil producers (GCC countries and Russia). The gain is most pronounced for oil consumers (the United States, Euro area and Asia). These oil price shifts are playing an important role in helping resolve some of the imbalances that have proven to be a threat to global stability. Most specifically, they are helping U.S. consumers rebuild their saving rate even through a phase of weak nominal income growth.

The stresses during this phase of weak growth for emerging market borrowers result mainly from difficulties in rolling over market-based debt under conditions where it is not just their own prospects that have deteriorated, but also those of their lenders. Moreover, borrowers in emerging markets now face the prospect of being "crowded out" by the massive borrowing needs of G10 governments. We estimate the U.S. Federal borrowing requirement to be about $1.75 trillion in the current fiscal year. G7 governments are also extending significant guarantees to banks and other corporations in their own economies (including some industrial companies), while G7 central banks have provided unlimited amounts of liquidity (via swap lines) to banks within their jurisdictions. While many of these support programs look warranted and helpful, they have the side-effect of creating an "insider/outsider" problem, whereby relative conditions facing banks and companies in emerging market economies are made more challenging.

Table 5
Global Current Account Balances
$ billion

	2006	2007	2008e	2009f
United States	-788	-731	-650	-485
Euro area	8	50	-47	-25
Japan	172	212	178	203
Other Mature Countries	31	-15	-30	20
Emerging Economies (IIF 34)	595	640	703	343
Africa/MidEast (ex.GCC)	15	10	31	30
Gulf Cooperation Council	211	206	316	21
Latin America	54	27	0	-65
Emerging Europe	25	-23	-30	-117
o/w Russia	94	75	98	-46
Emerging Asia	289	420	386	474
o/w China	250	372	400	450
Global Discrepancy	17	156	154	57

Comparison with Previous Episodes

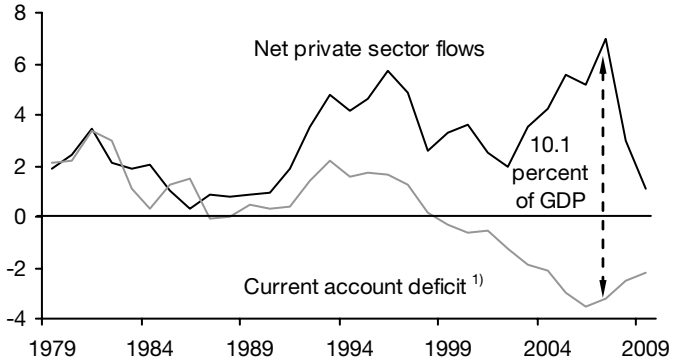
The current slump in net private capital flows to emerging markets is shaping up to be the most dramatic on record. This is a remarkable development, since the two previous serious crisis episodes—1981-86 and 1996-2002—were periods of very severe adjustment for emerging market economies. Net private inflows fell from a peak of 3.5 percent of emerging market GDP in 1981 to a trough of 0.3 percent on GDP in 1986; they fell from a peak of 5.7 percent of GDP in 1996 to a trough of 2 percent of GDP in 2002. This time around, however, net flows seem likely to fall from a peak of 6.9 percent of GDP in 2007 to just 1.1 percent of GDP in 2009 (Chart 6).

The current episode thus contrasts with the two major previous episodes over the past 30 years in a number of important dimensions. First, not only is the severity of the decline more extreme (5.8 points of GDP, versus 3.2 and 3.7 percentage points of GDP, respectively, in the previous two episodes), but the time frame over which it occurred has

been more compressed. Of course, it is perfectly plausible that the current downturn will be more extended than just two years; both previous episodes had an early phase of sharp adjustment, followed by a second leg down a few years later. For this reason, it is perhaps more appropriate to compare the projected decline in the current episode (of 5.8 percentage points of GDP) with the declines in the first two years of the previous episodes of 1.6 percentage points between 1981 and 1983, and 3.2 percentage points of GDP between 1996 and 1998.

