IIF RESEARCH NOTE

Capital Flows to Emerging Market Economies

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- **Net private capital flows to emerging economies are projected to be $825 billion in 2010, up from $581 billion in 2009 and the April forecast of $709 billion**
- **Flows promoted by continued strength in emerging market fundamentals and weakness in mature markets**
- **Portfolio equity flows have been very strong in 2010; bank-related flows weak**
- **FDI flows increasingly two-way: emerging market companies are becoming increasingly important global players**
- **Foreign exchange reserve accumulation by emerging economies to remain high, and is liable to be a growing source of global policy tension. It would be appropriate for most emerging market currencies to appreciate against mature market**

Private capital flows to emerging economies continue to rebound from their short-lived slump in the last part of 2008 and early months of 2009, helped by relatively favorable economic prospects across a wide array of emerging markets. Net private inflows to emerging economies are projected to be $825 billion, up from $581 billion in 2009 (Table 1, next page). The forecast for 2010 has been revised up by $116 billion since our estimates were last prepared in April (see Box 1, page 3). This upward revision in flows has been accompanied by an upward revision in our estimates for aggregate emerging market growth relative to that in mature economies (Chart 1). Relatively buoyant flows are expected to persist into 2011, when net private flows to emerging economies are projected to be $833 billion (Chart 2, next page).

Net private inflows to emerging economies are projected to be $825 billion, up from $581 billion in 2009

Chart 1
Net Private Capital Flows to Emerging Markets in 2010 and GDP Growth Gap
$ billion, IIF estimates as of dates below *percentage points*

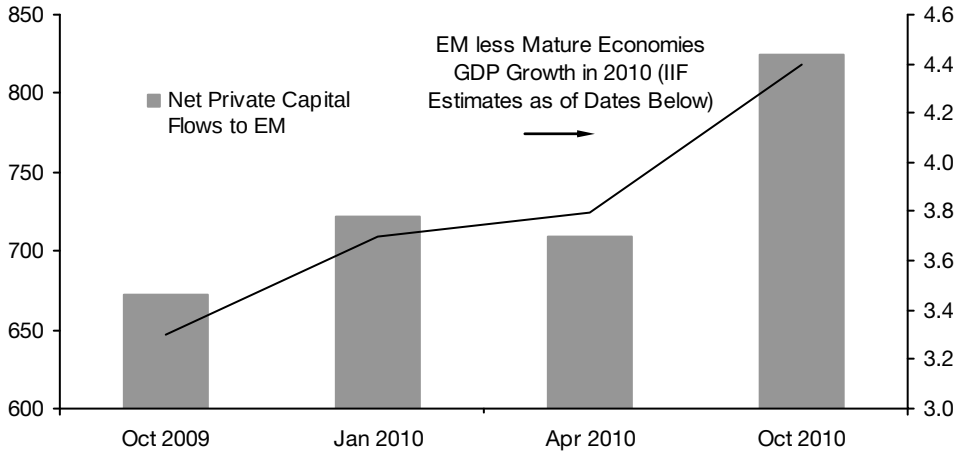

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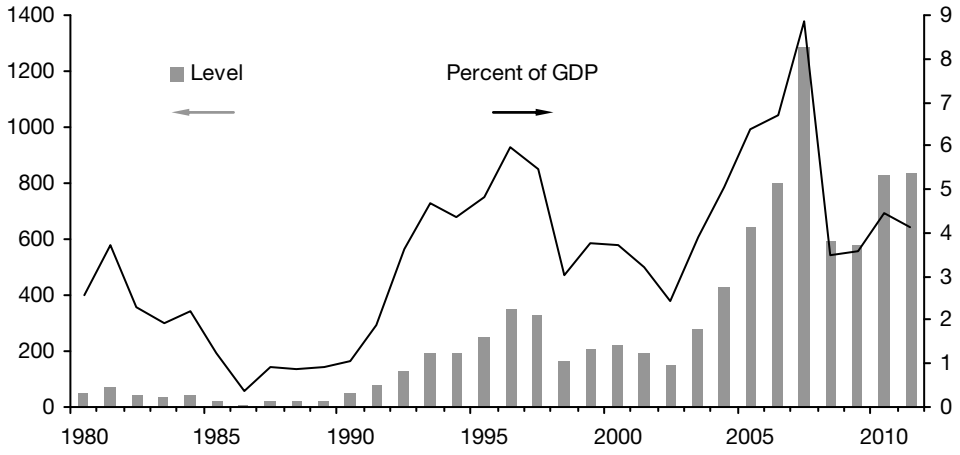
Table 1
Emerging Market Economies: External Financing
$ billion

	2008	2009	2010f	2011f
Current Account Balance	591.0	386.3	289.2	145.0
External Financing, Net:				
Private Inflows, Net	594.4	581.4	825.0	833.5
Equity Investment, Net	422.3	490.4	553.0	549.5
Direct Investment, Net	508.5	341.8	366.5	406.5
Portfolio Investment, Net	-86.2	148.7	186.5	143.0
Private Creditors, Net	172.1	91.0	272.0	283.9
Commercial Banks, Net	29.1	-44.3	84.9	111.6
Nonbanks, Net	143.0	135.3	187.1	172.3
Official Inflows, Net	62.0	62.8	53.2	42.5
IFIs	26.0	46.0	29.8	22.4
Bilateral Creditors	36.0	16.9	23.4	20.1
Equity Investment Abroad, by Residents, Net	-228.7	-261.0	-300.4	-317.8
Resident Lending/Other, Net	-543.6	-233.1	-349.1	-354.7
Reserves (- = Increase)	-475.1	-536.5	-515.2	-345.5
Memo:				
Private Flows, Net (IIF Former Measure)	365.8	320.4	524.8	515.8

By components, equity-related inflows remain the strongest. Indeed, the most dynamic component of our capital flows estimates in 2010 has been portfolio equity investment by nonresidents into emerging countries. This is forecast to be $186 billion in 2010, up from an average of about $62 billion per year in 2005-09 and up $94 billion from our April estimate. By contrast, net credit flows from banks are projected to be $85 billion in 2010, which compares to an annual average of $172 billion in 2005-09.

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



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BOX 1: REVISIONS TO OUR FORECASTS

There has been a substantial net upward revision to the IIF estimates of capital flows to (and from) a sample of 30 key emerging market economies in the past six months (see last page for a full listing of countries covered). In aggregate, we project $116 billion of additional net inflows for this year and $87 billion for next (Table 2).

There has been a substantial net upward revision to the IIF estimates of capital flows

Table 2
Revisions to IIF Net Capital Inflows
$ billion

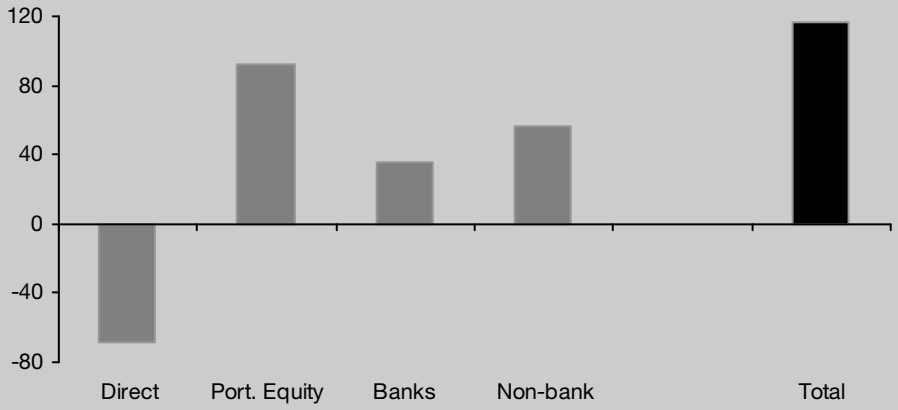
	2007	2008	2009e	2010f	2011f
IIF Capital Flows					
October 2010	1285	594	581	825	833
April 2010	1277	588	531	709	746
Difference	8	6	51	116	87
Breakdown by Region					
Latin America	6	-5	-19	23	18
Emerging Europe	-5	-3	17	3	18
Africa/Middle East	-3	0	-1	20	4
Emerging Asia	10	14	54	71	48

Emerging Asia stands out as the region with the most significant upgrade. Besides some modest historic revisions, our projections for 2010 and 2011 have been raised by a total of nearly $120 billion, reflecting stronger year-to-date inflows as well as sustained buoyant growth prospects and an even more supportive interest rate environment.

