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GLOBAL ECONOMIC & MARKET OUTLOOK

July 27, 2012

Eurobank EFG

FOCUS NOTES

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Capital Flows to Emerging Markets: heightened short-term risks but robust medium-term prospects

- The outlook for capital flows to emerging markets in the short-term remains subdued, with risks tilted to the downside, given that there are elevated risks for disruptive events in the euro area that would trigger new capital outflows.
- However, medium-term prospects are more positive as economic fundamentals in EM will continue to be robust, growth prospects are expected to remain substantially better and monetary policy is expected to remain tighter than in advanced economies, attracting portfolio investment flows.
- The impact of a sudden reversal of capital inflows on emerging market economies due to a deepening of the euro area crisis would be stronger on countries that have attracted significant amounts of hot money over the past few years and on countries with high external financing requirements.

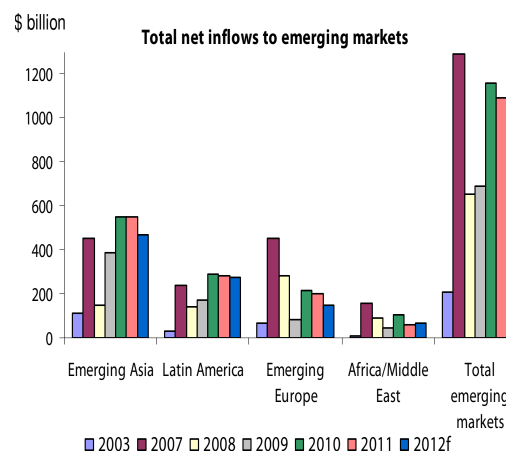
The volatility of capital flows to emerging markets has increased over the past year

Capital flows to emerging markets (EM) have risen markedly since 2003 (Figure 1), underpinned by strong fundamentals and the relative strength of EM economies compared to advanced economies. However, during the 2008 global financial crisis, capital flows to EM fell sharply, yet not below the levels seen before 2003. Meanwhile, in the immediate aftermath of the global financial crisis, there was a rapid surge in net capital flows to emerging markets. By the second half of 2011, however, intensifying financial stress in Europe reduced the willingness of lenders to fund emerging economies and investors' appetite for EM assets, resulting in a sharp fall of capital flows to emerging markets.

In the meantime, the release of good economic news early in 2012, along with the effect of the ECB's unconventional measures, led to an improvement in the global economic sentiment. Global risk aversion has declined, prompting emerging market assets to rebound (Figure 2). As a result, net capital flows to emerging markets rebounded significantly over the first four months of 2012, regaining much of the loss incurred during the second half of 2011.

Since the beginning of May, though, renewed concerns about a likely euro area break-up have reversed most of the gains witnessed in emerging equity markets over the first four months of the year. The increased market volatility triggered new capital outflows from EMs. According to the World Bank, gross capital flows to developing countries fell by 45% m-o-m in May, with the decline concentrated mainly in bond and equity issuance.

Figure 1



Source: Institute of International Finance

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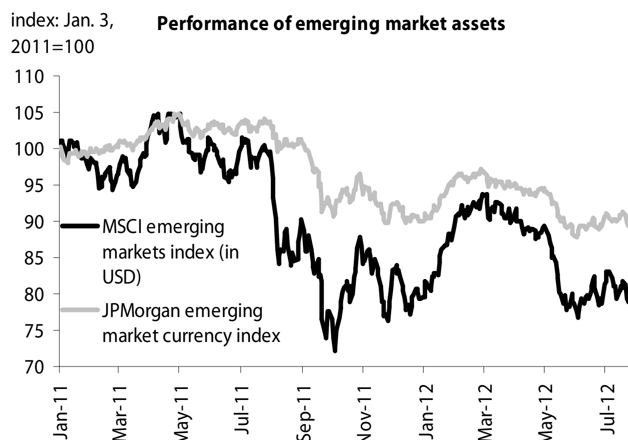
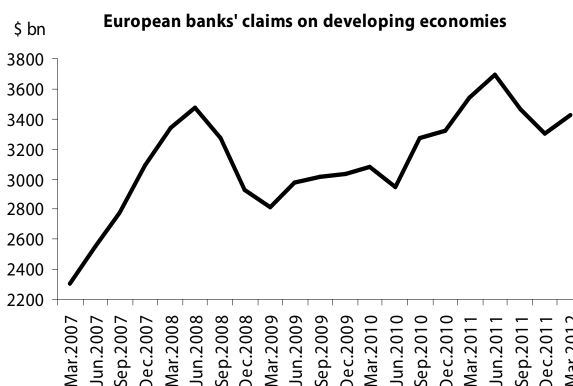
Figure 2



