FINANCIAL FLOWS TO EMERGING MARKET ECONOMIES: CHANGING PATTERNS AND RECENT DEVELOPMENTS

Emerging market economies have become increasingly important on account of their rising integration into global markets. Following a spate of financial crises in the late 1990s and early 2000s, these economies are currently enjoying a period of relative stability and improving fundamentals. At the same time, the pattern of their integration is going through an extraordinary period. For these economies as a group, the current account is in surplus and this surplus has widened considerably, rendering them net exporters of capital to the rest of the world. Official reserves have accumulated at a rapid pace to unprecedented levels and other financial flows, which last year emerged unexpectedly from a five-year trough, are becoming more concentrated in particular categories and among certain economies. The growth of the Chinese economy is just one factor, albeit a major one, driving these developments. This article explores some of the factors affecting financial flows, including those in official reserves, and raises some questions about the unusual changes taking place.

1 THE INCREASING IMPORTANCE OF EMERGING MARKET ECONOMIES IN FINANCIAL MARKETS AND THE GLOBAL ECONOMY

Emerging market economies (EMEs) are currently experiencing an upturn in their fortunes. Following several years of very mixed performance marked by crisis episodes and reform-related difficulties, fundamentals are now improving and confidence is rising. As a result, emerging market economies are outperforming advanced economies in many respects, including in terms of economic and trade growth. Their current account surplus, which emerged after the Asian crisis in 1997-98 and was expected to dissipate as affected economies recovered, in fact continues to widen. While financial flows to these economies have doubled recently, their official reserves have risen at an even faster pace.[1] If changes in official reserves are included in financial flows, emerging market economies have increasingly become – contrary to conventional wisdom – net exporters of capital to the rest of the world, thus transferring surplus savings to more mature economies. These developments, in particular the pick-up in financial inflows and considerable reserve accumulation, are the subject of this article, which seeks to shed some light on these phenomena.

Developments in emerging market finance have become increasingly important as their role in global markets has grown. Through greater integration into financial markets, emerging market economies have not only been in a position to improve their own growth prospects, they have simultaneously offered greater diversification opportunities to foreign investors (from advanced economies and, increasingly, other less advanced economies). However, developments in emerging market economies may also pose risks for global financial market stability and consequently the analysis of these economies has become an intrinsic part of the assessment of such stability. This is not least because they tend to exhibit greater variability in economic fundamentals and, as a result, greater volatility in financial flows. At an institutional level, emerging market economies have become instrumental in shaping the new international financial architecture. This is not only because they have replaced mature economies as the main focus of assistance packages from international financial institutions, but also because the absolute level of assistance received through lending programmes has set new records and launched a debate about appropriate levels of support.

1 This article uses both a narrow and a broad definition of financial flows. The narrow definition (referred to in this article simply as "financial flows") encompasses all net private flows in the form of foreign direct investment, portfolio investment, other private investment (such as bank loans, trade credits and financial derivatives), as well as official flows, mainly in the form of financial assistance and portfolio investment. A broader definition, which the article uses in Sections 4 and 5 and which is referred to as "financial flows including official reserves", also includes the changes in official reserve assets.

For the purposes of this article, emerging market economies are represented by a group of economies selected from the EU neighbouring regions, Latin America and Asia.[2] This group comprises most of the key emerging market economies tapping international financial markets and thus captures the main developments affecting all such economies.

Emerging market economies have rapidly integrated into the world economy. Indeed, it could be argued that globalisation primarily reflects the integration (mainly via trade rather than financial flows) of these economies with mature economies. The share in world exports of the group of selected EMEs is expected to rise to 30% in 2004, i.e. over 60% more than the export share of the euro area, three times the share of the United States and over four times the share of Japan.

At the global level, this group of economies contributes significantly to world population and production. The group includes the two most populous countries in the world and accounts for over half of the world's population. Its combined gross domestic product (GDP) accounts for roughly one-third of world GDP (in purchasing power parity, PPP, terms), well above the 21% for the United States and 16% for the euro area. Within the group, China is by far the largest economy. Based on nominal GDP in 2003, it was twice the size of the second largest economy in the group, Mexico, and accounted for over 25% of the group's total. Moreover, for 2004, the group's contribution to the world's real GDP growth – using PPP weights – is estimated to reach 1.1 percentage points, with Asia alone accounting for 0.7 percentage point, i.e. more than the euro area or Japan (see Table 1).

The euro area is the single most important trading partner and provider of foreign direct investment (FDI) for several of these economies, notably for its European neighbours and in Latin America. At the same time, the selected group of EMEs accounts for 23% of euro area imports, 17% of euro area exports, and just under 15% of both euro area gross FDI outflows and the consolidated foreign claims of euro area banks. In addition to the macroeconomic and financial aspects of the relationship between the European Union and these economies, there is also an institutional

2 These economies comprise, on the European fringe, Russia and Turkey; in Latin America, Argentina, Brazil, Chile, Colombia, Mexico and Venezuela; and in Asia, China, Hong Kong SAR, India, Indonesia, Malaysia, Singapore, South Korea, Taiwan and Thailand.

