Capital Flows to Emerging Markets

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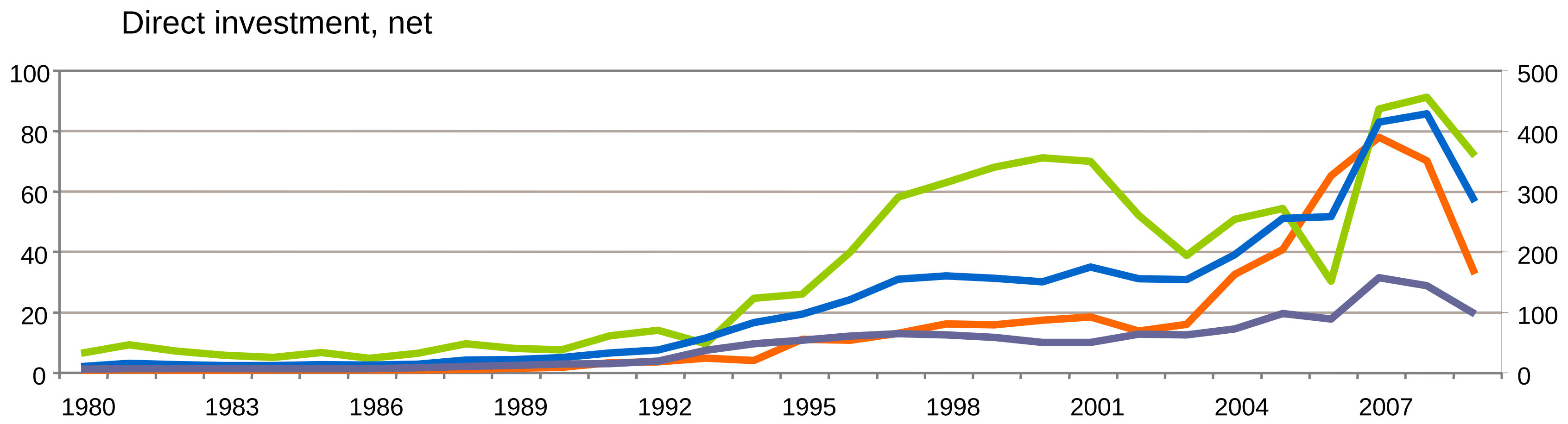
The Macroeconomic Context

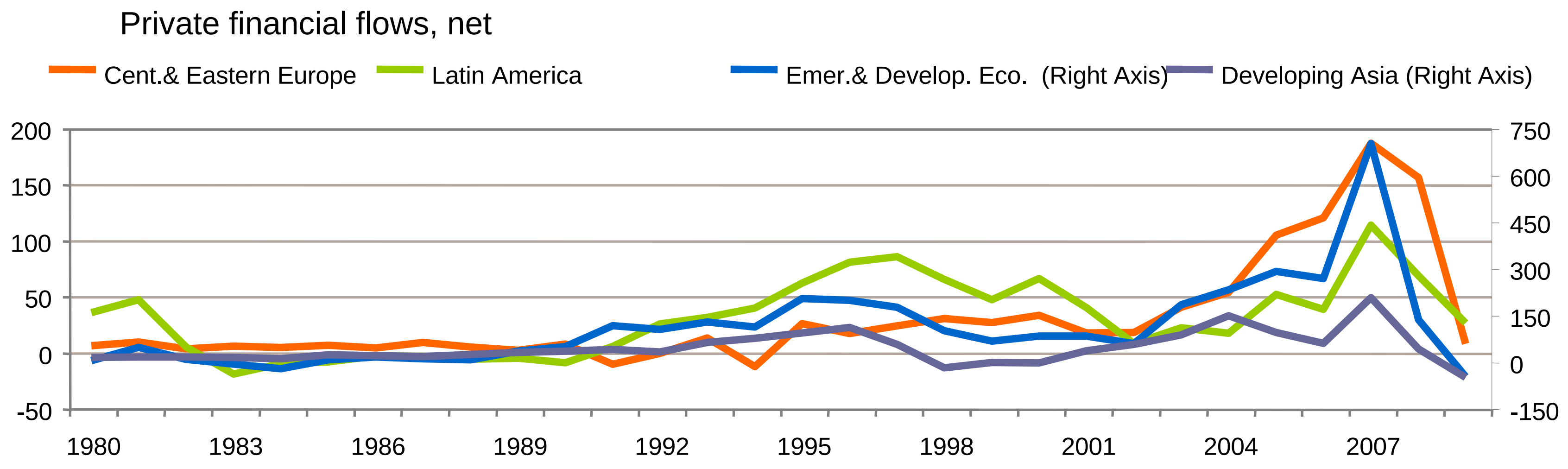
Saving and investment rates in EM

- After a peak in 2007, private capital flows to emerging markets have dropped substantially in the last two years, especially in 2009.
  - Direct foreign investment has been a little more resilient.
- The region that has been affected the most is Central and Eastern Europe that on the eve of the crisis had large current account deficit and relied heavily on external financing.
- However, in recent months bond financing has been raising.