Chart 6: Net External Financing of Emerging Economies

as percent of emerging market GDP



1) Negative numbers represent surpluses

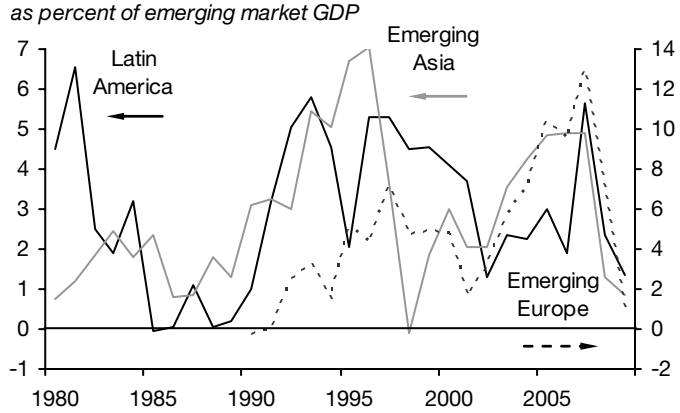
Second, the scale of the boom in private flows to emerging economies in the upswing of the current episode was unprecedented. At their peak (in 2007), net inflows amounted to almost 7 percent of GDP, or $929 billion. This contrasts with a previous peak of 5.7 percent of GDP in 1996, or $320 billion.

Third, the relationship between net private sector flows and the overall current account deficit of our sample of 28 emerging market countries was very different in this episode. Between 1979 and 1990 net flows and current account balances broadly matched one another. From 1990 through 2002, net flows exceeded the current account deficit (reflecting a steady accumulation of foreign assets by both the private and public sectors in emerging economies), although they tended to move in line with one another. After 2002, however, the relationship between the aggregate current account balance of emerging economies and net private capital flows changed dramatically. As a whole, emerging economies moved into sizeable current account surplus, at the same time that net private capital inflows soared. Emerging economies were thus dramatically "over-financed", with this degree of over-financing exceeding 10 percent of GDP in 2007. The offset to the substantial flow of capital into emerging economies was thus an even greater outflow of capital from emerging markets back into mature markets (including reserve accumulation), helping to sustain the rally in fixed income instruments there that has more recently turned to disaster. Moreover, the build up in foreign exchange reserves in emerging economies was not fully sterilized, and this contributed to very rapid rates of growth of money and credit in most emerging economies after 2002, most notably in Emerging Europe.

Fourth, the regional pattern of flows is important (Chart 7 and Table 6). In the previous two expansion phases (1978-81 and 1990-96) there was a dominant region that attracted more flows than other regions. In the early 1980s, the dominant region was Latin America. In the early 1990s, lending to Latin America surged once again, although this was tempered by the Mexican crisis in 1994-95 and its aftermath. Following that, lending surged to Emerging Asia, setting the stage for the Asian crisis in 1997-98. This time around, lending surged to all regions in 2007, before contracting sharply to all regions in 2008 and, most likely, in 2009. The most extreme swing underway, however, is in flows to Emerging Europe, which are estimated to contract from about 13 percent of GDP ($393 billion) in 2007 to 1 percent of GDP ($30 billion) in 2009. Such a swing is unprecedented in scale, and helps explain why financial strains have been most acute, and are likely to remain so, across Emerging Europe.

Chart 7: Net Private Capital Flows by Major Region

as percent of emerging market GDP



There are also a number of interesting comparisons in financial variables between the current episode and the last extreme capital flow downturn, of 1996-99 (Table 7). In the downturn of the 1990s, there were regular currency crises which, in turn, often developed into debt crises, in large part because of the impact of devaluations on the local currency value of foreign currency debt. In the current phase of difficulties, currency depreciations have been less significant (at least to date), or where they have occurred (as in the case of Korea) have been far less traumatic than was the case in 1997-98. On the other hand, equity market weakness has been more pervasive, as the stresses resulting from high levels of corporate sector leverage (both domestically and externally financed), falling commodity prices, and weakening export markets have become more evident.