Table 1 Importance of emerging market economies in the global economy

(percentages; 2004 projections)

	Share in world population	Share in world GDP (PPP terms)	Share in world goods exports [1)]	Contribution to world real GDP growth [2)]	Share in the EMBI Global [3)]
Euro area	4.8	15.5	18.4	0.5	-
United States	4.7	21.0	11.2	1.3	-
Japan	2.0	6.8	7.0	0.5	-
Selected non-EU emerging market economies	54.0	34.9	30.1	1.1	-
of which:					
Asia	44.2	25.0	23.0	0.7	6.3
Latin America	6.4	6.5	4.2	0.2	51.0
European neighbours	3.4	3.5	2.9	0.2	19.7
Global total	100.0	100.0	100.0	4.9	100.0

Sources: IMF Direction of Trade Statistics, Eurostat, JPMorgan Chase, IMF World Economic Outlook and ECB calculations.
1) Data refer to 2003 and are net of intra-euro area exports.
2) Average (in percentage points) of real GDP growth rates weighted by nominal GDP in US dollars.
3) The EMBI Global refers to the JPMorgan Emerging Markets Bond Index Global, which is a benchmark index for emerging market US dollar-denominated debt. Data are for September 2004.

dimension, e.g. the prospect of accession of Turkey to the EU, the Partnership and Cooperation Agreement with Russia, the framework inter-regional agreement with the countries of MERCOSUR (the "Common Market of the South" of Latin America) and the Asia-Europe Meeting (ASEM) with several Asian countries.

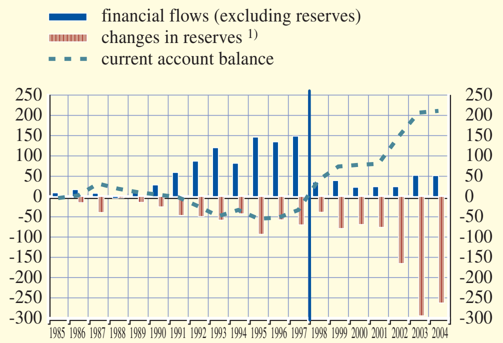
Of interest is not only the increasing role that emerging market economies are playing in global economic and financial spheres, but also the nature of their integration, which is going through an unusual period. The group's current account is in surplus long after their main crisis period. Following the financial crises in several Asian economies in 1997-98, it came as no surprise that the current accounts of these countries, and by aggregation the current account position for the selected group as a whole, swung into surplus. Financial inflows collapsed as international investors lost confidence in these economies and withdrew funds. Most currencies in the region were forced off their peg to the US dollar and plummeted, causing a surge in exports and a fall in imports. However, as the situation stabilised, the reverse could have been expected. Yet this did not happen. The current account surplus was not only maintained during the recovery phase, it has recently risen further (see Chart 1).

The surplus represents net financing provided to the rest of the world arising from a surplus of savings (at around 28% of the group's GDP) over investment (at around 22%). The current account surplus is accompanied by rising reserve accumulation, which has been no less dramatic. Reserves have reached unprecedented levels, particularly in Asia, partly driven by a desire to stabilise exchange rates in the face of appreciation pressures.

Moreover, financial flows have also experienced change. Not only have flows risen recently, there have been changes in both the type of flows and their geographical spread. Significantly, China has received increasingly

Chart 1 EMEs as importers/exporters of capital from/to the rest of the world

(USD billions)



Sources: IMF WEO database and ECB calculations.
1) For reserves, negative changes correspond to an increase in the level of reserves.

large inflows, so much so that were it not for China, net financial flows of the group would be negative. The changes provide insights into developments in borrower and investor sentiment, economic and financial structures across emerging market economies and, crucially, the nature of their integration into global financial markets. Section 2 explores the factors determining the recent changes in financial flows. Section 3 looks in more detail at the nature of the changes taking place. The issue of reserves is discussed in Section 4, while Section 5 examines regional differences in financial flows, including official reserves. Section 6 concludes.

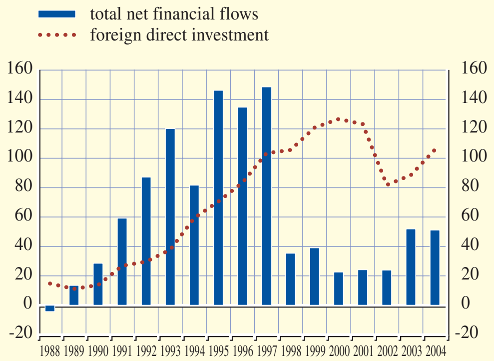
2 DETERMINANTS OF EME FINANCIAL FLOWS

In a surprise development, financial inflows to emerging market economies turned markedly upwards in 2003, more than doubling inflows during the previous year. This followed a five-year retrenchment in financial flows to these economies that had led to speculation about the demise of the asset class. Indeed, up to November 2002, primary bond markets were effectively closed to emerging market issuers in a six-month "drought".[3]

3 See "Global Financial Stability Report", IMF, March 2003.

Chart 2 Total net financial flows[1] and FDI flows to selected emerging market economies

(USD billions)



Source: IMF WEO database.
1) Excluding changes in reserves.

The five-year retrenchment period followed a series of crises in emerging markets. The series of crises began in Thailand in 1997 and spread rapidly through much of emerging Asia, followed in succession by Russia, Brazil, Turkey, Argentina and Uruguay. The adverse investment climate was perpetuated by the onset of unfavourable macroeconomic conditions in mature economies in 2000. By the end of that year, net inflows to EMEs had fallen to their lowest level in a decade.

The long period of retrenchment of financial flows from emerging market economies after 1997 marked the end of the expansion into a promising new asset class. New investment opportunities had opened up in the late 1980s and early 1990s as a wave of capital account liberalisation swept through these economies, removing restrictions on capital mobility. Investors had increasingly ventured into these markets and, with the exception of exposures to Mexico in 1994, fared relatively well until signs of strain emerged in certain of these economies. Chart 2 traces the rise, fall and partial recovery of net financial inflows to the group of selected EMEs since the late 1980s and, for comparison, the key component, FDI flows.

EME DETERMINANTS OF FINANCIAL FLOWS

The rejuvenation of financial inflows to emerging market economies in 2003 and 2004 was due to a combination of factors in both these and mature economies. In emerging markets, economic fundamentals improved in this period owing not least to reform processes in previously afflicted economies. The absence of crises and the presence of stability set the stage for the return of financial flows.