Capital Flows to Emerging Markets

Direct investment and private financial flows (billions of USD)

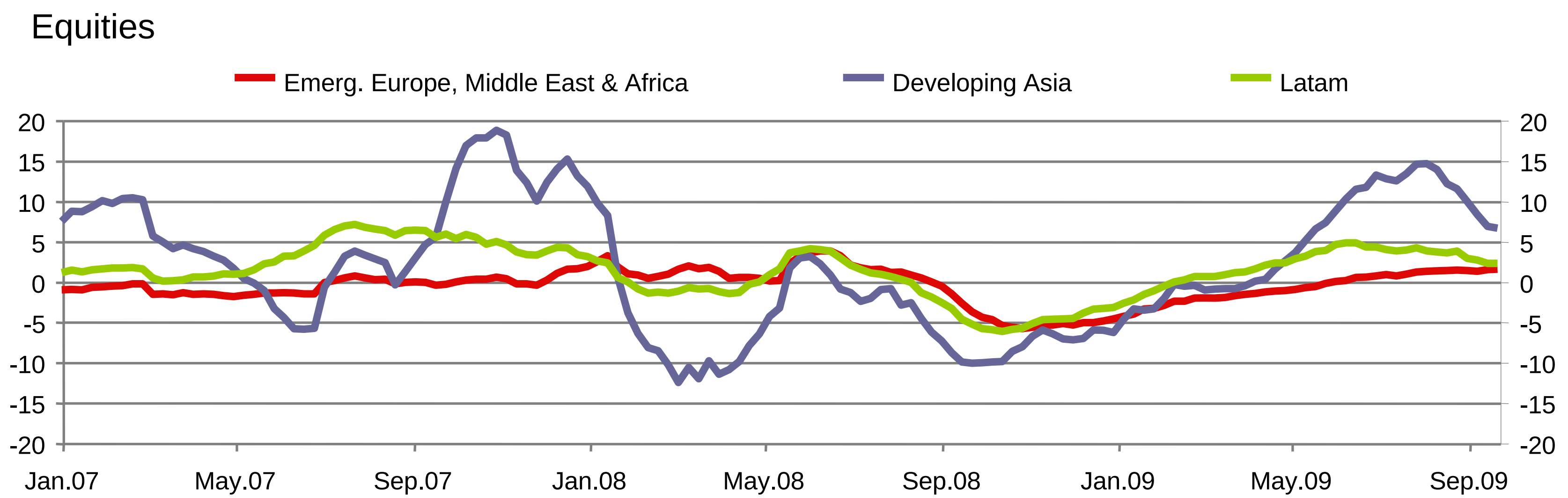


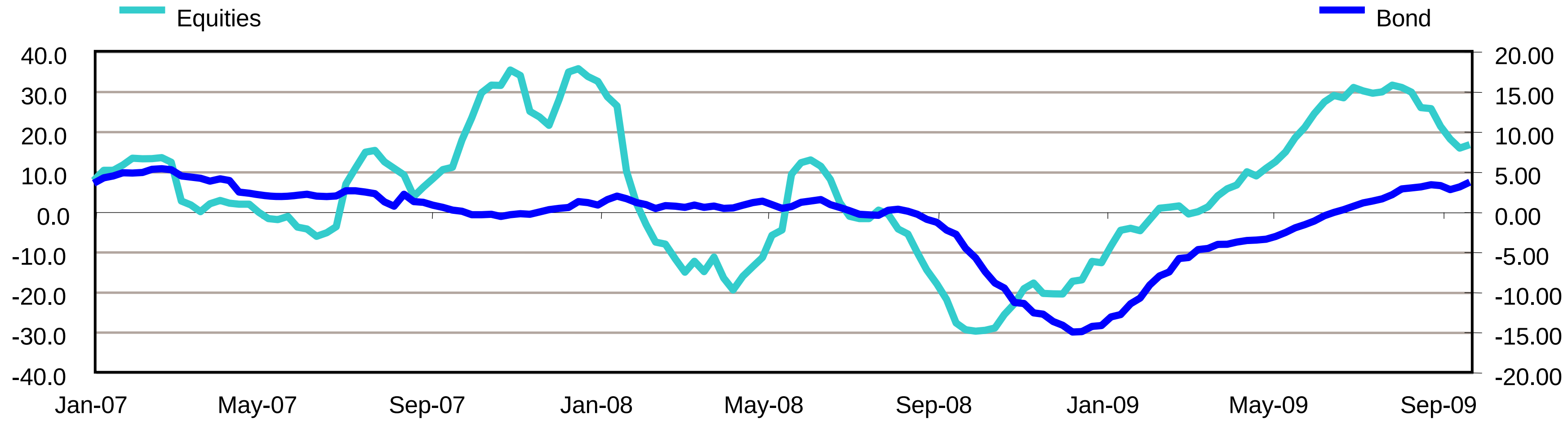


Source: IMF, *World Economic Outlook Database*, October 2009

Capital Flows to Emerging Markets

Net investment flows (billions of USD, accumulated 4 month moving window)





Source: Emerging Portfolio Fund Research.

I. Capital Flows in a Macroeconomic Context

The Macroeconomic Context

Saving and investment rates in EM

- Following the Asian Crisis, Asia's emerging countries simultaneously increased their savings rates and decreased their investment rates.
  - The result was a sharp rise in current account surpluses and a net accumulation of foreign assets.
- The most dramatic accumulation of net foreign assets and gross reserves was carried out by China and the oil-exporting countries.
- Emerging countries that were heavily dependent on the exports of primary goods began saving part of their windfall income from the boom in commodity prices during 2003–2007.