Emerging Asia stands out as the region with the most significant upgrade

For 2010, short-term equity and debt inflows account for most of the upward revisions, with portfolio inflows projected to grow by an additional $92 billion (Chart 3). Foreign direct investment (FDI), which is more long-term in nature, should rebound less rapidly than previously estimated: we have trimmed our 2010 forecast of FDI inflows by $68 billion.

Chart 3
Revisions to Private Capital Inflow Estimates for 2010 by Component
$ billion, change between April 2010 and latest (Oct 2010) estimates



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The economic backdrop for private capital flows to emerging economies continues to be unusually favorable in the current economic expansion. These conditions reflect a mixture of "push" and "pull" factors, both of which have intensified in recent months. Among the "push" factors, a key driver is the likelihood that the low nominal interest environment in the mature economies will be more extended than we had earlier thought. Associated with this, prospects for low nominal income growth across the mature economies will depress rates of return on capital as the expansion unfolds. The "pull" factors include higher interest rates in some key emerging economies (e.g., Brazil and India), strong growth and, in some cases, improved terms of trade, which are especially powerful in attracting inflows into commodity exporting economies.

The persistent strength in private capital inflows raises new headaches for emerging market policy makers

The persistent strength in private capital inflows raises new headaches for emerging market policy makers. For one thing, flows are apt to lead to upward pressure on emerging market real exchange rates vis-à-vis most mature market currencies (especially the dollar, yen, euro and sterling). In recent weeks, this issue has come into focus, with a number of emerging market policymakers expressing concern that upward pressure on their currency could become unduly strong, especially as central banks in mature economies signal increasingly easy monetary conditions.

Recent renewed upward pressure on emerging market exchange rates needs to be seen in context. Many had weakened in 2010 Q2, so recent upward pressure is generally returning currency rates to where they were at the start of the year. Moreover, there is a fairly compelling case for further sustained real currency appreciation for many leading emerging market economies vis-à-vis mature economies, matching the re-rating of their respective economic prospects in recent years. Yuan real appreciation would be one important mechanism through which necessary global rebalancing could take place, although by no means the only one.

There is a fairly compelling case for further sustained real currency appreciation for many leading emerging market economies vis-à-vis mature economies, matching the re-rating of their respective economic prospects in recent years

The near-term danger, however, is that this upward pressure escalates and market adjustment becomes disorderly, causing renewed strains in global financial markets and, possibly, igniting policy tensions and, possibly, protectionist measures between key economies (most obviously, the U.S. and China). Policymakers thus need to keep an eye on the international, in addition to purely domestic, implications of the actions they take. For the Federal Reserve, for example, this means evaluating the costs and benefits of further quantitative easing from a global as well as domestic perspective.

One way that EM policymakers are able to offset upward pressure on their currencies would be by curtailing inflows through more extensive use of capital controls. This approach carries with it all the large and understood costs associated with capital controls, which do not have a particularly celubrious history. Another is to promote outward investment by emerging market residents. Indeed, the growth of capital flows from, rather than to, emerging market economies has become one of the most important features of the global financial scene.

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CONTINUED STRENGHTENING IN RELATIVE FUNDAMENTALS

The global economy is entering the second year of an expansion phase, following a year of sharp recession. That expansion continues to be led by strength in emerging market domestic demand, while demand growth in mature economies remains lackluster (Chart 4). Unfortunately, the second year of the expansion (mid-2010 through mid-2011) is liable to be significantly weaker than the first year, in part reflecting normal cyclical patterns such as the fading in the boost from inventories. It also reflects the withdrawal of some stimulus policies enacted in 2008-09 to lift the global economy out of recession (e.g. China's credit easing and U.S. fiscal stimulus), as well as more general fiscal tightening underway by governments concerned to signal a medium-term limit of the current rise in their public debt-to-GDP ratios (e.g. the U.K. government's fiscal policies).

The second year of the expansion (mid-2010 through mid-2011) is liable to be significantly weaker than the first year

We project global growth to slow to 2.7% in 2011, down from 3.4% in 2010 (Table 3, next page). The absolute amount of the slowing projected is similar for both mature and emerging economies—about three quarters of a percentage point. All major economies are projected to moderate, although the slowing will likely be most pronounced in Japan, where the reversal of the recent boost from net trade will leave anemic domestic demand to carry the economy. The Euro Area economy has surprised on the strong side through the middle of 2010, but we suspect that this period of outperformance is now close to over. By contrast, U.S. GDP growth disappointed in Q2, but seems likely to have rebounded in Q3. Activity patterns in both economies through 2011 will be shaped by fiscal tightening. In Europe, the tensions surrounding sovereign debt strains in the Euro Area seem likely to persist and, at the minimum, will keep market interest rate spreads wide (Chart 5). In the United States, the housing market remains moribund. This casts a shadow over the health of the consumer and the financial system.

Sovereign debt strains in the Euro Area seem likely to persist and, at the minimum, will keep market interest rate spreads wide

Growth among emerging economies will be sustained at a close to trend pace in 2010-11 (we estimate trend growth in emerging economies to be in the 6%-6.5% range). Emerging Asia will continue to lead the way, helped by strong growth in both China and India. Latin America will slow more appreciably. In part, this is because of the disappearance of some

Chart 4
Global Domestic Demand
percent y/y, 5-year moving average

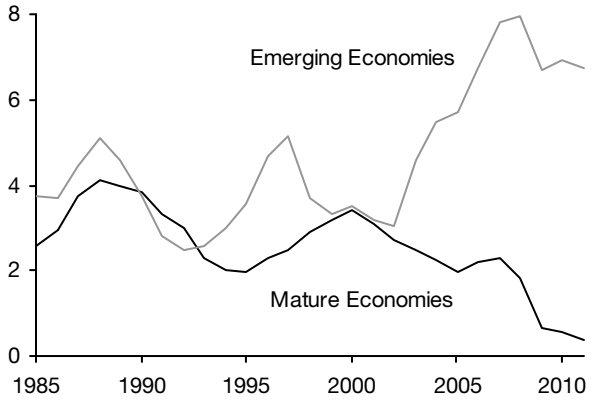

Chart 5
EMBIG and GIPS Bond Spreads
basis points, GIPS=average of 10-year spread over Bunds

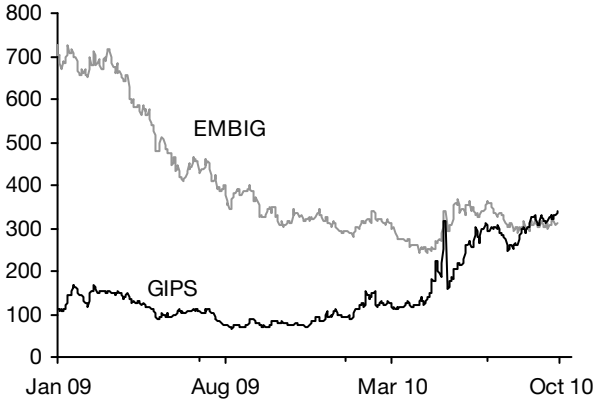

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Table 3
Global Output Growth
percent change over previous year

	2008	2009	2010f	2011f
Mature Economies	**-0.1**	**-3.6**	**2.4**	**1.7**
United States	0.0	-2.6	2.8	2.3
Euro Area	0.3	-4.0	1.7	1.4
Japan	-1.2	-5.2	3.0	1.0
Emerging Economies	**5.7**	**1.5**	**6.8**	**6.0**
Latin America	4.1	-2.3	5.7	4.3
Argentina	6.8	-2.6	7.0	4.4
Brazil	5.1	-0.2	7.7	4.8
Mexico	1.5	-6.6	4.4	3.5
Emerging Europe	4.0	-5.8	4.1	3.6
Russia	5.6	-7.9	3.5	3.6
Turkey	0.7	-4.7	8.5	5.0
Asia/Pacific	7.3	6.6	8.9	8.1
China	9.6	9.1	10.0	9.5
India	6.7	7.4	8.5	8.3
Africa/Middle East	5.1	1.0	3.7	4.3
South Africa	3.7	-1.8	2.9	4.0
World	**1.2**	**-2.5**	**3.4**	**2.7**

special factors that have raised growth in 2010—transitory windfall commodity price gains and pre-election fiscal and quasi-fiscal expansion in Brazil. It is also due to tighter policies. Prospects for Emerging Europe are closely tied to those of Western Europe, so a slowing in the latter will inevitably spill over to the former, even though the sovereign debt difficulties of the Euro Area have had—to date—remarkably limited spillover to Emerging Europe. Key countries in Africa and the Middle East should actually build momentum in 2011 relative to 2010. This is partly the result of the (lagged) benefits of stronger real commodity prices.