The "silver lining" of the crises was that emerging market economies endeavoured to put their house in order and many of the difficulties of the reform process have been overcome. This has been an important factor supporting the return of financial flows. In particular, most emerging market economies have made remarkable progress in: (i) improving the soundness of domestic macroeconomic policies, as well as the transparency and communication of monetary policy; (ii) the liberalisation, deregulation and privatisation of the economic system, as well as in areas such as banking supervision, financial sector stability and other aspects of domestic institutional and market infrastructure; and (iii) enhancing the availability and quality of information on local economies and financial markets.

These improvements have contributed to a strengthening of fundamentals, which has also played a role in attracting net inflows. Indeed, current macroeconomic conditions in emerging market economies, including large borrowers such as Brazil and Turkey, are currently healthier than they have been in a long time (see Table 2).

Overall, the real GDP growth of the group of emerging market economies accelerated to an (unweighted) average of around 6% in 2003 and is set to rise to close to 7% in 2004, the fastest pace in more than 20 years. A number of countries are growing at even higher rates, such as China and Russia, as well as Argentina and Turkey which are recovering after the crises of

Table 2 Main macroeconomic indicators of emerging market economies[1)]

	2001	2002	2003	2004[2)]
Real GDP growth (%)	3.7	4.9	6.0	6.7
CPI inflation (%)	5.6	5.1	5.1	4.9
General government balance (as a % of GDP)	-4.2	-4.5	-3.8	-3.3
Balance on current account (as a % of GDP)	1.6	2.7	2.6	2.0

Sources: IMF WEO database and ECB calculations.
1) Weighted averages (using PPP shares in world output) of the figures for the emerging market economies selected in this article.
2) Figures for 2004 are estimates.

2001-02. These rates of growth exceed those of mature economies and are unusual in that they reflect sound growth in all three EME regions simultaneously. To a degree, the high growth rates of these economies are mutually reinforcing. Resource-exporting economies have benefited from strong growth in resource-importing economies such as China and, to a lesser extent, India.

Other macroeconomic indicators have also improved. Inflation, at around 5%, is on a declining trend, although some countries (including Russia, Turkey and Venezuela) are still expected to record double-digit inflation rates in 2004. The soundness of public finances has improved overall, with general government deficits decreasing to close to 3% of GDP on average. Some countries however are still running high public deficits, such as India (almost 10%) and Turkey (6%), in part due to high levels of outstanding sovereign debt.

Reassuring to investors is arguably also the accumulation of reserves (predominantly in Asia). These provide a substantial cushion against possible limited access to global financial markets in the future and scope to stabilise the exchange rate of the domestic currency. This accumulation has been made possible by current account surpluses of emerging market economies as a group since 1998. The average balance on their current accounts rose sharply in 2002-03 to an unprecedented level and is expected to be close to 2% of GDP in 2004.

Indeed, improving economic and financial conditions have fostered a virtuous cycle supporting inflows. The commitment to a reform agenda and continuous improvement in fundamentals have helped stabilise exchange rates against key currencies, especially in Asia. The reform efforts and results led to a number of emerging market economies, including systemically relevant ones, receiving a rating upgrade of their foreign currency-denominated long-term debt in the last two years. Partly in consequence, their bond and equity markets have outperformed those of mature economies.

In a positive development, occurrences that could have been expected to dampen inflows across the board had a contained effect. Although subject to further verification, it is conceivable that improvements by emerging market economies, such as greater transparency and better information in terms of availability, timeliness and quality, assisted investors in better assessing risk and discriminating accordingly. This would explain the absence of contagion from, and limited effect of, negative factors such as SARS in East Asia in early 2003.

EXTERNAL DETERMINANTS OF FINANCIAL FLOWS

Due to the increasing integration of emerging market economies into global financial markets, mature and emerging market economies became increasingly intertwined over the course of the 1990s through a variety of channels, including trade, interest rate differentials and financial asset price trends.

In this respect, the upswing in financial flows in 2003 may be partly attributable to developments, which were to some extent interrelated, in advanced economies.

Undoubtedly, a key external contributor to improved emerging market inflows has been the improved growth and growth prospects in the three major mature economies as a group and individually. One channel is via exports. The economic recovery in mature economies in 2003 improved the prospects for EME exports and, in consequence, expectations of emerging market economies' macroeconomic performance and future corporate profits, thereby raising financial inflows (e.g. to Asia). Another channel is via reduced risk aversion. The confidence inspired by faster growth in mature economies rejuvenated investor sentiment and contributed to a shift away from safe-haven assets, such as triple A-rated mature economy government bonds, towards lower-rated debt such as that of most emerging market sovereigns.

In addition, the abundance of liquidity coupled with the persistence of historically low yields in mature economies have driven a "search for yield" that enticed investors back into emerging markets. Cash positions were built up as investor aversion towards mature economy financial assets grew around the turn of the century, partly in response to the bursting of the equity bubble in late 2000. Moreover, nominal and real interest rates in many mature economies – and thus the opportunity cost of holding money – fell to historically low levels.

As a consequence of the widening interest rate differentials with mature economies, investments in emerging markets became increasingly attractive. This is in line with the so-called "old view" of the determinants of flows to emerging market economies, which is based on divergent monetary conditions. There are however new developments in this regard. One is the greater investment interest shown by financial institutions with liabilities carrying guaranteed nominal returns (such as life insurers). The need to generate the promised returns coupled with the rating upgrades of debt to investment grade for several emerging market economies have enticed these institutions into the asset class. Another is the large rise in "carry", that is, investment in high-yielding EME instruments using debt raised at lower cost in mature markets. While the first development may bring stability to the asset class, the second is more likely to increase its vulnerability in that "carry" is highly sensitive to a narrowing of the interest rate differential.