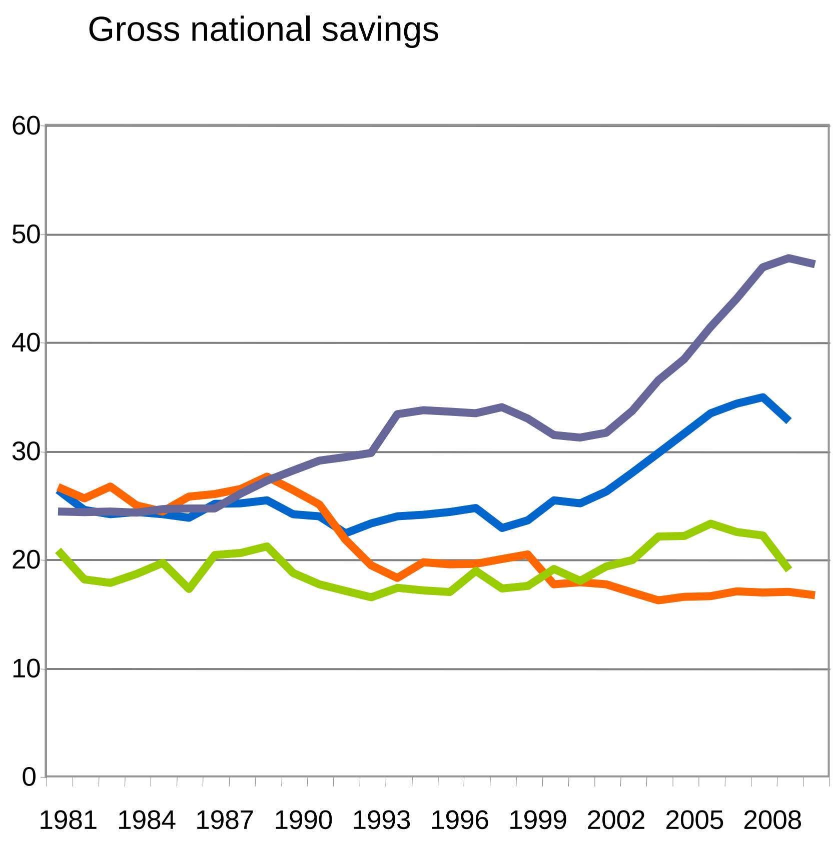
The Macroeconomic Context

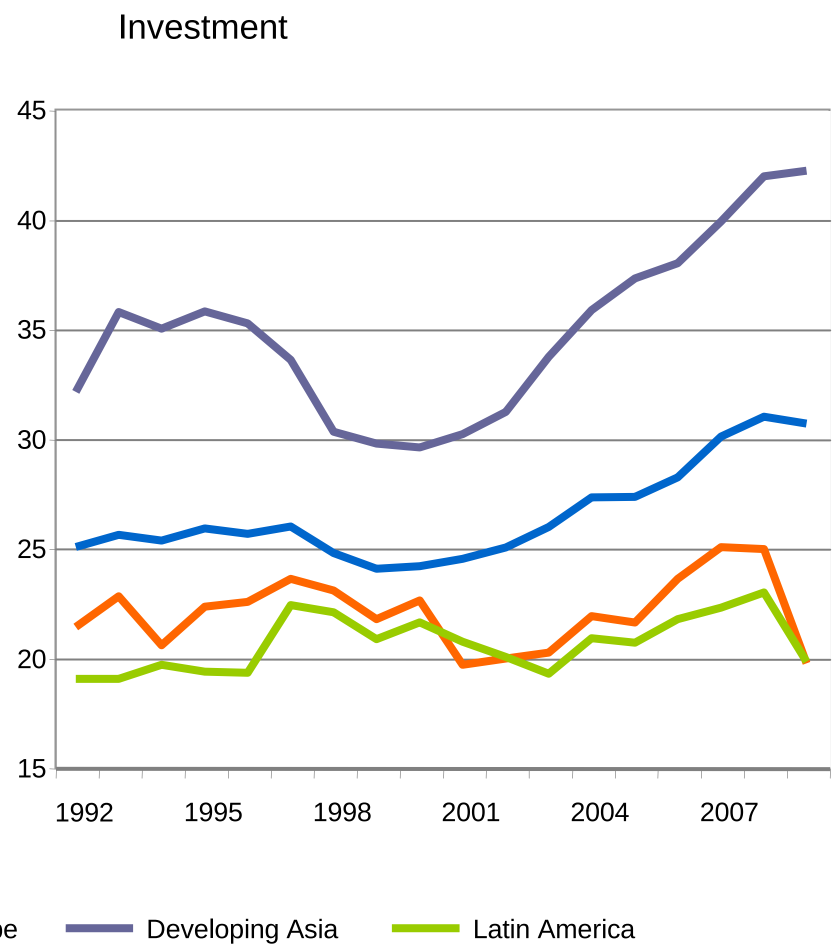
Saving and investment rates in EM

- In parallel, emerging European countries—especially Baltic countries—were running large current account deficits to finance a consumption boom caused by an increase in permanent income.

The Macroeconomic Context

Gross national savings and investment markets (% of GDP)