Unfortunately, this global growth slowing is apt to keep unemployment rates in the mature economies relatively high compared to both history and those in emerging economies (Chart 6, next page). In turn, this will contribute both to concerns about deflation in mature economies, as well as to weak growth in household income. The latter is important as it means that it will be difficult for households to engineer any significant decline in debt-to-income ratios without continued outright declines in debt. Low nominal income growth (Chart 7, next page) will also imply weak tax revenue growth, while high unemployment and underlying demographic trends will add to spending pressures. As a result, governments in mature economies are likely to enjoy relatively modest (if any) deficit reduction benefits from the operation of automatic stabilizers—any progress in arresting rising public debt-to-GDP ratios will have to come from outright fiscal tightening. Given how challenging it is to enforce tighter fiscal policies in an environment of otherwise sluggish growth, there is a significant risk that budget deficits in mature economies will be reduced by much less than current medium-term plans (where available) call for. As a result, it seems quite likely that mature market sovereign debt risk will continue to be a major focus—and concern—of global financial markets, especially in some of the smaller countries of the Euro Area. It is

This global growth slowing is apt to keep unemployment rates in the mature economies relatively high compared to both history and those in emerging economies

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Chart 6
Global Unemployment Rates
percent of labor force

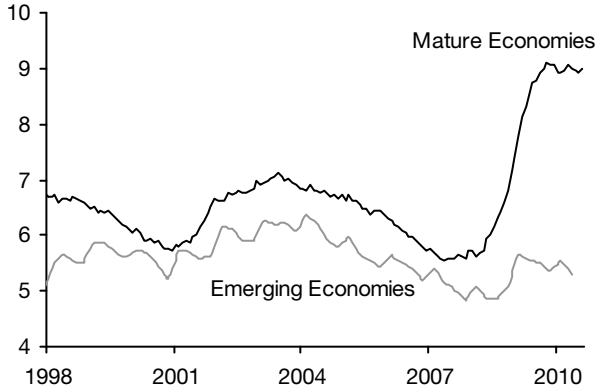
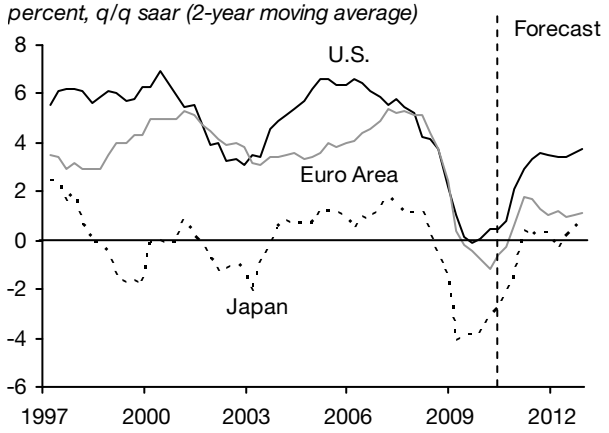


Chart 7
G3: Nominal GDP Growth
percent, q/q saar (2-year moving average)



remarkable that the average level of spreads between Greece, Ireland, Portugal and Spain (GIPS) and Germany is now *above* the spread on the benchmark emerging market bond index (EMBIG; Chart 5, page 5).

The combination of stronger growth in emerging markets and more risk in mature markets is a fairly potent combination to accelerate private sector capital flows to emerging economies. By way of illustration, it is interesting to compare revisions to our estimates of real growth in emerging economies relative to mature economies for 2010 with our estimates of net private flows for 2010. Our forecasts for emerging market growth for 2010 have been consistently revised up in the past year (while the overall forecast for mature economies has been unchanged). The revisions to our estimates of net flows have broadly tracked these growth revisions (Chart 1, front page). This relationship probably reflects cause *and* effect: higher growth prospects lift flows; and higher flows lift growth prospects.

NARROWING (SOME) GLOBAL IMBALANCES

The strength of domestic demand in emerging economies relative to that in mature economies is producing a sizeable narrowing in global current account imbalances between the major mature economies and the emerging economies (Chart 8 and Table 4, next page). Of course, not all countries are experiencing a decline in their current account imbalances. Most notably, progress in reducing the still sizeable U.S. current account deficit has been reversed since the onset of the U.S. recovery, due to a combination of stronger imports and, more recently, weaker exports. We suspect that this phase of U.S. export weakness will be relatively short-lived, however, especially now that the dollar has resumed its weakening trend.

The strength of domestic demand in emerging economies relative to that in mature economies is producing a sizeable narrowing in global current account imbalances

The narrowing in current account imbalances is not solely a reflection of differences in trends in relative demand. Movements in real exchange rates also play a role by (a) switching demand away from domestically produced goods and towards foreign goods for countries

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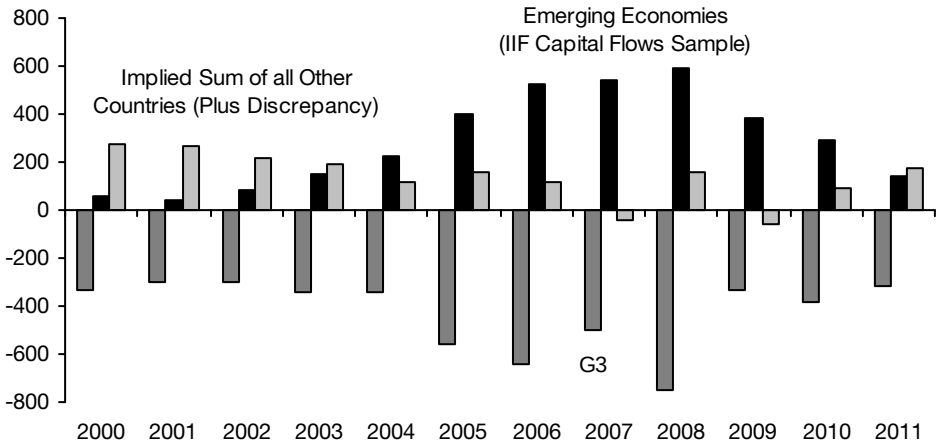
Chart 8:
Global Current Account Imbalances
$ billion



experiencing real appreciation, and vice versa for countries experiencing real depreciation; and (b) switching domestic supply away from tradable items to non-tradables in appreciating countries, and vice versa for depreciating countries. In this context, the recent tendency for emerging market currencies to appreciate in real terms against mature market currencies should be viewed as conducive to a further narrowing in global imbalances (Chart 9, next page). With the exception of Emerging Europe, there would seem to be room for further real appreciation.

Shifting external balances can also be helpful in dealing with the differential inflation tensions that are evident across the global economies (Table 5, next page). For mature economies facing a deflationary threat resulting from excess goods supply, a reduced supply of imports and the reorientation of domestic production to exports is helpful in dampening those

Table 4
Global Current Account Balance
$ billion

	2008	2009	2010f	2011f
United States	-669	-378	-498	-507
Euro Area	-238	-94	-50	45
Japan	160	142	168	145
Other Mature Economies	51	34	37	15
Emerging Economies (IIF 30)	591	386	289	145
Africa / Middle East	185	2	56	48
Latin America	-13	-13	-47	-86
Emerging Europe	-17	25	20	-51
o/w Russia	102	49	72	12
Emerging Asia	436	372	261	233
o/w China	426	297	220	210
Other Countries*	104	-89	53	157

* Includes global discrepancy

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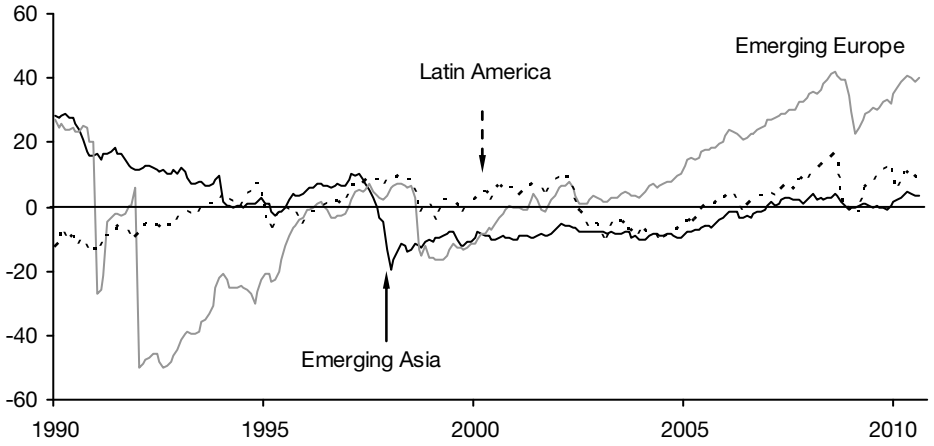
Chart 9
Emerging Markets: Real Effective Exchange Rate
IIF measures, deviation from 1990-2008 average



deflationary worries. For emerging economies—where concerns about accelerating inflation are more pressing—a more plentiful supply of imports and the reorientation of domestic production *away* from exports can help temper inflation.