Table 6
Financial Flows to Emerging Market Economies by Region, Net
billions of U.S. dollars

	2006	2007	2008e	2009f
Private flows	564.9	928.6	465.8	165.3
Latin America	51.5	183.6	89.0	43.1
Emerging Europe	226.3	392.8	254.2	30.2
Africa/Middle East	28.3	37.4	26.4	27.2
Emerging Asia	258.9	314.8	96.2	64.9
Official flows	-57.5	11.4	41.0	29.4
Latin America	-20.3	3.8	7.9	8.3
Emerging Europe	-24.7	0.1	16.5	22.0
Africa/Middle East	-9.2	-3.3	0.4	0.2
Emerging Asia	-3.3	10.7	16.1	-1.1

e = estimate, f = IIF forecast

Table 7
Financial Market Developments in Two Episodes of EM Stress [1)]
percent change

	Real Effective Exchange Rate		Equity Indices	
	1990s	Current	1990s	Current
Latin America	1.3	1.1	42.0	2.3
Brazil	-33.1	-4.3	96.3	7.1
Mexico	25.6	-8.4	72.0	18.3
Emerging Asia	-13.5	1.9	-16.0	-13.4
China	5.4	21.5	93.5	21.2
India	-3.0	-3.3	4.1	-4.2
Indonesia	-26.6	-10.8	11.4	0.8
Korea	-20.3	-35.1	-3.0	-10.8
Thailand	-15.3	0.1	-59.2	-36.2
Emerging Europe	-13.6	11.3	131.6	-46.6
Hungary	8.3	12.9	108.5	-37.4
Poland	9.2	3.8	26.1	-29.1
Russia	-38.9	10.5	-32.6	-53.5
Turkey	19.1	13.7	671.3	-26.1

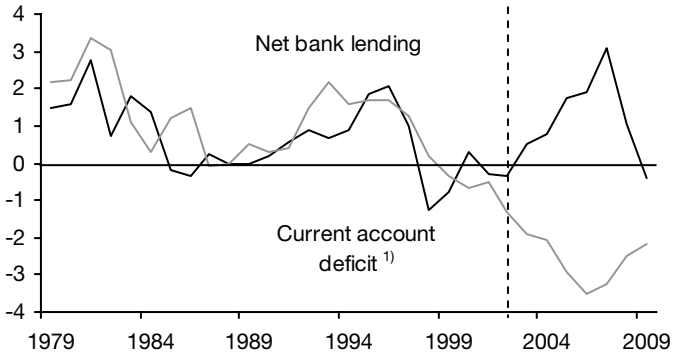
[1)] The two episodes are: June 1996-June 1999 and June 2006-December 2008

Weak Bank Lending

Net bank lending to our sample of 28 emerging economies peaked at $410 billion in 2007, and fell by about $240 billion, to $167 billion in 2008. A similar pace of decline is in prospect for 2009, which would lead to net outflows (payback) from borrowers in emerging economies to banks of about $61 billion for the year as a whole.

Commercial bank debt was repaid on a sustained basis between 1998 and 2002. Until 2002, net lending by banks had quite closely tracked the overall current account deficit of emerging economies, with net repayment during 1998-2002 coinciding with the emergence and then the rise in current account surpluses of the emerging markets. Since then, however, bank debt has soared, even as the current account position of emerging economies improved (Chart 8).

Chart 8: Net External Financing of Emerging Economies
as percent of emerging market GDP



[1)] Negative numbers represent surpluses

The pattern of the shift in bank lending flows is common across the major groups of emerging economies, although the magnitudes are most severe in Emerging Europe and Emerging Asia:

- Net banking flows into Emerging Europe peaked at $217 billion in 2007, of which $107 billion were accounted for by flows into Russia. In 2008, these flows fell to $123 billion (of which Russia accounted for $28 billion). In 2009, net repayments by Emerging Europe borrowers to commercial banks of $27 billion are expected, with Russia repaying $49 billion.

- Net banking flows into Emerging Asia were $156 billion in 2007, but fell to just $30 billion in 2008. In 2009, net repayments to banks of $25 billion are forecast. By country, the bulk of the adjustment between 2007 and 2009 is accounted for by Korea (where net flows are forecast to fall by $87 billion), China (down $52 billion), and India (down $32 billion).

- Among regions, the magnitude of the banking shock is least severe for Latin America, where net inflows of $31 billion in 2007 and $9 billion in 2008 are forecast to become net outflows of $12 billion in 2009.