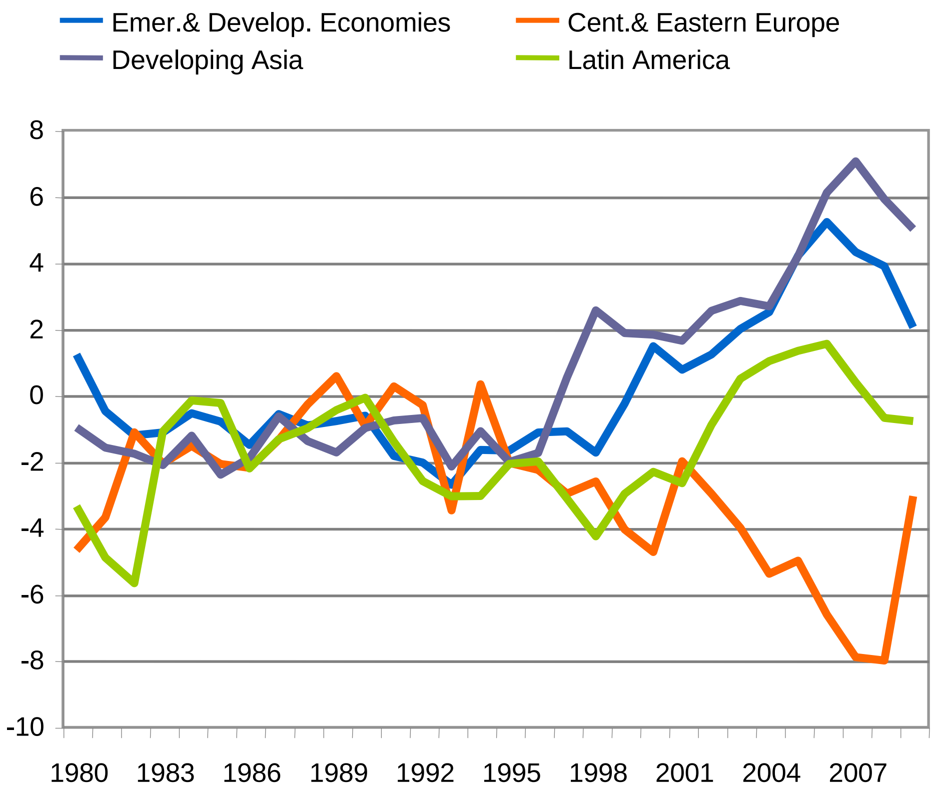


Source: IMF, *World Economic Outlook Database,* October 2009.

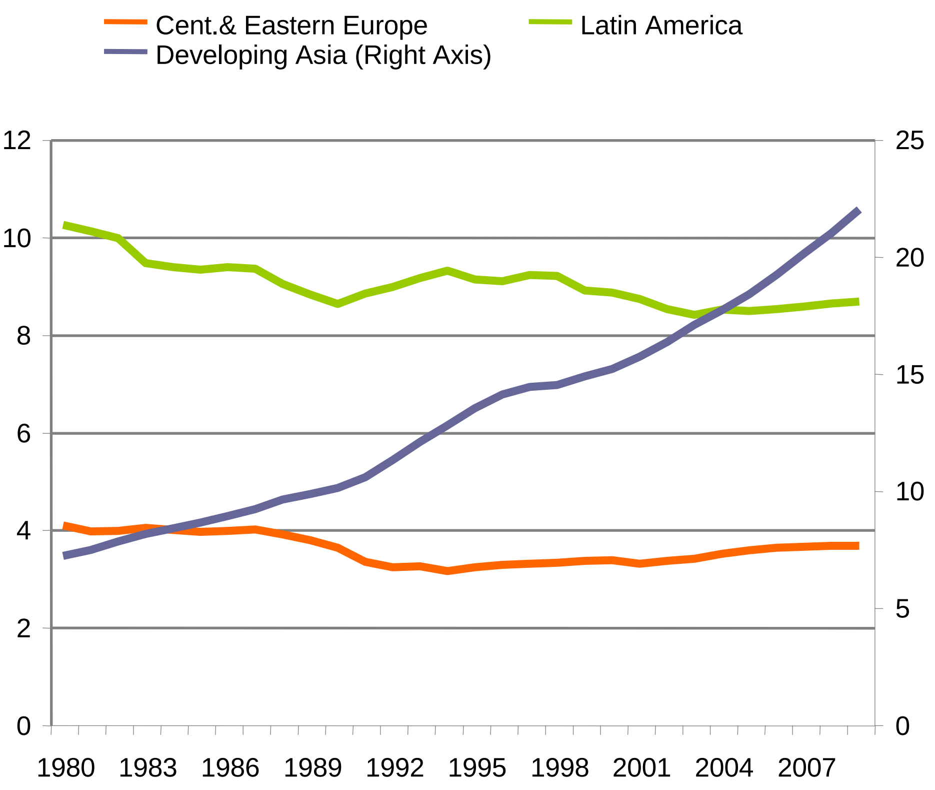
The Macroeconomic Context

Current account balance and GDP based on PPP

Current account balance (% of GDP)