We now project G7 central banks to be on hold through the end of 2011

In turn, trends in global monetary policy are generally consistent with what is needed to engineer stronger, more balanced global growth. We now project G7 central banks to be on hold through the end of 2011, and to accompany the "low for long" interest rate policy with a willingness to use the balance sheet creatively. Easy money in the G3 works to support demand directly (although traditional transmission mechanisms work less well than was the

Table 5
Consumer Prices
percent change over previous year, end of period

	2008	2009	2010f	2011f
Mature Economies	**0.6**	**1.4**	**0.7**	**0.7**
United States	-0.1	2.8	0.8	1.3
Euro Area	1.6	0.9	1.2	0.5
Japan	0.4	-1.7	-0.4	-0.7
Emerging Economies	**6.4**	**5.0**	**5.3**	**5.6**
Latin America	8.8	6.2	8.0	8.7
Argentina	15.4	17.4	23.9	24.0
Brazil	5.9	4.3	5.2	5.6
Mexico	6.5	3.6	3.8	4.8
Emerging Europe	10.2	6.8	6.8	5.8
Russia	13.3	8.8	8.0	7.0
Turkey	10.1	6.5	7.3	6.5
Asia/Pacific	2.5	3.5	3.3	3.8
China	1.2	1.9	2.6	3.4
India	1.5	10.2	5.0	4.7
Africa/Middle East	11.0	5.4	6.2	6.2
South Africa	9.5	6.3	3.8	4.2
World	**1.9**	**2.2**	**1.7**	**1.8**

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case in previous cycles) and indirectly, through its impact on currency values. Modestly tighter money in emerging economies can be calibrated so that it does limited damage to domestic demand, but helps promote real currency strength, which becomes one important way in which incipient inflation pressures are addressed (albeit at the "cost" of a declining current account surplus).

The challenge facing policy makers is to attempt to make these monetary policy and resulting currency adjustments occur at a *pace* that is consistent with a steady, sustained global expansion. If the U.S. Federal Reserve were to embark on an additional aggressive quantitative easing strategy, then this could trigger a destabilizing collapse in the dollar, which would most likely cause turbulence in other U.S. asset markets. The resulting rapid appreciation in emerging market currencies could also be very damaging to their economies, possibly leading to an over-expansion of domestic demand, as well as severe weakness in the export sector. In considering its own joint mandate (low and stable inflation and maximum employment), the Fed would thus seem well advised to plot a monetary policy that best promotes robust foreign demand growth (for U.S. goods and services), given that its ability to use monetary policy to support domestic demand looks to be substantially reduced now.

If the U.S. Federal Reserve were to embark on an additional aggressive quantitative easing strategy, this could trigger a destabilizing collapse in the dollar, which would most likely cause turbulence in other U.S. asset markets

MOMENTUM IS STRONGEST IN PORTFOLIO EQUITY FLOWS

Net inflows of non-resident portfolio equity have been particularly strong in 2010. We project that they will total $186 billion in 2010, up from $149 billion in 2009. This estimate is up $67 billion from our last forecast in April (see Box 1, page 3). This rebound needs to be seen in context. Portfolio equity flows had reversed sharply in 2008, so the revival in flows in 2009 and, to a lesser extent, in 2010 possibly reflects the return of investors who had initially feared that the global crisis would be devastating for the corporate sector in emerging economies. Even allowing for this payback, however, it seems clear that net inflows of non-resident portfolio equity have moved up to a higher level as global investors' comfort level with holding corporate securities from emerging markets increases. In 2011, net portfolio equity flows are forecast to remain high, at $143 billion.

By region, flows into Emerging Asia are forecast to be largest, at $93 billion, with about $36 billion and $30 billion going into China and India, respectively. This regional total is much higher than we had projected for 2010 in April ($63 billion). Foreign purchases of Indian stocks jumped to $5.1 billion in September, taking the total for Q2 and Q3 combined to $17 billion. Non-resident portfolio equity flows into Latin American countries have been particularly strong. For the year as a whole, they are forecast to be $72 billion, which is double the amount expected in April, and up from $58 billion in 2009. Brazil dominates the region, attracting $58 billion, net. This includes about $18 billion of new Petrobras stock recently bought by foreign investors. Net portfolio equity flows to Africa and the Middle East are a relatively small absolute amount (about $10 billion), but have rebounded strongly in 2010, led by Egypt. Flows to Emerging Europe are also reviving, but are likely to be lower for 2010 as a whole ($12 billion) than we had expected in April ($17 billion). The main disappointment is Russia.

Non-resident portfolio equity flows into Latin American countries have been particularly strong

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BOX 2: OFFICIAL FLOWS SHIFTING FROM EM TO MATURE ECONOMIES

Net official flows to emerging markets are projected to decline to $53 billion in 2010, down from $63 billion in the previous year. This is mainly due to reduced need for emergency financing received during the crisis years of 2008/09, particularly by countries in Emerging Europe. This does not mean, however, that demand for official financing has declined. While emerging markets have shown reduced reliance on official aid during the crisis, it is mature economies that have recently reinvigorated the case for official lending of last resort.

Indeed, the amount of official support that is needed to keep troubled Euro Area economies afloat dwarfs the volumes of emergency loans provided to emerging markets during the crises of the 1990s and 2000s (Chart 10). Among the European sovereigns facing financing difficulties, Greece is the only country that has received *formal* support from official lenders. In May 2010, the IMF and the EU provided joint assistance to the tune of $38 billion (16% of Greek GDP). This compares to a previous record net official disbursement of 12% of GDP to Thailand ($13 billion) at the height of the Asian crisis in 1998.

It is important to note that the formal support constitutes only a small part of the *de facto* assistance public lenders have provided to Greece and other troubled European sovereigns. The majority of support has been made available through guarantees and outright purchases of government bonds under the ECB's Securities Markets Program. In the case of Greece, we estimate that the net new ECB financing for Greece will amount to $90 billion, or 38% of GDP in 2010 (Chart 11).

We estimate that the net new ECB financing for Greece will amount to $90 billion, or 38% of GDP in 2010

Since June 2010, strained public finances in Euro Area countries are backed by the European Financial Stability Facility (EFSF). Equipped with a total lending volume of up to €750 billion and a AAA credit rating, the EFSF stands ready to provide unprecedented official support to Euro Area sovereigns facing financing difficulties.

Chart 10
Net Official Support for Countries with Financing Difficulties
net disbursements, % of GDP

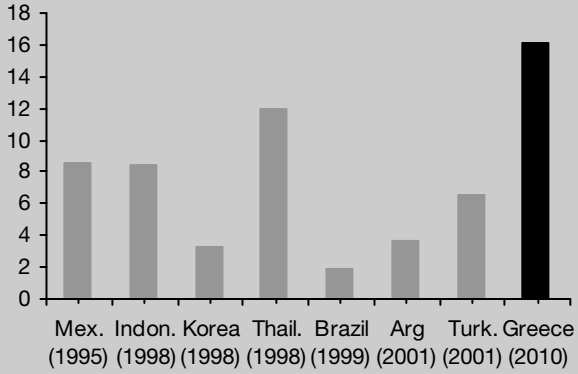
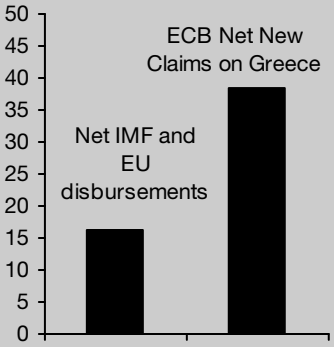


Chart 11
Net External Financing for Greece, 2010
net disbursements, % of GDP



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The recent growing momentum in portfolio equity flows is consistent with the relative strength of the outlook for emerging economies. But it is also more than simply a tactical bounce. Global investors seem to be in the process of shifting their asset allocations towards emerging market companies, driven by the attraction of superior growth. The share of the capitalization of emerging market equity markets in the global total has been rising steadily in recent years (Chart 12). With so many problems afflicting previously prestigious companies in mature economies, the relative risk of investing in emerging market companies has declined. (Note that this does not mean that the absolute risk of EM investing has declined, or that thorny issues such as corporate governance and the treatment of minority shareholders have gone away). With the (bond) risk premium associated with emerging economies having declined (along with the risk free real discount rate), standard equity valuation models would suggest a rise in warranted valuations relative to history. It is thus no great surprise that the price-earnings ratio for emerging markets has risen relative to mature markets in recent years (Chart 13). Indeed, it is plausible that emerging market equities should trade at a markedly higher P/E ratio than mature market equities since the former are somewhat akin to growth stocks and the later to value stocks, based on relative expected nominal GDP growth over the next few years.