Other Debt Flows from Private Creditors

The weakness in debt flows to emerging economies from non-bank sources is, in aggregate, less pronounced than in the case of bank lending flows. It is also geographically more diverse, with adjustment significant in all major regions.

Non-bank lenders are projected to lend just $31 billion, net, in 2009, which would be down from $125 billion, net, in 2008 and a peak of $222 billion, net, in 2007. A key factor accounting for the broad-based weakening in flows is the unwinding of substantial investments in local fixed income markets by investors in mature markets. These flows typically leave investors exposed to currency risk and, as concerns about the economic outlook for emerging markets and global investor risk aversion have risen, many of these "carry-trades" have been unwound. One factor supporting carry-trade related flows, however, has been the aggression with which central banks in mature economies have cut official interest rates in recent months. In most cases, this has led to a widening in short-term interest differentials vis-à-vis emerging markets.

Another likely development in 2009 is that sovereign borrowers may begin to access international markets more actively. More emerging economies are adopting expansionary fiscal policies in the current downturn than used to be the case. This is an indication of the more healthy nature of many public sector balance sheets in emerging markets. While most of the financing of these more expansionary policies will be raised in local markets, debt managers may choose to issue in international markets, especially with the absolute level of borrowing rates quite low.

That said, a number of Latin American sovereigns—Argentina, Ecuador and Venezuela—have no access to international markets, while governments in many Emerging European countries—especially those subject to IMF programs (in the case of our sample Hungary, Ukraine and, likely quite soon, Turkey)—will be required to run contractionary, rather than expansionary, fiscal policies.

Foreign Direct Investment Flows: How Much Stability?

Historically, foreign direct investment (FDI) is typically less volatile than other forms of private sector capital flows. In the period 1998-2008, for example, the average annual net inflow of FDI was $170 billion, and the standard deviation of these flows was $62 billion. By contrast, the average annual net inflow from banks over the same time period was $84 billion, but the standard deviation was a massive $142 billion.

Looking into 2009, our forecasts reflect this tendency for FDI flows to be somewhat more stable than other components of private capital flows. They are forecast to decline, to $197 billion, from $263 billion in 2008 and a peak of $304 billion in 2007. Once again, this decline is fairly uniform across regions. Another factor moderating the decline in our measure of net FDI flows is that these flows are measured as net inflows less net outflows of FDI from emerging economies to other countries. There were significant FDI outflows from China, India and Brazil to mature economies in 2007-08, and we expect these flows to drop precipitously in the year ahead.

While past performance thus makes it plausible to project a steady decline in FDI inflows, there are some reasons to be concerned about downside risk to our estimate. First, a global plunge in capital spending appears to be underway, as businesses respond immediately to tighter credit conditions and weaker demand. Second, profits have weakened sharply across most sectors, reducing reinvested earnings which have accounted for an increasing share of FDI. Third, suddenly weak commodity prices are a gain for commodity using businesses, but will undermine new investment in commodity producing industries, which had been an important component of FDI strength in recent years. Fourth, global weakness in real estate prices will weaken FDI in the construction sector, especially in the residential and tourism sectors. Finally, a number of firms in mature economies may be under pressure to raise cash, and may choose to liquidate equity holdings in emerging markets (depending on the size of their investment, this could either be negative FDI or negative portfolio equity investment). For example, several banks in mature markets have recently sold equity stakes in Chinese banks.

Portfolio Equity Flows: The Worst May Be Over

Net portfolio equity flows were strongly negative in 2008, as investors reacted fairly aggressively to suddenly deteriorating corporate prospects. Net outflows totaled $89 billon. In turn this was dominated by net outflows from Emerging Asia ($55 billion, of which $37 billion was accounted for by Korea). Equity price developments were consistent with these flows: the MSCI global emerging market equity index in dollar terms was down 55 percent in 2008.

With equity positions smaller and prices much lower, we project net portfolio equity outflows to be quite modest in 2009 (about $3 billion). On balance, secondary market equity prices have recovered somewhat from their lows during 2008Q4. Primary market issuance will remain very subdued, however.