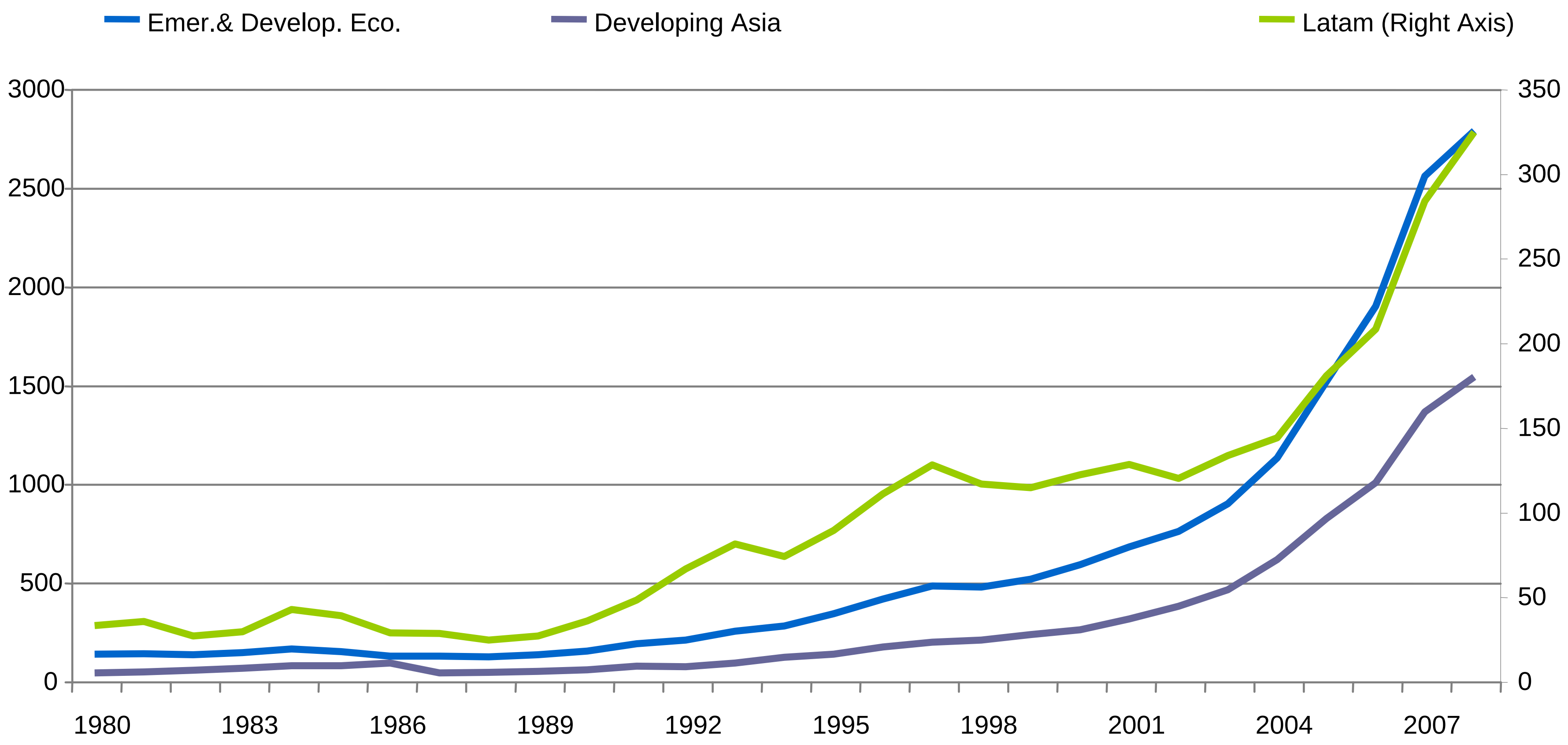
GDP based on purchasing-power-parity (PPP) share of world total (%)



Source: IMF, *World Economic Outlook Database,* October 2009.

The Macroeconomic Context

International reserves in emerging markets (billions of SDRs)



Source: IMF, *International Financial Statistics*.

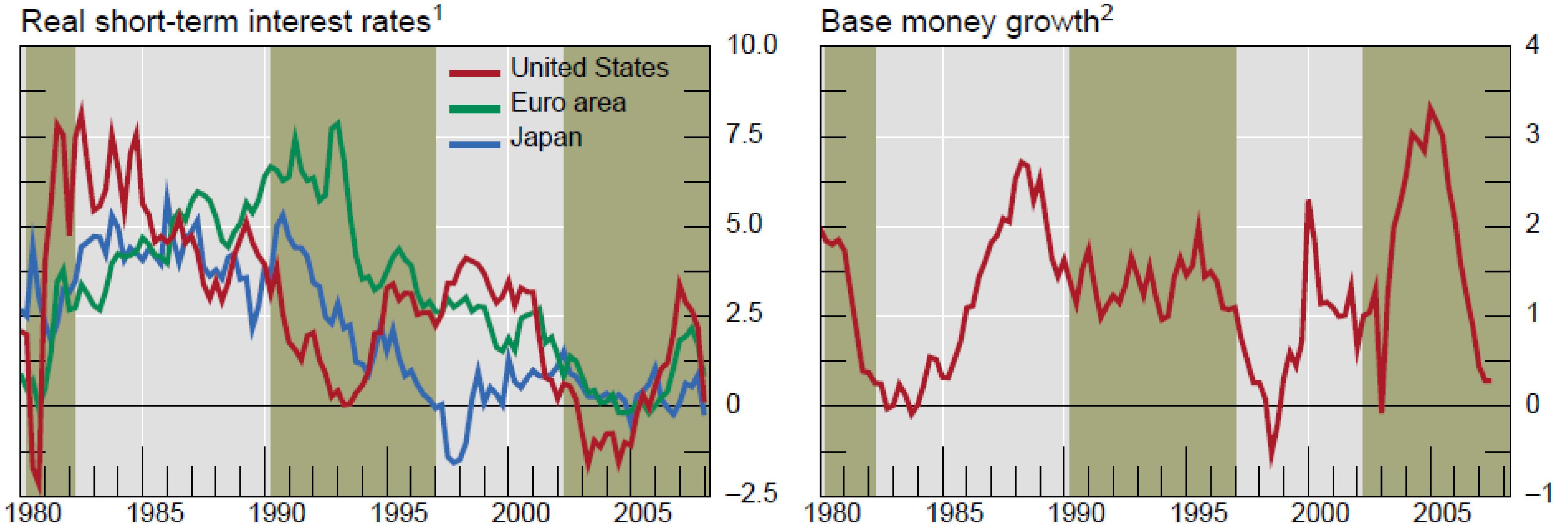
Macroeconomic Determinants of Capital Flows

Explaining capital flows

- The factors that determine capital flows can be separated between those related to the conditions in investors' countries (external factors) and those specific to the receptor country (internal factors).
  - External factors that have contributed to capital flows in recent years:
    - Low nominal and real interest rates and plenty of liquidity in industrial countries;
    - Large saving-investment gap in Emerging Asia and Oil exporting countries;
    - Volatility of financial asset prices (and the associated risk appetite).
    - The economic cycle in industrial countries.