Global investors seem to be in the process of shifting their asset allocations towards emerging market companies, driven by the attraction of superior growth

An increasing number of emerging market companies are choosing to take advantage of the opportunities offered by favorable market conditions to issue new stock, as was illustrated by the recent Petrobras equity sale.

As portfolio equity investment by non-residents becomes an increasingly important component of net inward private capital flows, the question arises whether this is a more stable form of financing than debt finance, especially external financing provided by the banking system. Over the last 10 years (2001-10) the coefficient of variation of net portfolio inflows has indeed been lower than that for banking flows, but this is not saying much since both far exceed unity (1.19 and 1.54, respectively). In other words, portfolio equity flows are quite volatile, and subject to sizeable swings not always obviously related to the underlying fundamentals of the market. Moreover, it is possible that as investors' positions in emerging economies become more sizeable and viewed as a core position in their portfolios, they will

Portfolio equity flows are quite volatile, and subject to sizeable swings not always obviously related to the underlying fundamentals of the market

Chart 12
EM Stock Market Capitalization
percent of global stock market capitalization, end of year

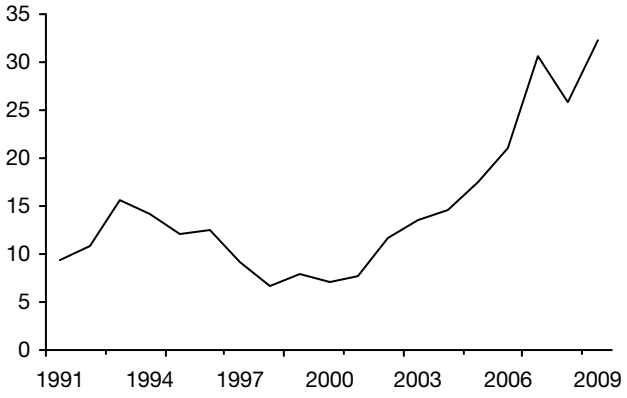
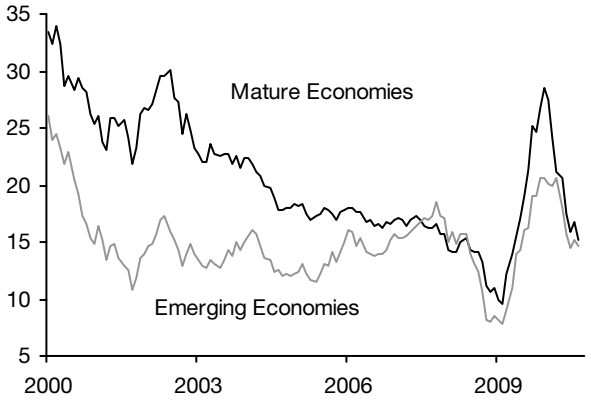


Chart 13
Equity Market Valuations
MSCI indices, trailing price-to-earnings (P/E) ratios



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react to growing (macro) uncertainty by proxy hedging through, say, buying credit default swap (CDS) protection, meaning that selling pressure would be more evident in CDS spreads and debt markets more generally. The main stability advantage of greater reliance on inward portfolio equity investment, however, is that the servicing cost of capital is directly tied to the underlying performance of the company and, in aggregate, to the economy. In tough times, net outflows (dividends) naturally decline, thus protecting the health and viability of the issuing company.

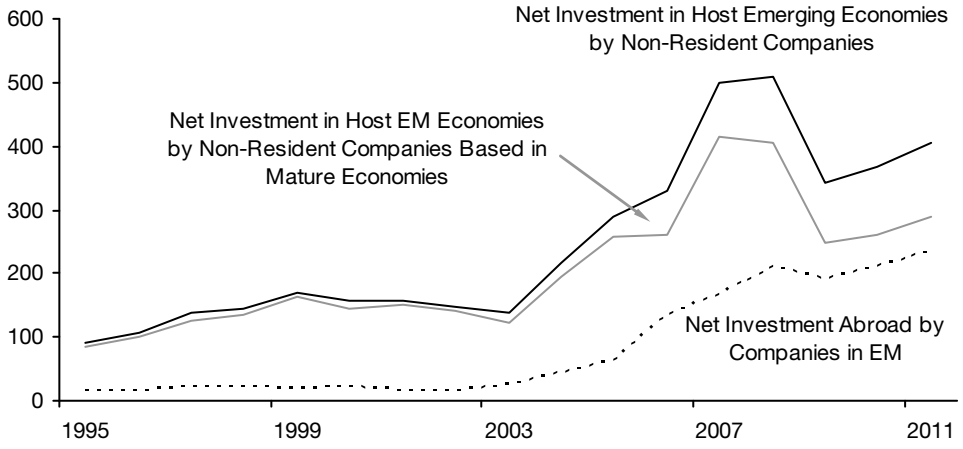
FDI: EMERGING COMPANIES INCREASINGLY LOOK ABROAD

Foreign direct investment remains the single largest component of private capital flows to emerging economies. In 2010, it is expected to total $367 billion, which would be about 45% of all net private flows. The recovery in net inflows from their peak in 2008 ($508 billion) has been quite sluggish, however (Chart 14). In 2010, FDI will have been boosted by the revival in corporate earnings, which will have increased the retained earnings component of FDI. Despite this, however, the projected recovery in FDI relative to 2009 is quite modest (a net increase of about $25 billion). The main reason for this relative sluggishness is undoubtedly the weak overall global investment environment.

Foreign direct investment remains the single largest component of private capital flows to emerging economies

Emerging Asia remains the largest recipient of non-resident FDI ($156 billion) and China the single-largest recipient ($90 billion). All other regions enjoy healthy inflows, however, albeit well down from the peak years of 2007 and 2008, when real estate investment featured large in FDI flows. By sector, more FDI is now concentrated in the extraction industries. A number of mature market banks are bolstering the capital in their emerging market subsidiaries, and this is supporting FDI, especially in Emerging Europe. There is no obvious advantage of scale: the BRIC countries combined account for $188 billion of inward FDI flows in 2010, or 51% of the total of our 30 country sample. Remarkably, this is identical to their share of the combined GDP of the group.

Chart 14
Net Foreign Direct Investment Flows
$ billion



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Perhaps the biggest FDI story at present, however, relates not to the amounts of investment being done *in* emerging markets by companies headquartered in mature economies, but to the rising amounts of outward FDI being done in other economies by companies based in emerging economies themselves. Of course, part of this FDI is being done in other emerging economies (some of which are outside our 30 country sample). By way of illustration, if it is assumed that 50% of the FDI done abroad by companies resident in our 30 country sample involves investing in other sample countries (i.e., China investing in Brazil), then it is possible to identify an implied amount of FDI being done in our emerging market sample by companies resident in the mature economies. This implied total from the mature market economies would be the same in 2010 as it was in 2005.

Perhaps the biggest FDI story at present relates not to the amounts of investment being done in emerging markets by companies headquartered in mature economies, but to the rising amounts of outward FDI being done in other economies by companies based in emerging economies

DEBT FLOWS TEMPERED BY PERSISTENT CAUTION IN BANK LENDING

Debt-related flows used to dominate private capital flows to emerging economies. By creditor, banks dominated debt flows. At the peak in 2007, there were net debt flows of $688 billion to the countries in our sample (54% of total flows), of which banks accounted for $451 billion, net. The global deleveraging wave has meant that these debt flows have slumped, however. In 2010, net debt flows are projected to total $272 billion, net (about 33% of total flows), of which banks will account for only $85 billion, net.

- Bank-related debt flows are recovering, but slowly. In 2009, there were net repayments of about $44 billion to our sample. Our estimate of net flows of $85 billion is about $36 billion higher for 2010 than it was in April. Two factors seem to be holding back cross-border bank lending to emerging economies:

- Banks' efforts to re-establish strong balance sheets are leading to rapid de-leveraging, with a particular emphasis on reducing external assets. Looming regulatory changes will make lending to emerging economies more expensive (higher capital charges). The de-leveraging effort is particularly troubling for Emerging Europe, where net bank repayments were a heavy $66 billion, net, in 2009 and where net lending will be only $12 billion in 2010, which is $6 billion less than our estimate in April.