Official Sector Lending Revives

The official sector is responding to the current turmoil in financial markets in a number of important ways:

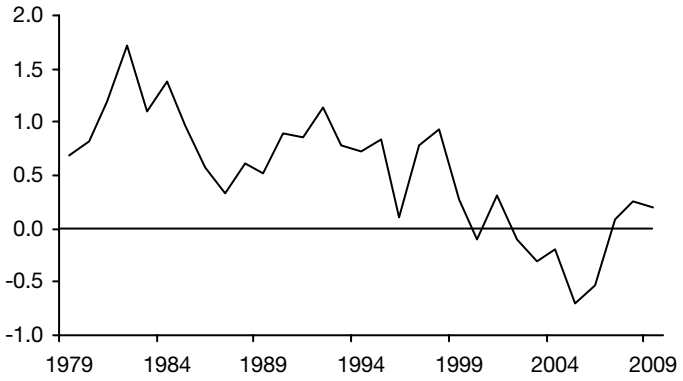
- Multilateral lending institutions, especially the IMF and World Bank are stepping up their activities, in order to provide emergency financing. Stand-by IMF programs have recently been put in place for two countries in our sample: Hungary and Ukraine, with talks on a third—for Turkey—reportedly far advanced. Other recent IMF programs have been instituted for Belarus, Iceland, Latvia, Pakistan and Serbia. The preponderance of smaller European (rather than Latin American) countries on this list is a reminder of the shifting nature of the debt problems in this crisis relative to previous ones. The IMF's new short-term facility offering rapid disbursements has yet to be used, however.

- Additionally, bilateral lenders have become more active. Hungary's IMF program was accompanied by a sizeable additional commitment from the European Union. And the Federal Reserve's swap facilities with four key emerging market central banks—Brazil, Korea, Mexico and Singapore—have provided short-term financing.

The net outcome for official flows in 2009 to our sample of 28 countries will be quite modest, however, totaling $29 billion, down from about $40 billion in 2008 (the 2008 total has been boosted by some emergency short-term disbursements, some of which will have been repaid during 2009). These activities will have been enough to reverse the 25 year trend decline in official sector financing of emerging economies in the short-run, although this will probably be a relatively short-lived development for our middle income sample (Chart 9).

Chart 9: Net Official Sector Flows to Emerging Economies

as percent of emerging market GDP



Declining Capital Exports from Emerging Economies

The decline in net inflows of private sector capital to emerging economies is being matched by a decline in net outflows *from* these economies. To an extent, this is an arithmetic relationship: smaller net inflows from abroad imply less need to accumulate foreign exchange reserves. In 2009, our sample of countries is projected to accumulate $246 billion of reserves. While this would have been a substantial amount before 2002, it looks small by recent standards, particularly relative to the $949 billion gain in 2007. As noted, companies in emerging economies will also be cutting back on their outward equity investments. Conditions affecting debt investments abroad by private sector investors in emerging economies are more mixed. On the one hand, tighter credit conditions reduce the scope for such investments; on the other, perceived greater local risk increases the likelihood of capital flight. Resident net lending from Russia is projected to average $150 billion per year in 2008-09, up from an average of $60 billion in 2005-07.

The region from which capital exports will fall sharpest in 2009 is the Gulf Cooperation Council (GCC). In large part, this is because these countries will have far smaller

Table 8

GCC Countries: External Financing

billions of U.S. dollars

	2006	2007	2008e	2009f
Current account balance	210.6	206.1	315.7	20.6
Non resident flows	147.2	212.6	119.3	29.5
Equity investment, net	38.8	47.5	42.3	34.0
Direct investment, net	37.5	44.9	41.3	32.7
Portfolio investment, net	1.2	2.6	1.0	1.3
Debt flows, net	108.5	165.0	76.9	-4.5
Official flows, net	-0.2	-0.6	2.1	0.2
Commercial banks, net	86.8	159.7	68.3	-9.9
Other creditors, net	21.9	5.9	6.5	5.1
Resident flows	-274.9	-276.1	-307.6	-48.3
Equity investment, net	-139.4	-132.1	-171.6	-84.9
Direct investment, net	-35.9	-43.9	-41.4	-36.3
Portfolio investment, net	-103.6	-88.1	-130.2	-48.7
Resident lending/other, net[1]	-135.5	-144.0	-136.1	36.7
Reserves (- = increase)	-82.9	-142.6	-127.3	-1.8

e = estimate, f = IIF forecast

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

trade and current surpluses to deploy thanks to the lower oil price (Table 8). The region will also experience much reduced net capital flows from abroad, especially through the banking sector. The extreme swings in the oil price could stress parts of the private sector in the GCC.