External Determinants of Capital Flows

Real interest rates and base money growth in industrial countries (%)

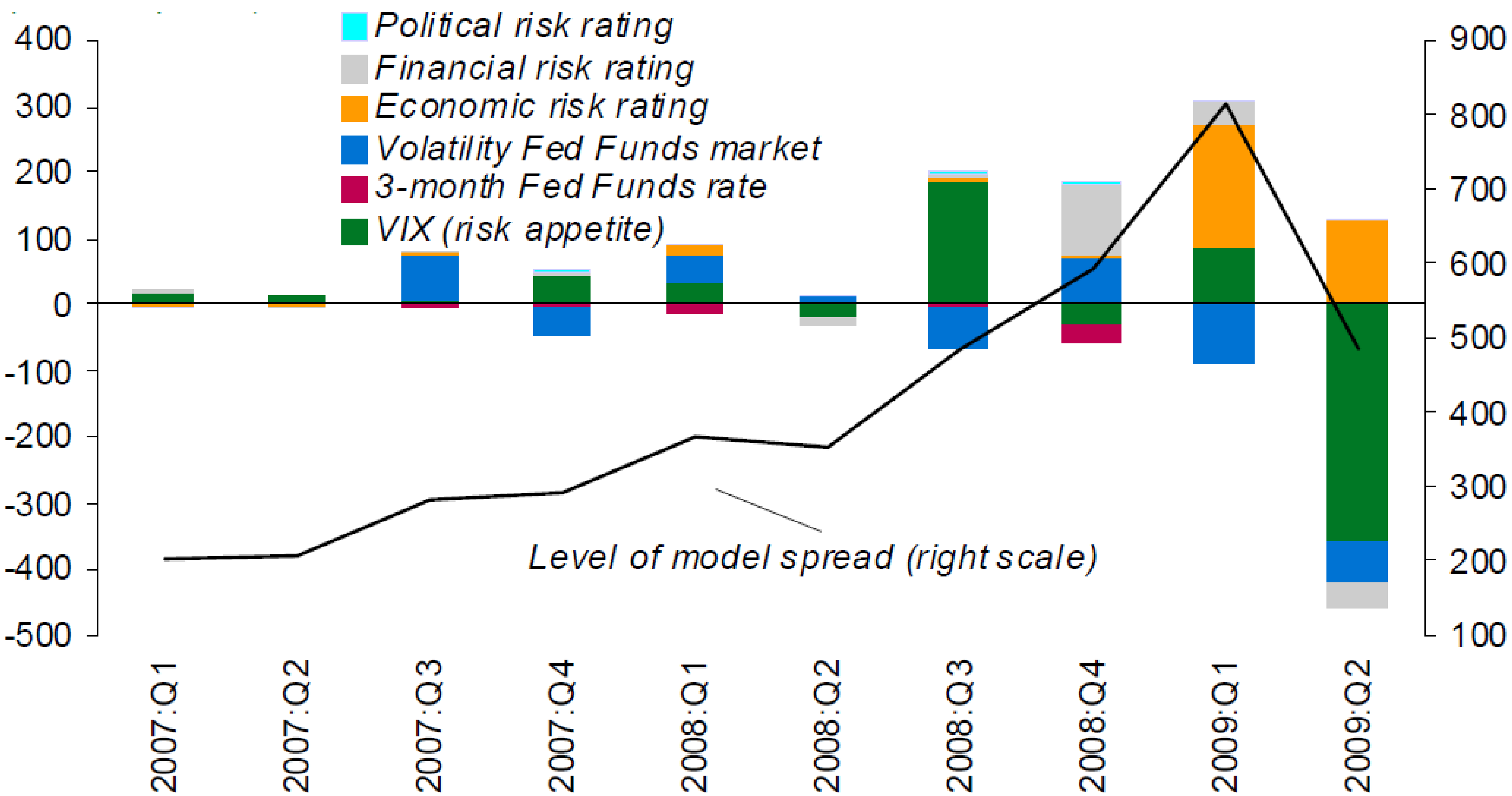


[1] In per cent. [2] GDP-weighted change over three years for the G3 economies. Shaded areas are capital flow cycles.

Source: IMF, World Economic Outlook.

Capital Flows to Emerging Markets

Contributions to Changes in EM Sovereign External Spreads (basis points)



Sources: GFSR, September 2009.

External Determinants of Capital Flows

Explaining capital flows.

- External factors contribute to the cyclical character of capital flows, but could also affect the trend.
- Portfolio diversification of institutional investors could lead to more stable growth in capital inflows to emerging countries.