The demand for cross-border bank lending is muted, low G3 interest rates notwithstanding. This can be seen graphically in Emerging Asia, where the healthy local banking system and booming local credit demands might suggest a strong demand for external interbank funding. Local banks appear to be well positioned not only to meet all local credit demands from non-banks, but also are very well funded locally (strong deposit growth). Net bank lending to Emerging Asian borrowers is projected to be $42 billion in 2010, which is up on the $31 billion, net, in 2009 and our April estimates of $14 billion, net. It is low relative to the 2005-07 average of $105 billion, however.

The demand for cross-border bank lending is muted, low G3 interest rates notwithstanding

Non-bank lending has recovered more vigorously than bank lending. Non-bank credit flows are projected to be about $187 billion, net, in 2010, up from $135 billion in 2009. This total

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would be below the 2007 peak ($237 billion), but not dramatically so. Three factors seem to account for the relative strength of non-bank credit flows:

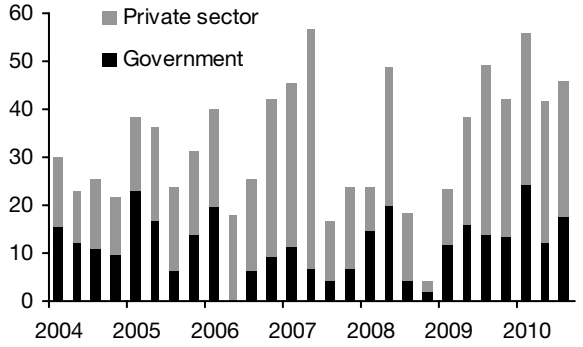
- Non-bank credit intermediaries have been less damaged by the financial crisis. Perhaps more significantly, the tightening in regulatory constraints will be less severe in coming years.
- Low G3 interest rates are spurring a wave of foreign currency issuance in G3 bond markets by borrowers who had moved away from such external debt issuance as they built their local bond markets (Chart 15). Now, such low G3 bond yields are too tempting to many emerging market corporate treasurers and public debt managers.
- Rising rates in a number of emerging economies are widening rate differentials over G3 countries and leading more investors to re-establish carry trades (Chart 16). (The counter to this is that banks are more unwilling to fund leveraged carry trades by hedge funds). It should be noted that although rates are edging up in a number of emerging economies, they remain stable in most and absolute rate differentials are historically very low, limiting the prospective absolute return (and Sharpe ratio) on many carry trades.

EMERGING MARKET CAPITAL OUTFLOWS: PROBLEM AND SOLUTION

The IIF has been focusing on net private capital flows to emerging economies for over 25 years. In some periods our focus has been on the shortage of flows; in others, attention shifts to headaches created by an excess. Through these swings, it is helpful to remember that capital flows tend to move in cycles.

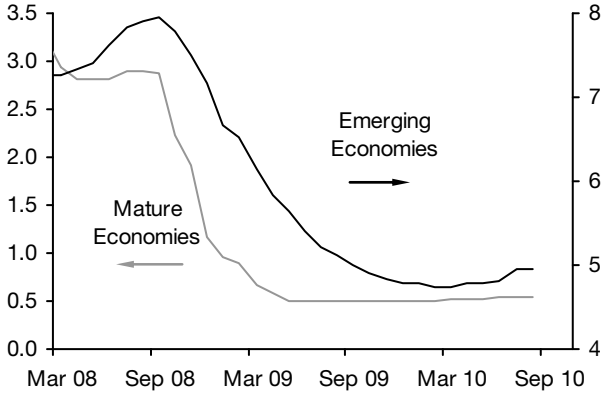
There are also (less frequent) *structural* changes that deserve to be highlighted. One was the emergence of FDI as an external financing source for emerging economies through the 1990s. Another was the emergence of remittance flows in the first decade of the current century. More

Chart 15
Emerging Market External Bond Issuance*
$ billion



Source: Thomson Financial; IIF calculations. * Includes foreign currency denominated bonds issued in an external market, for the 30 major EM countries covered in the IIF's Capital Flows to EM sreport.

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



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recently, the most striking development is the rise of emerging economies as investors abroad, often in each other.

We divide net capital exports by emerging economies into three (identified) categories: equity investment by all resident sectors which, in turn, is also split into FDI and portfolio investment; debt flows (net lending) by all resident sectors excluding the reserve management agency; and the net acquisition of foreign exchange reserves. In 2010, we project these EM capital exports to total $1.2 trillion, or 5% of the combined GDP of our 30 country sample. This huge number is well down on the peak of $1.8 trillion (12.5% of GDP) in 2007 (Chart 17).

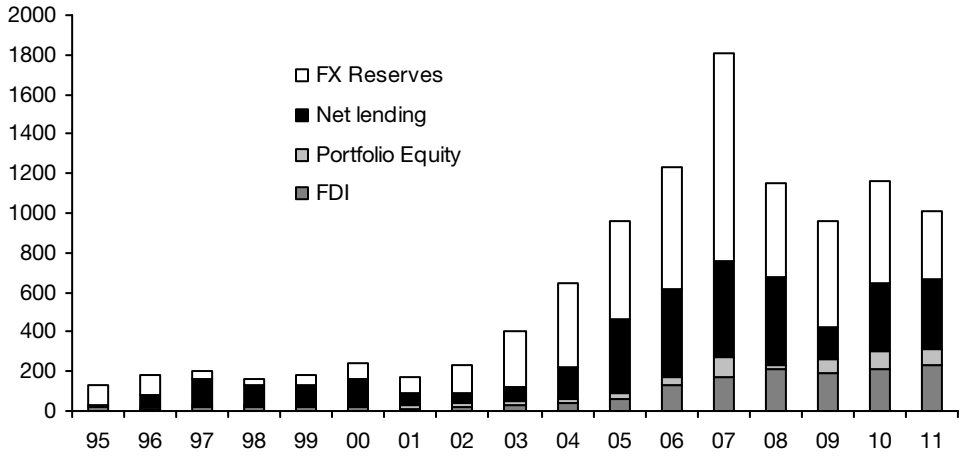
Emerging economies continue to acquire massive amounts of foreign exchange reserves

Emerging economies continue to acquire massive amounts of foreign exchange reserves. In 2010, aggregate reserve acquisition will be about $515 billion, of which $304 billion will be accounted for by Emerging Asia (China $190 billion). The traumas of 2008-09 left a number of large emerging economies (e.g., Korea and Mexico) with the view that they had large but insufficient reserve holdings. There are thus some grounds for emerging economies to accumulate modest amounts of additional reserves. The accumulation of a further $515 billion in 2010 (and projected $345 billion in 2011) looks too high for two basic reasons:

The accumulation of a further $515 billion in 2010 (and projected $345 billion in 2011) looks too high

- It leaves emerging economies vulnerable to the claim that they are holding their currencies below equilibrium rates, thus distorting the pattern of international trade.
- It leaves emerging economies vulnerable to a sudden loss in net worth should the assets that they hold in in their reserve portfolio suddenly decline sharply in value. The financial chaos that can result from a sudden loss in the value of assets that we previously counted as AAA was graphically illustrated in 2007-08.

Chart 17
Net Capital Exports by Emerging Economies
$ billion



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By contrast, the continued strong acquisition of foreign assets by the private sector in emerging economies looks to be less of a problem, although specific transactions are sure to raise persistent strategic and political concerns. For one thing, it allows companies in emerging economies to diversify. For another, if the assets are acquired for a commercial purpose, then it is quite likely that they will be well managed. Finally, the acquisition of foreign assets (including fixed assets in mature economies) is both a way to dampen upward pressure on the real exchange rates of emerging economies, and increase the supply of capital to mature market borrowers at a time when domestic investors in mature markets may be excessively leery about taking risk.

The continued strong acquisition of foreign assets by the private sector in emerging economies looks to be less of a problem

EMERGING ASIA: INFLOWS ATTRACTED BY BUOYANT OUTLOOK

Strong growth and prospects of high returns for investors are sustaining last year's upturn in private capital flows to the region, although demand for external financing is dampened by ample domestic liquidity. The seven countries constituting our sample for Emerging Asia are likely to account for around 40% of net private capital flows to emerging markets this year and next, averaging close to $330 billion in 2010-2011 (Table 6). Flows of foreign direct investment will continue to be sizeable at around $160 billion a year, $90 billion of which is accounted for by China and $40 billion by India. Foreign purchases of domestic stocks are set to remain close to $90 billion in 2010 before easing somewhat to $65 billion in 2011, again dominated by China and India.