The initial pick-up in inflows to emerging market economies in early 2003 is thought to have been encouraged by rising financial asset prices in mature economies at that time. These price rises both increased risk tolerance and reduced the need to close EME positions to cover losses elsewhere. This reflects a "new view" of the relationship between mature economies and financial flows to emerging market economies, based on asset price developments in mature economies rather than on monetary conditions as in the "old view". This new view arose as equity and bond markets in advanced economies faltered and flows to emerging market economies weakened, and it appears to have retained its validity as these markets recover. Since March 2003, the strengthening of advanced economy equity markets and declining risk premia on corporate bond yields in mature economies have helped to lessen investor aversion towards EME assets and fuel net inflows to these economies.

An indication of investor risk aversion is provided by the Chicago Board Options Exchange SPX volatility index, a market estimate of future volatility based on the weighted average of the implied volatilities for a wide range of strike prices. Although only a proxy for risk aversion in relation to the US equity market (by gauging uncertainty surrounding future equity returns), it is nevertheless revealing in that it has declined steadily from its peak of about 40% in

September 2002 (at the time of the Brazilian presidential election) to around 13% at the end of the first quarter of 2004, a level well below its ten-year average.[4]

THE RECOVERY IN FINANCIAL FLOWS: WEAK OR STRONG?

Although much is made of the recent upswing in financial flows, by historical standards the recovery in inflows appears rather moderate so far. This is especially the case if inflows to China are excluded (which results in the net group inflow of USD 51 billion turning into a net group *outflow* of an estimated USD 43 billion). As discussed previously, the fundamentals of emerging market economies have improved and are reasonably sound, even if less stable than those of mature economies. Economic growth is strong in both advanced and emerging market economies, and the growth differential favours EMEs. Circumstances also support strong net inflows in line with both the "old" and "new" views of their relationship with mature economies, namely, interest rate differentials favouring EMEs and rising asset prices in advanced economies respectively. Yet even though net inflows in 2003 and 2004 were double the average of the previous three years, they pale in comparison with the size of the current account surplus and change in official reserves. Remarkably, they are only one-third of the financial inflows at the height of the last peak in 1995-97.

This raises the question of whether the 1995-97 peak is an appropriate benchmark, or whether – as has since been claimed – the net inflows of the mid-1990s were symptomatic of a bubble inflated by a range of advanced and emerging market factors. According to this interpretation, upon the opening-up of capital accounts in emerging market economies, strong demand for finance in those economies was readily accommodated by mature economy investors, against a backdrop of healthy growth prospects relative to advanced economies and fixed exchange rates that effectively removed exchange rate risk. The novelty of the asset class may also have played a role insofar as credit and investment decisions may have been made on the basis of analytical tools more suited to advanced economies and of poorer information (in terms of availability, timeliness and quality) than in mature economies.

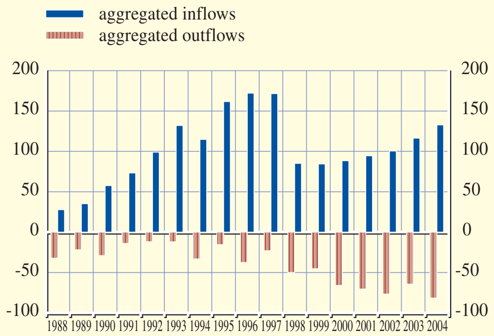
To the extent that these factors played a role, the magnitude of net inflows in the mid-1990s might be considered excessive. If so, the lower levels currently observed may better reflect economic and financial conditions, and provide the basis for a more appropriate benchmark. Unlike in the mid-1990s, there is now less scope for moral hazard-induced inflows. Not only have many emerging market economies (though few in emerging Asia) shifted to a floating exchange rate regime, which removes the scope for speculative attacks on pegged rate regimes, FDI has replaced more footloose types of finance such as bank lending and portfolio flows. Moreover, investors are now better able to discriminate among EMEs and thus target their investment. This is borne out by the fall in contagion, which may be due in part to efforts by EMEs to develop the availability and quality of information and in part to improved credit analysis. Importantly, the swing from current account deficits to surpluses also implies a diminished need for external financing.

A major development of the last few years that suppresses the figures for *net* group inflows is the strength of financial outflows. The strength of outflows can be gauged by a comparison of aggregated net inflows with aggregated net outflows of individual economies in the group for each year. Aggregated net inflows (outflows) represent the sum of net inflows (outflows) for all those economies in the group that recorded a net inflow (outflow). Chart 3 shows that aggregated net inflows have been

4 See "Determinants of the rally in emerging market debt – Liquidity and fundamentals" in the *Global Financial Stability Report*, IMF, April 2004.

Chart 3 Aggregated net financial flows[1] of individual emerging market economies

(USD billions)



Sources: IMF WEO database and ECB calculations.
1) Excluding changes in reserves.

on a steady upward trend since 1999, but that aggregated net outflows are on average considerably higher now than in the boom years of the mid-1990s, which drags down the figures for net flows for the group as a whole. Of these net outflows, while some are signs of weakness (e.g. capital flight from Russia owing to banking sector instability in 2004), others are quite the opposite (e.g. outward investment from the major financial centres of Singapore and Hong Kong SAR).

There has also been an increasing concentration of net inflows and dispersion of net outflows. By way of illustration, seven economies were expected to attract more net inflows in 2004 than thirteen did in 1993 (a year of comparable net inflows for the group as a whole). This may in part reflect increased investor discrimination, but the rapid emergence of a relatively large economy – China – is highly significant. Since 2002 net inflows to China have risen by twice as much as total aggregated inflows, and in 2004 China was set to account for as much as 70% of the total.