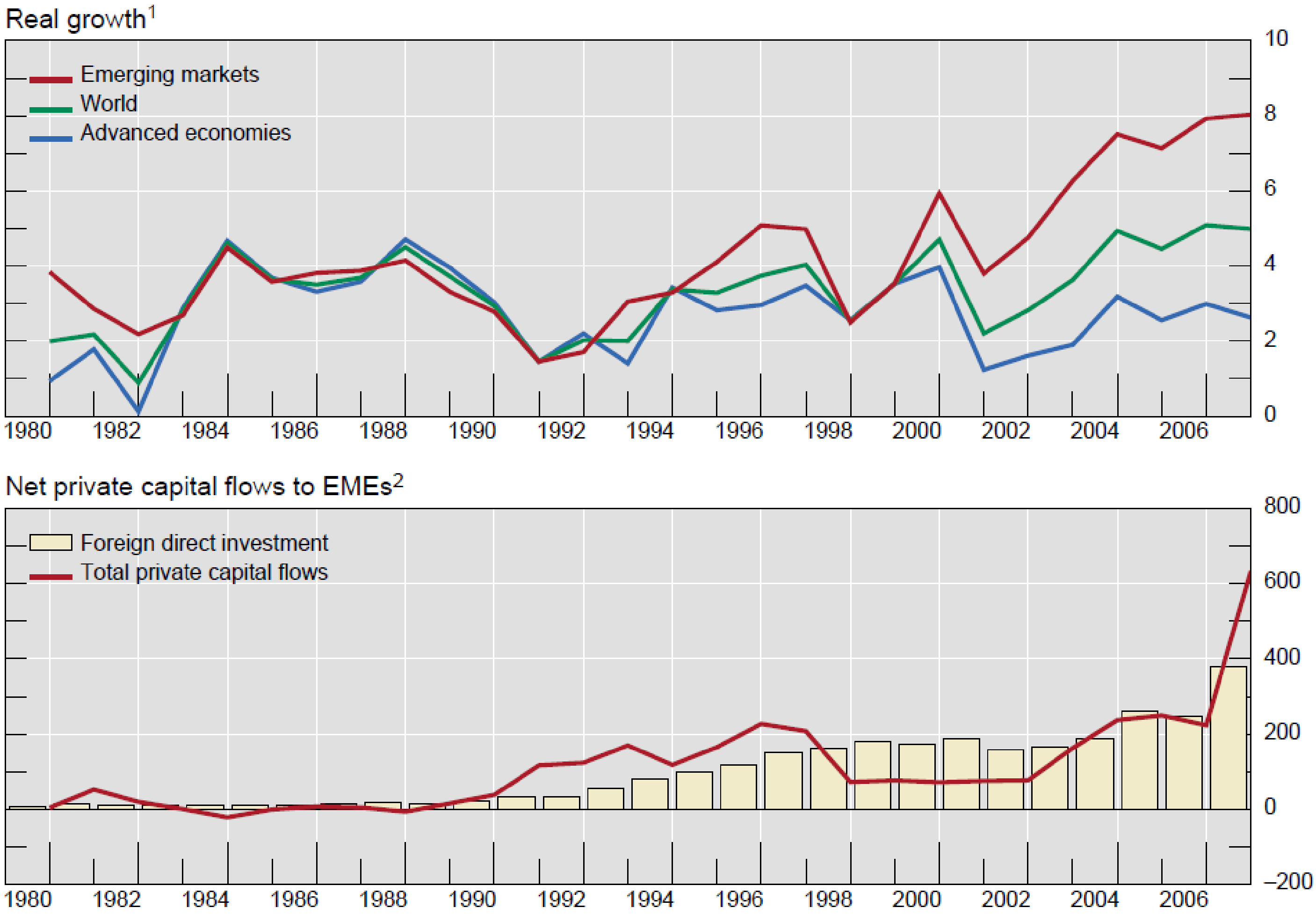
Macroeconomic Determinants of Capital Flows

Internal determinants of capital flows

- Domestic Factors: A major element that “pulls” capital flows towards emerging countries is a higher expected risk-adjusted return.
- The main determinants of the expected risk adjusted return are:
  - The difference in the rate of growth between emerging countries and industrial countries;
  - A reduced gap of the volatility of output growth and of inflation in relation to advanced countries;
  - The enforcement of contracts and the respect for property rights;
  - The institutional and incentive framework for capital flows and FDI.

Macroeconomic Determinants of Capital Flows

Real growth and net private capital flows to EME's (%, billions of USD)



Source: IMF, World Economic Outlook Database, October 2008.

Macroeconomic Determinants of Capital Flows

Foreign direct investment in emerging markets

- In the case of FDI, a recent panel data regression model for emerging markets flows of Deutsche Bank's finds that the main significant explanatory factors are:
  - The level of GDP (variable representing scale),
  - real GDP growth and the quality of public institutions (macroeconomic fundamentals), and
  - the performance of the U.S. equity market index, Dow Jones (external conditions)
- While deterioration in financial conditions has clearly taken a toll on FDI this year (almost -40%), the model suggests that there has been a structural break and domestic fundamentals have become relatively more important.
- FDI might rebound in countries that have managed to minimize the impact of the crisis on economic growth.

II. Capital Flows and Latin America

Capital Flows to Latin America

The change in fundamentals.

- The region has undergone many changes in recent years that have improved risk-adjusted rates of return:
  - Improvement in macrofundamentals;
    - More fiscal responsibility;
    - Monetary policies oriented towards achieving low and stable inflation, mainly using IT frameworks with increasingly autonomous central banks;
    - Improvements in regulation and supervision of the financial system;
  - More responsible fiscal policies during periods of commodity price booms, producing current accounts surpluses and the accumulation of foreign reserves.
  - Although net capital inflows have been affected by the current crisis the prospects for DFI and Equity flows should improve now that the financial crisis is being left behind and if the good regional fundamentals are strengthened.

Latin America

Fiscal Balance and Current Account Surpluses (% of GDP)

	Fiscal Balance		Current Account Surpluses	
	1991-1994	2004-2007	1991-1994	2004-2007
Argentina	0.83%	1.86%	-2.65%	2.88%
Brazil	-0.60%	2.38%	0.20%	1.20%
Chile	1.87%	4.25%	-2.65%	3.18%
Colombia	-0.73%	-3.79%	-0.38%	-1.68%
Mexico	0.25%	0.02%	-5.60%	-0.63%
Peru	-3.15%	-0.13%	-5.70%	1.40%
Venezuela	-0.44%	0.29%	-0.45%	13.75%
Average	-0.28%	0.70%	-2.46%	2.87%

Note: Fiscal Balance is the moving average of the Overall Balance between t-4 and t-1 quarters.
Source: Own calculations.