Flows of foreign direct investment will continue to be sizeable at around $160 billion a year, $90 billion of which is accounted for by China and $40 billion by India

Table 6
Emerging Asia: External Financing
$ billion

	2008	2009	2010f	2011f
Current Account Balance	435.9	372.5	260.7	233.3
External Financing, Net:				
Private Inflows, Net	121.8	337.0	342.9	317.3
Equity Investment, Net	158.5	260.2	248.2	224.5
Direct Investment, Net	212.9	174.1	155.6	159.3
Portfolio Investment, Net	-54.4	86.1	92.6	65.2
Private Creditors, Net	-36.7	76.8	94.8	92.9
Commercial Banks, Net	-64.6	30.8	41.7	48.6
Nonbanks, Net	27.8	46.0	53.1	44.3
Official Inflows, Net	23.7	9.6	13.8	12.8
IFIs	1.7	2.7	2.5	2.9
Bilateral Creditors	22.0	6.9	11.3	9.9
Equity Investment Abroad, by Residents, Net	-96.0	-150.0	-189.5	-200.7
Resident Lending/Other, Net	-127.4	-66.3	-123.7	-108.0
Reserves (- = Increase)	-357.9	-502.7	-304.3	-254.7
Memo:				
Private Flows, Net (IIF Former Measure)	25.7	187.0	153.4	116.6

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In tandem with a reduction in the aggregate current account surplus for Emerging Asia from $372 billion in 2009 to $233 billion in 2011 and move towards greater exchange rate flexibility, there is a moderation in the reserve build up. Nevertheless, the region will remain a major exporter of capital as evident from the rise in outward FDI as well as portfolio equity outflows from residents.

The only country in our regional sample to run a current account deficit is India, of around $40 billion this year and next. This should be more than covered by a surplus on the capital account, attracted by real GDP growth of 8-9% a year, the dynamism of the private sector and resumption of the privatization program. The Indian government's recently raised limits on foreign purchases of domestic bonds partly to help finance infrastructure investments. The ceiling on foreign holdings of domestic government securities was raised by $5 billion to $10 billion and that of domestic corporate bonds by $5 billion to $20 billion. This will boost net debt inflows in 2010-11. Relatively high interest rates are also attracting net debt flows to Indonesia. Foreign holdings of domestic government securities surged to $19.7 billion at the end of August 2010 from $11.7 billion in December 2009, while those of central bank certificates rose to $6.1 billion from $4.7 billion.

EMERGING EUROPE: MODEST REVIVAL IN PRIVATE FLOWS

Capital flows to Emerging Europe are likely to triple to $180 billion this year

Capital flows to Emerging Europe are likely to triple to $180 billion this year. The rebound in private inflows will more than offset the decline in official financing. Even so, capital inflows remain one-third lower than the 2004-2008 average (Table 7).

Table 7
Emerging Europe: External Financing
$ billion

	2008	2009	2010f	2011f
Current Account Balance	-16.9	25.0	19.5	-50.9
External Financing, Net:				
Private Inflows, Net	260.0	60.7	182.5	229.6
Equity Investment, Net	111.1	69.4	96.2	116.8
Direct Investment, Net	125.9	61.9	84.1	102.4
Portfolio Investment, Net	-14.7	7.5	12.1	14.4
Private Creditors, Net	148.9	-8.7	86.4	112.8
Commercial Banks, Net	87.1	-66.3	12.5	33.6
Nonbanks, Net	61.8	57.5	73.9	79.3
Official Inflows, Net	21.0	26.7	14.7	6.0
IFIs	19.3	29.8	15.3	10.9
Bilateral Creditors	1.7	-3.1	-0.6	-4.9
Equity Investment Abroad, by Residents, Net	-68.6	-44.0	-49.7	-58.1
Resident Lending/Other, Net	-228.6	-48.4	-56.6	-91.3
Reserves (- = Increase)	33.0	-20.0	-110.5	-35.4
Memo:				
Private Flows, Net (IIF Former Measure)	191.5	16.7	132.9	171.5

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- Borrowing form commercial banks has been slower to recover, except for Turkey. Sluggish credit demand and tighter lending standards have constrained bank lending, prompting domestic banks to repay debt owed to abroad (including to foreign parents).
- Borrowing from other private creditors has picked up substantially. This reflected a rebound in intercompany lending in line with economic activity, stepped-up international bond issuance and increased foreign purchases of local currency-denominated government bonds.
- Eurobond issuance has been supported by narrower borrowing spreads and declining benchmark. Low foreign interest rates have attracted substantial amounts of short-term capital inflows, especially into countries with high interest rates and appreciating currencies, such as Turkey and Russia.
- Large part of the FDI inflows into Russia and Ukraine appears to have reflected returning flight capital from offshore centers
- Borrowing from official creditors has dropped sharply as access to capital markets has improved, but Romania and Ukraine will remain dependent on IMF and EU financing this year and next.

In Turkey, the abolition in July 2009 of the ban on domestic lending in foreign exchange to corporations led domestic banks to unwind part of the round-tripped lending booked earlier via their foreign branches. The net impact of these changes is to lower recorded net debt inflows in 2009-10 (with some offset in reduced resident net lending abroad).

LATIN AMERICA: GROWTH POWERING SURGE IN NET EQUITY INVESTMENT

Net private flows to Latin America are approaching the record level registered in 2007, led by strong equity investment, carry trade inflows and bond issues. Total net private inflows, including bond issues, are projected to reach $214 billion this year, only 10% below the record $234 billion in 2007 (Table 8, next page). Much of the increase this year is the consequence of accelerating net equity investment inflows, including both higher net FDI and a surge in portfolio equity investment. Portfolio equity flows into Brazil have been especially strong (see Box 3). We project them to reach $148 billion, exceeding by a wide margin the previous record $92 billion in 2007.

Net private flows to Latin America are approaching the record level registered in 2007, led by strong equity investment, carry trade inflows and bond issues

Strong counter-cyclical monetary and fiscal/quasi-fiscal stimulus has pushed up regional growth of domestic demand and resulted in rapid recovery of output from the 2009 global downturn. Regional GDP is forecast to grow close to 6% this year, led by Brazil, Peru, and Argentina, following a contraction of 2.3% in 2009. Capacity utilization is at high levels in a number of countries and business investment spending is rising rapidly, financed by an increase in corporate profits, equity investment inflows and market borrowing. Taking advantage of substantial global liquidity, reduced risk aversion and tighter spreads, there has been a surge of external bond issues by corporates, accounting for 46% of EM bonds sold during the first eight months of the year compared with 16% during the same period of 2009.

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Table 8
Latin America: External Financing
$ billion

	2008	2009	2010f	2011f
Current Account Balance	-12.9	-13.2	-46.7	-85.6
External Financing, Net:				
Private Inflows, Net	124.6	137.2	213.6	201.5
Equity Investment, Net	92.2	114.1	147.4	140.5
Direct Investment, Net	94.6	56.6	75.7	83.7
Portfolio Investment, Net	-2.4	57.5	71.6	56.8
Private Creditors, Net	32.4	23.1	66.2	61.0
Commercial Banks, Net	4.0	-3.3	18.0	19.6
Nonbanks, Net	28.3	26.3	48.2	41.4
Official Inflows, Net	13.4	23.3	16.9	16.8
IFIs	3.8	9.5	7.2	4.5
Bilateral Creditors	9.6	13.8	9.7	12.3
Equity Investment Abroad, by Residents, Net	-35.4	-52.4	-46.6	-42.5
Resident Lending/Other, Net	-46.3	-54.8	-69.4	-57.3
Reserves (- = Increase)	-43.4	-40.1	-67.9	-33.1
Memo:				
Private Flows, Net (IIF Former Measure)	89.2	84.8	167.1	159.2

While private capital inflows to Latin America fell sharply in August, the pace of borrowing picked up in September. Led by VALE SA, the world's largest iron-ore producer and Gerdau SA, the biggest steel producer in Latin America, Brazilian corporates alone have sold a record $8.7 billion so far this month (to September 27). We expect the pace of borrowing to continue to be strong to the end of the year given the substantial existing pipeline. We project total net market borrowing by corporates, sovereigns and local governments in Latin America to reach $45 billion this year, more than double that of 2009.

Three factors have triggered a surge in capital inflows to Chile: i) earthquake-related capital repatriation equivalent to $1.0 billion from the country's sovereign wealth fund (ESSF); ii) the issuance of a 10-year global bond by the Treasury for $1.5 billion; and iii) substantial capital transfers stemming from reinsurance claims estimated at $5 billion (accounted for in errors and omissions). Private capital inflows are projected to increase to a record $23.7 billion this year.