On the basis of the above, there are grounds to conclude that the recent net inflows to emerging market economies are not particularly poor when set in a historical context. However, whether 2003-04 net inflows provide a better benchmark in view of the large current account surplus and the group's even larger build-up of reserves remains an open question and constitutes an important avenue of further research. In this regard, a pertinent issue is the extent to which the large size of foreign exchange reserves relative to other financial flows represents "insurance" and could supplant the role of the IMF in a crisis situation.

3 CHANGES IN FINANCIAL FLOW COMPOSITION

The doubling of net financial inflows in 2003 to around USD 50 billion – a level which is expected to hold in 2004 – not only represents the highest level of inflows since the onset of the Asian crisis in 1997, but also reflects a change in composition compared with both the retrenchment period and the previous rise in flows prior to 1997. Overall, the upswing in net financial flows reflected a resumption of growth in net FDI inflows which, at around 170% of total net flows, provided the mainstay of net financial inflows, as they have over the past decade. These FDI inflows (estimated at over USD 100 billion in 2004) were partially offset by net outflows of bank loans and related flows[5] (of around USD 30 billion) as well as official flows (USD 15 billion). Portfolio inflows and outflows were roughly in balance, after recovering from large net outflows in 2001-02. These developments, shown in Chart 4, reveal changes in investor sentiment towards different types of investment.

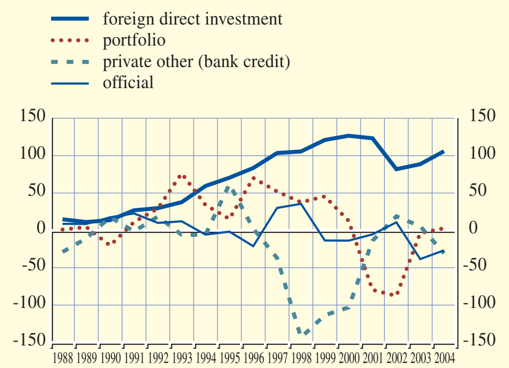
FOREIGN DIRECT INVESTMENT

Foreign direct investment remains by far the largest, least volatile and only continuously positive component of net inflows to the group of selected economies. This in part reflects the fact that FDI is unlike other types of finance in

5 "Bank loans and related flows" refer to the category entitled "private other investments" in the IMF's World Economic Outlook (WEO) database, from which data for this article were drawn. Note that while this category is mainly composed of bank-related flows, it also includes other items such as trade credit.

Chart 4 Net flows to the group of emerging market economies by type of flow

(USD billions)



Sources: IMF WEO database and ECB calculations.

that, in the context of flows between advanced and emerging market economies, the balance falls overwhelmingly in favour of the latter, not least on account of their lower production costs. Hence, FDI inflows to EMEs continue to dwarf FDI outflows from EMEs.

The recovery in mature economy growth after 2001 contributed to the pick-up in FDI inflows. Empirical studies confirm the link between advanced economy growth and FDI inflows, as well as portfolio flows, which is also observed. Yet the recent inflows (of around USD 100 billion on an upward trend) remain well below the peak in 2000 (of around USD 130 billion), even though advanced economy growth rates are no lower now than then. The 2000 peak followed a decade of rising FDI inflows (primarily to both Asia and Latin America in roughly equal measure) that was brought to an end not only by the fall in mature economy growth, but more specifically by rising political and economic instability in certain countries in Latin America. As a result, FDI inflows to Latin America are still less than half the levels in 2001 before the Argentine crisis.

More than any other type of financial flow, FDI is highly concentrated among a few countries. Since the dramatic fall in FDI to Latin America, Asia has consolidated its position as the main recipient region, and within Asia, China as the main recipient economy. China alone absorbed almost half of total net FDI inflows into the selected group in the past two years, while the top four recipients (a group which invariably also includes Mexico and Brazil) account for over 80% of all flows. Particularly in the case of China, this raises concerns about the extent to which the country is attracting FDI away from other emerging market economies.

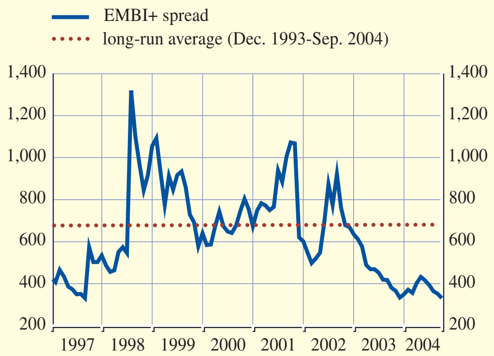
PORTFOLIO FLOWS

Portfolio flows are less stable than FDI flows and more influenced by short-term prospects, which suggests a balanced outlook for emerging market economies based on current trends. The switch in portfolio flows from large net outflows in the two years to end-2000 (during which bond markets were in effect closed to new emerging market issuers for six months) to small net inflows in 2003-04 disguises a rally in both emerging bond and equity markets, evident from falling bond spreads and rising aggregated inflows of individual economies. These aggregated inflows, spread over almost half of all major EMEs (but concentrated especially in China and South Korea), were offset by net outflows from Asian financial centres (Hong Kong SAR and Singapore), as well as Russia.

The rebound in inflows reflects improved economic growth rates and low interest rates in mature economies as well as strong fundamentals in emerging market economies, as discussed in Section 2. The improved fundamentals have been underpinned by a two-year period of rating upgrades affecting two-thirds of the group, including Argentina, Turkey, Russia and Brazil. Overall, investment-grade issuers now account for around two-thirds of the group's members and over half of the group's stock of outstanding external government bonds. Buoyed by the rally, both bond and equity returns rose strongly over the last two years relative to those in advanced economies.