Latin America

Exchange Rate Regime

	1991-1994	2004-2007
Argentina	Fixed	Intermediate
Brazil	Float	Float
Chile	Intermediate	Float
Colombia	Intermediate	Float
Mexico	Fixed/Intermediate	Float
Peru	Float/Fixed	Fixed/Intermediate
Venezuela	Intermediate	Fixed

Source: Own classification based on the intra-quarter coefficient of variation of Nominal Exchange Rate. A country classified with two regimes had both regimes during part of the reference period.

Latin America

GDP Growth

	GDP Constant Prices Growth (annual percent change)		GDP Growth Volatility	
	1991-1994	2004-2007	1991-1994	2004-2007
Argentina	8.22%	8.83%	0.077	0.038
Brazil	2.82%	4.63%	0.086	0.039
Chile	8.24%	5.22%	0.059	0.038
Colombia	4.40%	6.22%	0.066	0.041
Mexico	3.55%	3.92%	0.05	0.027
Peru	4.82%	7.10%	0.149	0.034
Venezuela	3.43%	11.84%	0.07	0.094
Average	5.07%	6.82%	0.079	0.045

Source: Own calculations.

Latin America

Inflation

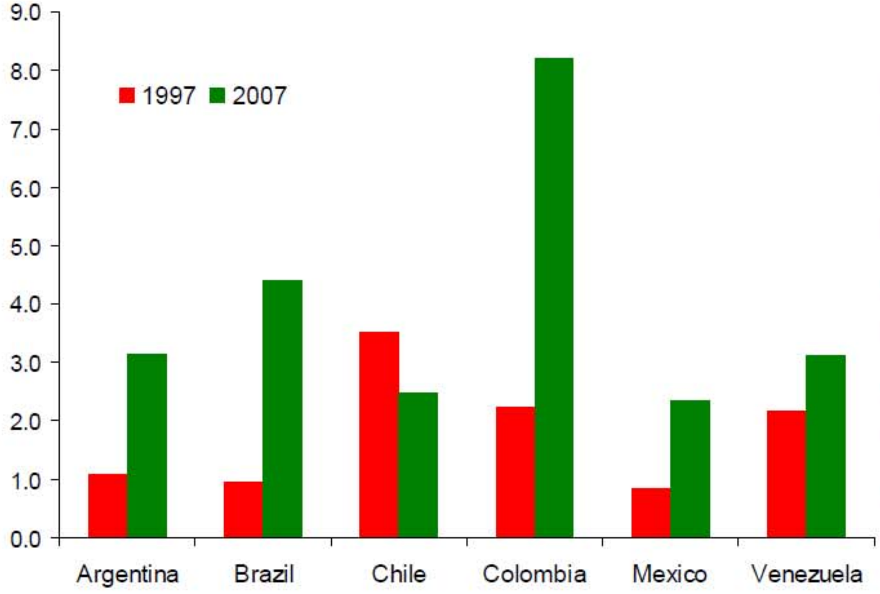
	Inflation - Average consumer prices (annual percent change)		Inflation Volatility	
	1991-1994	2004-2007	1991-1994	2004-2007
Argentina	54.82%	8.45%	0.741	0.022
Brazil	1375.76%	5.33%	9.565	0.018
Chile	15.35%	2.98%	0.072	0.034
Colombia	25.67%	5.20%	0.096	0.034
Mexico	13.72%	4.07%	0.044	0.028
Peru	138.84%	2.19%	327.586	0.022
Venezuela	41.14%	17.51%	0.072	0.049
Average	237.90%	6.53%	48.311	0.03

Note: Inflation Volatility is the rolling standard deviation of the inflation rate (average consumer prices, annual percent change) between t-3 and t quarters.
Source: Own calculations.

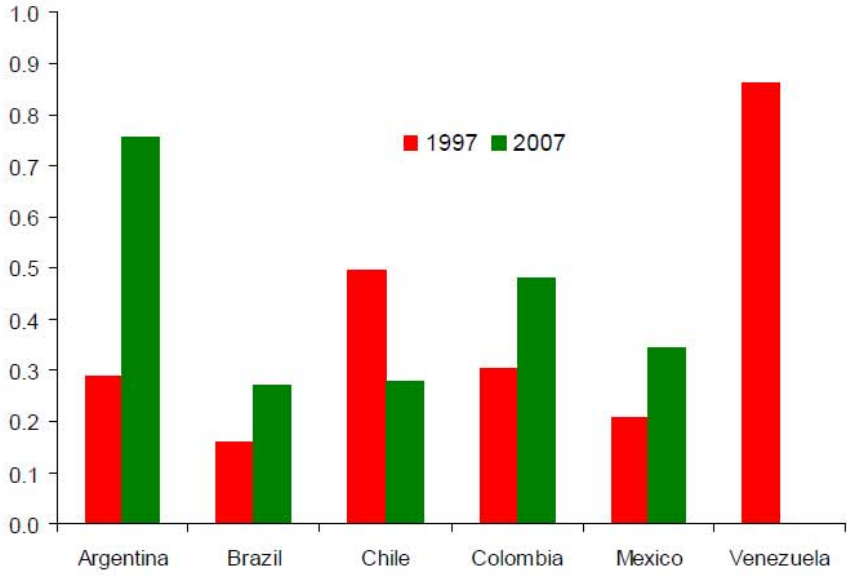
Capital Flows and Latin America

International reserves

International Reserves
(% of short term Debt)



International Reserves
(% of M2)



Source: IMF.

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