Despite growing current account deficits, the surge in capital inflows has resulted in sustained appreciation pressure on Latin American currencies. This has prompted central banks to intervene more heavily in spot foreign exchange markets and to be more cautious in raising interest rates. We project the region's international reserves to continue rising to a record $546 billion by year-end, the equivalent of 7 months of imports of goods and services. With declining marginal benefit of further reserve accumulation and rising sterilization-related quasi-fiscal costs, dollar purchases in the spot market are likely to be accompanied by additional controls on capital inflows and/issuance of reverse swaps in the futures foreign exchange market.

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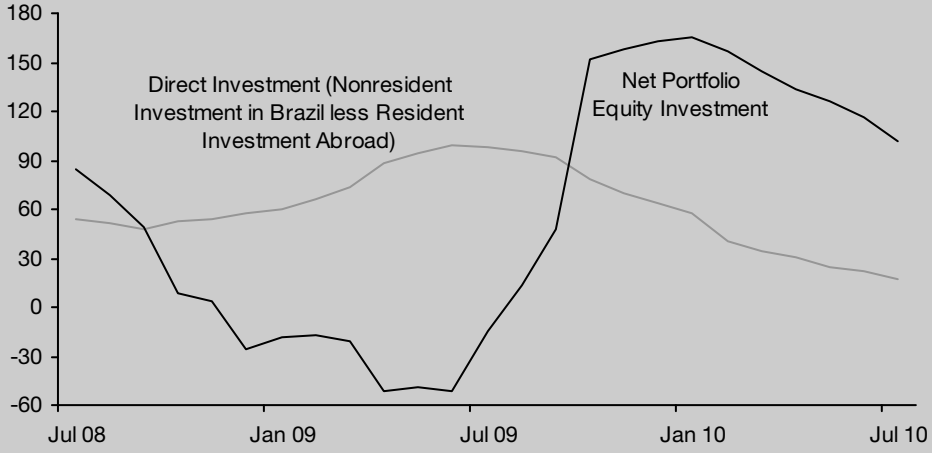
BOX 3: BRAZIL: THE SHIFTING PATTERN OF EQUITY INVESTMENT

Underpinned by Brazil's improved global standing, two investment trends appear to be taking hold:

1) Higher direct investment abroad: Seeking to establish a global presence in key markets, investment overseas by Brazilian corporations is on the rise. It climbed to $18.3 billion in the year to August, up from $6.3 billion in the same period a year earlier. Investment abroad has, thus far, concentrated on sectors in which Brazilian firms have a competitive advantage on which they wish to build on, such as commodities and food production. BNDES subsidized financing has supported the overseas investment drive.

2) Rising portfolio equity inflows: Excluding the one-off spurt induced by Petrobras's capitalization, portfolio equity inflows by nonresidents have trended upwards, driven by high commodity prices and a sizable growth differential between Brazil and the mature economies. We expect portfolio equity to play a growing role in the financing of the current account deficit. Since these inflows are very sensitive to shifts in market sentiment, the underlying volatility of external financing is bound to increase (Chart 18).

Chart 18
Brazil: Current Account Deficit Financing
percent, 12 month data



The region remains beset by a number of troubled cases, however. Flows to Ecuador and Venezuela remain anemic, as investors (especially equity investors) stay clear of increasingly turbulent economic conditions. Argentina has made some effort to normalize conditions with external creditors in recent months, although much more remains to be done (see Box 4).

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BOX 4: ARGENTINA'S LONG ROAD BACK TO CREDITWORTHINESS

Argentina's efforts to settle long-standing arrears with private creditors were partially successful in June when 67% of holders of $18.3 billion of its defaulted debt tendered their bonds in a second debt exchange. This brought the overall participation in the two debt exchanges (2005 and 2010) to 92.4%. However, it is not clear whether the government's access to global capital markets has been restored because of lingering legal challenges and associated attachment risk, $6 billion of Argentine debt to private creditors remains in default. The government issued $6.1 billion in new bonds for the debt exchange as well as $951 million in Global 2017s for the past-due interest.

Private capital flows to Argentina have picked up in 2010, however, helped by strong equity-related flows (Table 9).

Global debt issuance by sub-national governments and corporations has been rising. It reached $3.1 billion through September compared with only about $800 million and $250 million in 2009 and 2008, respectively; Nonresidents have been increasing participation in the local capital market.

Argentina was expected to issue a new $1.0 billion bond as a part of the exchange in June. However, the government decided not to do so because it could not borrow at a single-digit interest rate. Although the government appears to be able to issue debt at a lower cost now, it prefers using the central bank's international reserves instead. It has used $5 billion of the country's international reserves so far this year and plans to use an additional $7.5 billion next year.

Table 9
Argentina: External Financing

$ million

	2008	2009	2010f	2011f
Current account balance	6857	8794	2454	-1321
Equity investment, net	7792	3085	5905	6085
External borrowing, net	1172	2073	2155	4511
IBRD	-628	216	438	134
Other multilateral creditors	287	1384	540	338
Official bilateral creditors	114	128	156	152
Commercial banks	-933	-1690	90	-278
Other private creditors	2332	2035	931	4164
Resident lending abroad, net	-12422	-11827	-4430	-9915
Errors and omissions	-3390	-779	0	0
Reserves excl. gold (- = increase)	-9	-1346	-6084	640

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AFRICA AND MIDDLE EAST: EQUITY FLOWS CONTINUE TO DOMINATE

Net private capital flows to the Africa and Middle East region, which dropped sharply to $46.7 billion in 2009, are projected to recover to $86 billion this year. This is a similar level to 2008, but still well below the record $182.4 billion the previous year when bank flows to the UAE and Saudi Arabia surged. The bulk of the inflows in 2010 and 2011 are again likely to be foreign direct equity investment, which held up well during the global economic crisis. However, the increase in total flows compared with 2009 mainly reflects a turnaround in bank credit, from an outflow last year to an inflow in 2010, and a sharp increase in inflows from other private creditors (Table 10, next page).

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FDI is flowing into all countries in the region, although the two largest recipients this year are expected to be Saudi Arabia and the UAE, where investment in the oil and gas industry is projected to result in inflows of $16.0 billion and $14.0 billion, respectively. FDI into Egypt has slowed from a peak a couple of years ago, but was still fairly robust in 2009/10 (year-ending June) at $6.8 billion. Meanwhile, there is growing interest in South Africa. For example, Walmart has made an offer for South Africa's third-largest retailer, Massmart.

Portfolio equity flows are projected to shift from a net outflow in 2009 to a net inflow in 2010. Most of this is destined for the two largest stock markets in the region, South Africa and Egypt, where foreign investors appear to be rebuilding their positions following retrenchment during the global financial crisis. This will be partly offset by outflows from the U.A.E., with foreign investors still reluctant to rebuild positions in Dubai.

Although debt inflows tend to be somewhat smaller than equity investment, they remain significant in some countries. Bank credit extended to Saudi Arabia is forecast to rise to $6.9 billion in 2010, accounting for just over half of total bank flows to the region. There has also been a surge in other private creditor inflows into South Africa where large interest rate differentials have stimulated carry trade. Nonresidents have bought an increasing amount of South African paper this year, and in the first eight months net purchases of bonds rose to a record $9.2 billion, which was sharply higher than $2.3 billion in the whole of 2009.

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Table 10
Africa and Middle East: External Financing
$ billion

	2008	2009	2010f	2011f
Current Account Balance	184.9	2.0	55.7	48.2
External Financing, Net:				
Private Inflows, Net	88.0	46.5	86.0	85.0
Equity Investment, Net	60.5	46.7	61.3	67.8
Direct Investment, Net	75.1	49.1	51.2	61.1
Portfolio Investment, Net	-14.6	-2.4	10.2	6.7
Private Creditors, Net	27.5	-0.2	24.7	17.2
Commercial Banks, Net	2.5	-5.6	12.8	9.7
Nonbanks, Net	25.0	5.4	11.9	7.4
Official Inflows, Net	3.8	3.2	7.8	6.9
IFIs	1.2	4.0	4.8	4.0
Bilateral Creditors	2.7	-0.8	3.0	2.9
Equity Investment Abroad, by Residents, Net	-28.7	-14.5	-14.6	-16.5
Resident Lending/Other, Net	-141.3	-63.6	-99.5	-98.1
Reserves (- = Increase)	-106.8	26.4	-32.5	-22.4
Memo:				
Private Flows, Net (IIF Former Measure)	59.3	32.0	71.4	68.5

IIF CAPITAL FLOW REPORT COUNTRY SAMPLE (30)

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

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