Chart 5 EMBI+ spread since 1997 and the long-run average[1)]

(basis points)



Sources: JPMorgan Chase and ECB calculations.
1) EMBI+ "Performing" index (which excludes defaulted bonds).

The resumed interest in EME bonds in the search for yield has led to a large fall in bond spreads and a sharp decrease in spread dispersion across the credit spectrum. Bond spreads fell from their recent peak in September 2002 to more than 300 basis points below their ten-year average level, i.e. a level similar to that prevailing before tensions mounted in Asian economies in late 1997, as the Emerging Markets Bond Index Plus (EMBI+) spread over US Treasuries in Chart 5 illustrates. The narrowing in spreads has more recently been supported by the (short-run) positive impact of higher oil prices in international markets on weaker, net oil-exporting borrowers (such as Venezuela and Ecuador).

Several sovereign issuers have used the favourable conditions to better structure their liabilities and pre-finance future requirements, which has helped improve fiscal balances. This involved, for example, reducing the share of domestic debt linked to the exchange rate and of variable interest rate debt, and issuing cheaper Eurobonds in exchange for Brady bond debt, which became an expensive and illiquid form of financing in the late 1990s. Increasingly, and in a sign of growing EME readiness to accept a contractual solution in the event of a debt workout, collective action clauses covered by New York law have featured in new issues.

While prompting strong net issuance, the fall of the EMBI+ spread (see Chart 5) has also raised concerns over weakening investor discrimination in bond markets and potential mispricing. This reduction in investor discrimination, evident also from the compression of bond spreads across EMEs, may reflect a shift in the investor base. Cross-over investors (investors who move into and out of competing asset classes as profit opportunities shift) have taken an increasing interest in emerging market economies and are now estimated to account for around half of the market share. The increasing importance of opportunistic cross-over investors is likely to have increased the vulnerability of emerging markets to changes in interest rates in the United States. This implies that EME bond markets could now be more exposed to unexpected deviations from the expected path of future interest rate increases in the United States, which puts at risk particularly those economies that have large external financing, are sub-investment-grade borrowers or have a vulnerable debt structure.

BANKING-RELATED AND OTHER FLOWS[6]

After only two years of net inflows to emerging market economies, cross-border loans are set to weaken again in 2004. In contrast to all other components, bank flows appear to be negatively related to growth in mature economies and the growth differential between mature and emerging economies.[7] Moreover, bank lending to emerging market economies is, along with private portfolio flows, the most

6 The discussion here is based on the IMF's WEO database figures for "private other capital flows", which are mainly made up of bank lending. Determining actual bank lending with greater accuracy necessitates recourse to other sources, which introduces data consistency problems. Nevertheless, trends appear similar across sources.

7 There is empirical support for these relationships: see, for example, C. M. Reinhart and V. R. Reinhart (2001), "What Hurts Most: G-3 Exchange Rate or Interest Rate Volatility?" in S. Edwards and J. Frankel (2001), *Preventing Currency Crises in Emerging Markets*, University of Chicago Press, pp. 73-99.

volatile component of financial flows. (Such bank lending was mainly responsible for the collapse in financial inflows following the Asian crisis, when bank-related flows fell from a peak of over USD 50 billion in 1995, to minus USD 140 billion in 1998, before recovering to around USD 20 billion in 2002.) It is not surprising therefore that cross-border loans were expected to swing sharply into negative net outflows in 2004.

While bank flows and portfolio flows share a high degree of volatility, bank flows distinguish themselves in their discrimination according to credit quality. This is evident in the shift to better quality credits and sovereigns both within and across EME regions, and the increase in the share of claims backed by third-party guarantees.

Asia is by far the largest bank borrowing region, which is partly a reflection of bank-based domestic financial systems. Indeed, changes in banking flows to Asia drove the precipitous rise and fall of banking flows to the group of selected EMEs between 1995 and 1999, and their subsequent rebound. Increased net lending to Asia (mainly China, Taiwan and South Korea) is motivated by both interest rate differentials with US rates and speculative views on exchange rates. Banking flows into and out of European neighbours have been roughly in balance since the late 1990s, except for 2003 when net flows turned positive due to lending from almost every major banking system to all sectors. By contrast, Latin America has recorded net banking-related outflows since the mid-1990s, reflecting not least deposits by Latin American banks in foreign banking systems to contain exchange rate risk.

OFFICIAL FLOWS

The demand for official inflows has receded of late, as crises have passed. From modest net outflows averaging USD 5 billion between 1999 and 2002, official flows turned sharply downwards in 2003-04 as the need of emerging market economies as a whole for official inflows declined. Asia recorded its sixth year of net official outflows following net disbursements to the region in 1997-98 and increasing outward assistance from Singapore. Only Indonesia has yet to settle obligations outstanding to the IMF (of around USD 10 billion) following the Asian crisis. European neighbours also recorded large outflows as Russia continued to amortise IMF loans. For Latin America, official flows have shrunk over the last two years as there have been no more large receipts of official assistance, such as by Brazil in 2001 and 2002, and significant repayments (e.g. by Brazil and Argentina) are yet to commence.

4 FROM NET INFLOWS TO NET OUTFLOWS: RESERVE ACCUMULATION

Despite the recent upturn in net financial inflows, major emerging market economies were net exporters of capital in 2004 for the seventh year in a row. This reflects the switch of their current account balance from deficit to surplus after the Asian and Russian crises, as shown in Chart 1. Such a trend runs counter to standard economic theory, according to which capital is expected to flow from capital-abundant mature markets to capital-scarce emerging markets, where its marginal productivity should be higher. Net financial *outflows* including official reserves first occurred in 1998 for the selected group. These outflows rose most significantly between 2001 and 2003 to over USD 200 billion, compared with average *inflows* of USD 30 billion for 1990-97 and USD 3 billion for 1980-89.