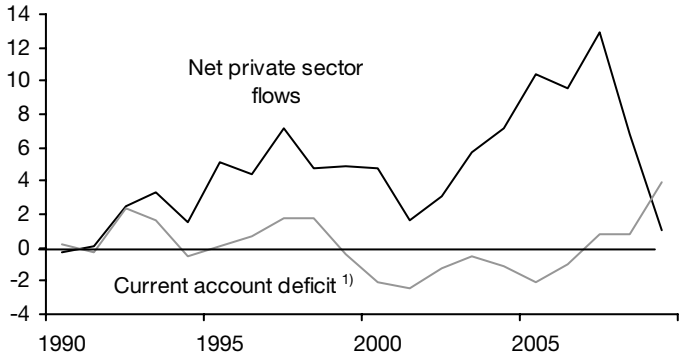
As a result, the growth in the assets of Sovereign Wealth Funds in the region will slow sharply. Most notably, the appetite by investors in this region to extend their equity stakes in financial institutions in mature markets would appear to be quite limited.

Emerging Europe: Most Affected by the Shock

As noted, it is Emerging Europe that, as a region, has been most affected by the severity of the current crisis. Within the region, however, there are important differences. The countries hardest hit have been those combining significant external exposures to banks with dependence on commodity exports, alongside a weak domestic policy framework—Russia and Ukraine.

The deterioration in the region's aggregate current account position in 2009 (Chart 10) is more than accounted for by Russia, where a $98 billion surplus in 2008 is forecast to give way to a $46 billion deficit in 2009. Excluding Russia, the region's current account deficit is forecast to decline from $128 billion in 2008 to $71 billion in 2009. Bank lending to the region is likely to be very subdued, as banks around the world retrench. Most Western European banks remain committed to longer-term relationships in the region, but will be hard pressed to increase exposures through local branches and subsidiaries in the near-term at anything like the pace seen through mid-2008. Net bank lending to the region, excluding Russia, is projected to be a meager $22 billion in 2009, down from $95 billion in 2008 and $110 billion in 2007. Russia is forecast to make net repayments of about $49 billion to commercial banks. This repayment is one factor behind the sizeable $220 billion drawdown in Russian foreign exchange reserves projected for 2009.

Chart 10: Net Private Capital Flows to Emerging Europe
as percent of emerging market GDP



1) Negative numbers represent surpluses

Table 9
Emerging Europe: External Financing
billions of U.S. dollars

	2006	2007	2008e	2009f
Current account balance	24.9	-23.5	-29.8	-117.2
External financing, net:				
Private flows, net	226.3	392.8	254.2	30.2
Equity investment, net	50.2	81.1	50.3	48.6
Direct investment, net	49.5	74.9	69.0	54.1
Portfolio investment, net	0.7	6.2	-18.7	-5.5
Private creditors, net	176.2	311.7	203.9	-18.4
Commercial banks, net	109.8	216.9	122.7	-27.2
Nonbanks, net	66.4	94.8	81.2	8.8
Official flows, net	-24.7	0.1	16.5	22.0
IFIs	-3.0	-2.5	11.9	19.9
Bilateral creditors	-21.7	2.6	4.7	2.1
Resident lending/other, net[1]	-95.7	-175.9	-266.3	-154.6
Reserves (- = increase)	-130.7	-193.5	25.5	219.6