The most significant aspect of the net outflows has been the growth in official reserves, which has been driven by Asia, and especially China. Part of the motivation for the accumulation of reserves is the wish by a number of economies to rebuild reserves after depletion during their currency crisis in the late 1990s, and to fulfil a precautionary need of self-insurance against future crises. However, for certain economies, it also reflects the desire to accommodate a current account surplus with the United States and keep the domestic currency from appreciating against the weakening US dollar. Maintaining a stable exchange rate with the US dollar is a cornerstone of these economies' development model.

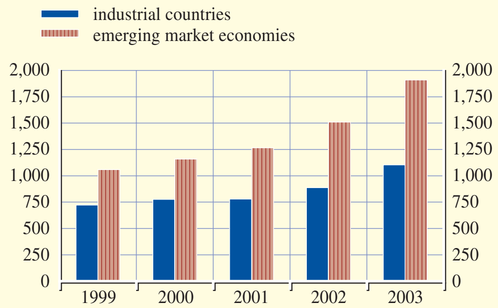
Growth in reserves overshadowed even the unprecedented rise in the current account surplus. The current account surplus rose by one and a half times on account of growing trade surpluses in Asia (especially in China, Singapore and Taiwan) and a shift from trade deficits to trade surpluses in Latin America (especially in Brazil and Argentina). Reserve accumulation however quadrupled in the three years to 2003. The addition to reserves is expected to reach USD 260 billion in 2004, following USD 290 billion in 2003 and USD 165 billion in 2002, compared with an average of USD 75 billion in the three prior years. Of this, Asia accounted for around 85% and China alone for around half.

This raises the question about the point at which reserves are sufficient and further accumulation is unwarranted. The rapid accumulation of reserves is not without risks and costs. It may increase opportunity costs, pose risks for central bank balance sheets (via increasing exposure to US bond prices and exchange rate movements), put upward pressure on goods, services and asset prices (to the extent that sterilisation is incomplete), and may to some extent hinder the necessary adjustment of global current account imbalances.

Already the stock of reserves held by emerging market economies well exceeds reserves of mature economies, at almost USD 2 trillion in 2003 (see Chart 6). Asia's reserves dwarf those of Latin America and the European neighbours, whose stocks amounted to USD 160 billion each in 2003 (the largest are in Brazil and Russia). Recent figures for Asian central banks confirm the upward trend in reserve accumulation, with stocks in Asia amounting to almost USD 1.4 trillion at the end of September 2004. Of Asia's reserves, China alone holds over USD 500 billion, and Hong Kong SAR, Taiwan and South Korea together a further USD 500 billion. It is now estimated that seven Asian countries hold reserves in excess of 30% of GDP (compared with an average for the world of 10%).[8] In this respect, Asian economies are most exposed to the risks and costs. Losses on sterilisation have already been recorded, owing to the positive yield differential between domestically issued bonds and US Treasuries, as the case of South Korea illustrates.

Chart 6 Stocks of reserves

(USD billions)



Sources: IMF (2004) and ECB calculations.

5 REGIONAL DIFFERENCES IN FINANCIAL FLOWS

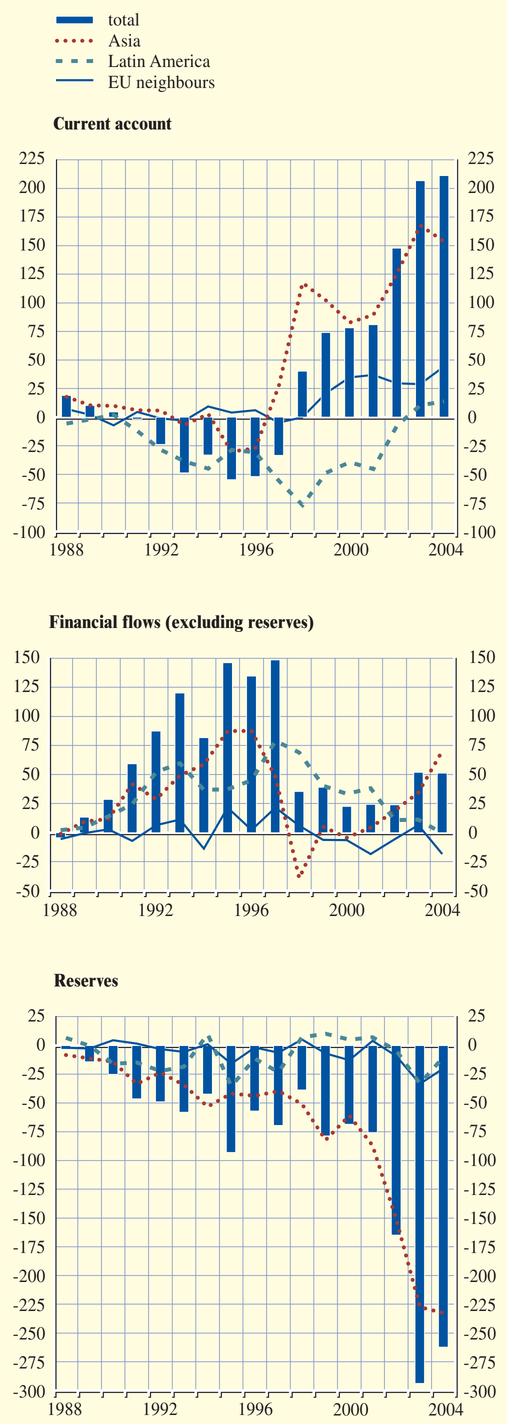
Not only have there been marked changes in the financing composition, but also in the distribution across regions. The three EME regions under consideration have experienced quite different developments in financial flows, both excluding and including reserve accumulation, and current account balances as Chart 7 shows.

Asia emerges as the driver of trends for the overall group. From the late 1990s, its

8 R. Subbaraman, J. Russel and H. Shiraishi (2003), "Damocles: low risks, but for how long?" in *Global Economics*, Lehman Brothers, 3 December. The seven economies are China, Hong Kong SAR, Malaysia, Singapore, South Korea, Taiwan and Thailand.

Chart 7 Regional differences in capital movements

(USD billions)



Sources: IMF WEO database and ECB calculations.

current account surplus, official reserves and other financial flows rose dramatically, far exceeding those of Latin America and European neighbours and dictating composite movements. The most striking development is arguably the rapid increase in reserves to unprecedented levels, as mentioned earlier. In view of these developments, Asia is also the largest exporter of capital.

Within Asia, China dominates. For 2004, China alone is expected to account for almost 20% of the group's current account surplus, almost 60% of reserve accumulation and over 180% of other net financial inflows. While Asia commands almost three-quarters of all FDI inflows, China alone commands almost half. A growing proportion of China's FDI inflows comes from other Asian economies such as South Korea and Taiwan. At the same time, net FDI receipts by several other Asian economies have come under pressure. On the upside, strong growth in China has raised demand for raw materials and investment goods, which has particularly benefited its regional neighbours, offsetting to varying degrees the negative impact of its low-wage competition with some of these countries. Partly in consequence, emerging Asia has been the fastest growing EME region over the last two years.

Latin America differs from the other two regions in that it eliminated its current account deficit and its financial inflows collapsed over the past several years. These years were marked by economic and political instability following successive years of crises and tensions.

Strikingly, the region's net financial inflows fell from a high in 1997 to negligible amounts in 2004. The region's traditional reliance on FDI suffered from both a reassessment of risk in light of measures taken by the authorities in the Argentine crisis and the gradual exhaustion of privatisation and M&A possibilities. As a result, FDI inflows are only half the 1997-2001 average. Official assistance, which buoyed inflows to Argentina and Brazil in 2001-02, has also come to an end. On the other hand, there has been a rally in bond and equity markets over the last two years as a result of both advanced economy and EME factors discussed in Section 2, in particular the "search for yield", which was greeted by active debt liability management by sovereigns to reduce vulnerability. Unfortunately, the rally has done little more than restore net portfolio inflows to just above balance following the massive exit between 1999 and 2001 as the Brazilian real was devalued and the Argentine crisis loomed. Bank credit remains a drag on net inflows as regional banks are parking deposits in overseas financial institutions.

The crisis and tensions prevented reserve accumulation until 2003, when the financial account swung into surplus. This shift out of a long-term deficit reflected, in the initial reversal of its downward trend, the devaluation of some currencies (such as the Brazilian real in 1999 and the Argentine peso in 2001), and later increased demand for raw materials (not least from China) and more recently increased oil prices.

The two major emerging economies *neighbouring Europe*, Russia and Turkey, both suffered debt-related crises, in 1998 and 2001 respectively. However, they currently enjoy improving macroeconomic fundamentals (good growth, falling inflation) and financing conditions (falling domestic interest rates and spreads, and improved sovereign credit ratings).

Turkey's economy continues to strengthen under the stabilising influence of political calm, official assistance, an IMF programme and advances towards the commencement of accession negotiations with the EU. Russia is enjoying strong demand for its natural resources and the windfall from high oil prices, posting its fifth fiscal surplus in a row and a rising current account surplus. The counterpart to this is a jump in reserves, which are the largest among emerging market economies outside Asia.

In contrast to the other two regions, net financial flows to both countries have been negative continuously since 1999 (with the exception of 2003 owing to a spike in bank loans to Russia), notwithstanding a large assistance package to Turkey in 2002. Net FDI inflows are negligible, while in bond markets, Russia's fiscal surplus obviates the need for government borrowing, although corporates (especially oil and gas companies) remain active. Turkey, on the other hand, continues to tap bond markets to finance its shrinking fiscal deficit.

6 CONCLUSION

Emerging market economies have become an important part of the global economy and global financial system. Latest developments in EME financial flows including official reserves are unprecedented and pose a number of challenges to conventional thinking, to domestic policy-making and to the international community. Not least important are the questions of how to interpret the switch by EMEs to becoming net providers of capital, the sustainability of reserve accumulation and the basis on which to judge the strength of the recent upturn in financial flows.

The remarkable thing about the recovery in financial flows after a five-year lull has been the concentration of flows by composition (in FDI) and by region (in Asia). Without FDI, or without Asia, net financial flows to emerging market economies would have been negative. Furthermore, China's rapid rise to a position of dominance within the group cannot be ignored. This is illustrated best by China's net receipts of FDI, which account for over 90% of total net EME financial flows. This raises questions about the relative role of portfolio and banking flows when FDI flows are overwhelmingly dominant. It also raises questions about whether the smaller economies are having difficulty raising finance with China absorbing such a large share of inflows.

The accumulation of reserves is also predominantly an Asian phenomenon. To the extent that it is motivated by the desire to self-insure against exchange rate or financial pressures, it raises a question about the role of the IMF in potential future crises in the region. A more imminent issue concerns the appropriateness of the high level of reserves and its sustainability in view of the accompanying rising risks and costs.

The persistence, indeed widening, of the current account surplus for the group of emerging market economies, even as crises have passed and economies recovered, is remarkable. Though not in such a pronounced manner as in reserve accumulation and other financial flows, Asia is the driving force here too. The extent to which domestic savings continue to exceed domestic investment will determine the durability of these surpluses, and concomitantly, net exports of capital to the rest of the world. The desirability of net resource flows from emerging market economies to mature economies hinges not least on the balance between the benefits of promoting mature economy demand for their exports and the scope for productive investment in emerging market economies.