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

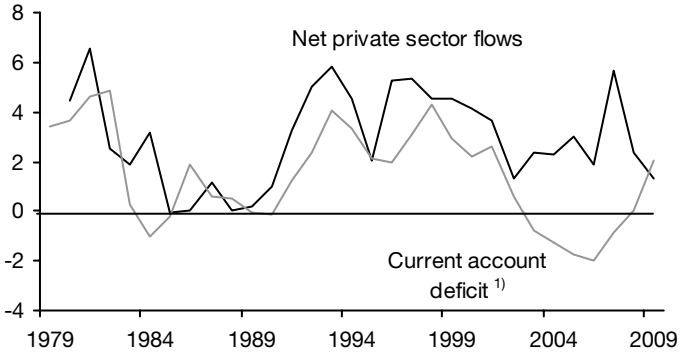
Latin America: Spending on a Rainy Day

Historically, Latin America was poorly placed to handle external capital market shocks, as it typically did little to save in expansion phases, leaving it quickly vulnerable to a joint deterioration in both real and financial external conditions. Key parts of the region remain prone to these problems: both Argentina and Venezuela are now facing much more challenging conditions in an environment of lower commodity prices. Ecuador has already defaulted.

By contrast, other countries in the region appear relatively well placed to handle global difficulties, in large part because of their relative prudence in the post 2002 global credit boom (Chart 11). Foreign currency borrowing by the public sector was sharply curtailed (although not by the private sector). Owing mainly to a fall in commodity prices, the region's aggregate current account will be in deficit of about $65 billion in 2009 (Table 10). The accumulation of substantial foreign exchange reserves provides some leeway to finance the deficit without putting undue strains on the rest of the economy, while reduced levels of dollar-denominated public debt allow currency depreciation to occur without raising solvency concerns. Relative fiscal prudence has even given governments in Brazil, Mexico and Chile some (albeit limited) scope to adopt counter-cyclical fiscal policies. The monetary easing cycle in Latin America has just begun, and has some months

to run. Net private debt inflows to the region will fall by about $40 billion in 2009, with repayments about equally split between banks and non-banks. Many investors have already pared carry-trade positions significantly, and these might actually increase in the second half of the year, as global growth returns, but the interest differential between Latin America and the mature economies (especially the United States) remains very wide, the coming Latin easing cycle notwithstanding.

Chart 11: Net Private Capital Flows to Latin America
as percent of emerging market GDP



1) Negative numbers represent surpluses

Table 10
Latin America: External Financing
billions of U.S. dollars

	2006	2007	2008e	2009f
Current account balance	54.4	27.2	0.3	-64.6
External financing, net:				
Private flows, net	51.5	183.6	89.0	43.1
Equity investment, net	28.9	81.5	48.4	42.0
Direct investment, net	26.2	65.7	58.9	43.7
Portfolio investment, net	2.7	15.7	-10.6	-1.7
Private creditors, net	22.6	102.1	40.7	1.0
Commercial banks, net	9.0	30.8	8.6	-11.7
Nonbanks, net	13.5	71.3	32.1	12.8
Official flows, net	-20.3	3.8	7.9	8.3
IFIs	-18.5	2.9	2.1	6.9
Bilateral creditors	-1.8	0.9	5.8	1.4
Resident lending/other, net[1]	-36.3	-85.5	-60.5	-25.1
Reserves (- = increase)	-49.3	-129.1	-36.8	38.4

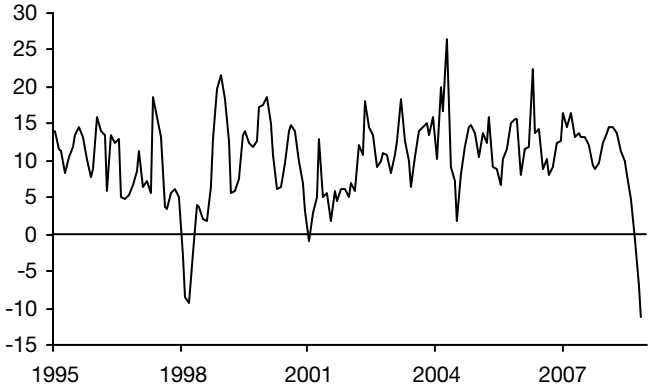
e = estimate, f = IIF forecast
[1]Including net lending, monetary gold, and errors and omissions.

Emerging Asia: Worse than 1997-98?

At one level, the current crisis is dramatically different for Emerging Asia than that of 1997-98. Then, the region was at the epicenter of the turmoil, external financing conditions were acute, real exchange rates plunged, and there was a significant decline in domestic demand.

In the current period, the region's external financial position is far stronger, with a sizeable, sustained external surplus having built a very significant net asset position with the rest of the world. Nonetheless, growth in the region has been severely affected by the global collapse in goods demand. As a result, the slump in industrial production has been more significant and more rapid than in 1997-98 (Chart 12). The severity of this slump relative to 1997-98 is a result of the breadth of weakness in demand components (both domestic demand and, especially, external demand have fallen this time around), as well as the geographic breadth in the weakening in growth. Most conspicuously, China has been more affected in the current cycle than it was in 1997-98.

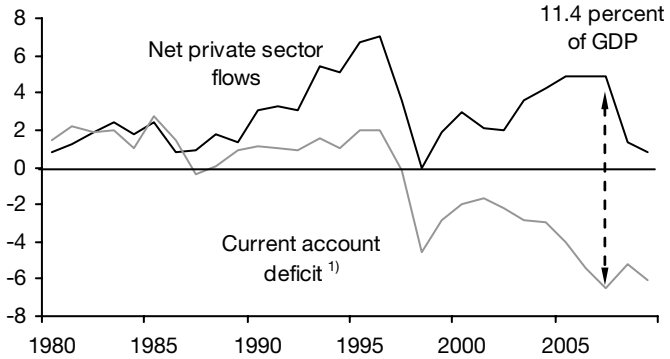
Chart 12: Emerging Asia: Industrial Production
percent, 3m/3m saar



In sharp contrast to 1997-98, the external financing picture for Asia remains one of relative strength. (Chart 13 and Table 11). Regional foreign exchange reserves are huge. Moreover, domestic financial institutions remain far more resilient. The only country experiencing any financial strains in recent months has been Korea where, despite its very large official reserves, extensive short-term external bank liabilities presented some challenges during Q4 at a time when global interbank funding difficulties were at their greatest. These tensions have since faded somewhat, especially following the agreement of swap lines, first between the Federal Reserve and the Bank of Korea and then later between the Bank of Japan, People's Bank of China and the Bank of Korea.

Recent developments will most likely boost Emerging Asia's trade and current account surplus in 2009. Falling export volumes will be offset by steeply falling import volumes, but the main driver of nominal improvement will be the rapid gain in the region's terms of trade that has occurred in recent months, thanks largely to the collapse in the oil price. As a result, China's current account surplus in 2009 will most likely rise further, to $450 billion (from $400 billion in 2008), while India's current account deficit will narrow from about $30 billion in 2008, to $18 billion in 2009.

Chart 13: Net Private Capital Flows to Emerging Asia
as percent of emerging market GDP



1) Negative numbers represent surpluses

Table 11
Emerging Asia: External Financing
billions of U.S. dollars

	2006	2007	2008e	2009f
Current account balance	289.5	420.2	386.4	474.5
External financing, net:				
Private flows, net	258.9	314.8	96.2	64.9
Equity investment, net	122.6	112.9	57.9	85.7
Direct investment, net	87.2	148.6	112.7	79.3
Portfolio investment, net	35.5	-35.7	-54.7	6.5
Private creditors, net	136.3	201.9	38.2	-20.8
Commercial banks, net	90.5	155.7	29.8	-25.3
Nonbanks, net	45.8	46.2	8.4	4.5
Official flows, net	-3.3	10.7	16.1	-1.1
IFIs	-6.8	0.6	2.2	3.2
Bilateral creditors	3.5	10.1	13.8	-4.3
Resident lending/other, net[1]	-207.7	-158.0	-125.5	-90.0
Reserves (- = increase)	-337.5	-587.8	-373.1	-448.3

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

Questions or comments regarding this report may be directed to Philip Suttle, Catalina Krauss or Julien Mazzacurati via telephone (202-857-3639 / 202-857-3308), or e-mail (ckrauss@iif.com / jmazzacurati@iif.com).

Emerging Asia	Latin America	Emerging Europe	Africa/Middle East
China	Argentina	Bulgaria	Algeria
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	Turkey	
	Venezuela	Ukraine	