Source: Bloomberg

Figure 3



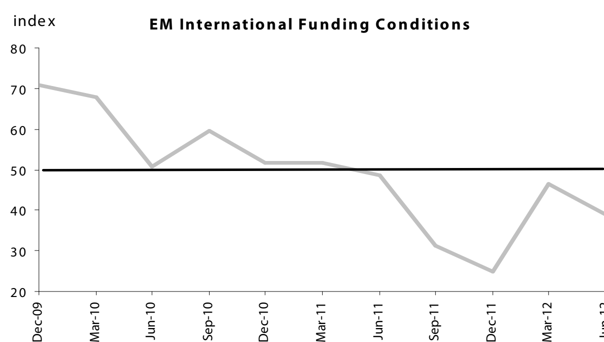
Source: BIS

European banking sector deleveraging continues to overshadow capital flows to EM

European banking sector deleveraging has weighed the most on EM capital flows. In particular, claims of European banks on EMs, which account for about 20% of their GDP, appear to have been particularly affected by the ongoing debt crisis. Bank's of International Settlement (BIS) data on cross-border bank claims indicate that European banks reduced their claims on EM economies for a second consecutive quarter in Q4 2011 compared with the previous quarter by a total of about $157 billion (Figure 3). Overall, in the second half of 2011, European banks' claims on EM economies decreased almost $400 billion. This was the biggest cumulative decline since 2008. Meanwhile, in the first quarter of 2012, European banks increased their claims on EM for the first time since June 2011, as a result of the ECB's massive 3-year repurchase operations. However, we believe that this will likely prove short-lived, due to the adverse developments in the euro area in Q2 that continue to undermine bank lending conditions in emerging economies.

This is also confirmed by the latest Emerging Market Bank Lending Survey conducted by the Institute of International Finance (IIF). Indeed, the IIF index of emerging markets bank lending conditions rebounded in Q1 2012 for the first time since the third quarter of 2010. However, this rebound also proved short-lived, as the index remained unchanged at 48.6 in Q2 2012 (below the threshold of 50 that indicates improvement), implying a net deterioration in overall emerging market lending conditions for a fourth consecutive quarter. Importantly, the IIF's index of international funding conditions declined to 39.0 in Q2 2012 (from 46.5 in Q1), confirming that spillovers from European banking sector deleveraging have worsened over the past few months (Figure 4). As it was expected, the tightening in international funding conditions was most evident in Emerging Europe, with 50% of the banks in the region reporting a tightening.

Figure 4



Source: *Institute of International Finance*

Subdued capital flows to EM for 2012, but more positive prospects in the medium-term

According to the Institute of International Finance, total net capital inflows to EM are estimated to have been $1,093 bn in 2011, down from $1,157 bn in 2010 (Table 1). For 2012, net total capital inflows are projected to decline further to $959 billion (12.3% below those recorded in 2011), as both foreign direct investment (FDI) and bank lending are expected to contract, undermined by the elevated uncertainty in the global economy and the ongoing deleveraging by large global banks, particularly in the euro area. Only net portfolio inflows are expected to increase, mainly due to interest rate and bond yield differentials between emerging markets and advanced economies, as investors hunt for yields abroad which are higher than those available at home.

Foreign direct investment inflows, which account for about a half of all capital inflows to EM and 2.7% of EMs' GDP, rose by about 14% y-o-y in 2011, mainly driven by investments in the services sector. Emerging Asia, and particularly China, are the top destinations for FDI among emerging economies and are expected to remain so in 2012 and 2013. Looking ahead,

however, FDI inflows are projected to fall slightly this year as the heightened uncertainty stemming from the euro area crisis seems to have started to cut into FDI. According to the World Bank's estimates, FDI inflows to selected developing countries declined by 14% in Q1 2012.

To sum-up, in the short-term the risks for capital flows to EM are tilted to the downside, since there are elevated risks for disruptive events in the euro area that would no doubt trigger new capital outflows towards safe-haven assets. European investors have historically been important suppliers of capital to EMs.

Regarding specific regions, Emerging Asia's relative strong fundamentals are expected to continue providing support to capital flows to the region, which account for almost 50% of total net inflows to emerging markets. Emerging Asia will continue to outperform its peers with growth of 7.1% this year versus 7.5% in 2013. Equity flows and particularly FDI are expected to be the main drivers. Emerging Europe is the region most exposed to the troubles in the euro area with negative implications for capital inflows. Indeed, private sector inflows fell about 60% y-o-y in Q1 2012. In Latin America, total inflows are expected to surpass the 2010 peak in 2013, with FDI remaining the main driver of private inflows. This most likely reflects relatively strong growth prospects as the region is well placed to face adverse events and has the resources and policy space to counteract their negative effects on growth.

Despite the volatile market environment, medium term prospects for capital flows to emerging economies are strong, as economic fundamentals in EM will continue to be robust and growth prospects are expected to remain substantially higher than advanced economies. Moreover, monetary policy in EM is expected to remain tighter than in advanced economies, attracting portfolio investment flows and debt flows from other private creditors, particularly flows into bond markets and deposits into local banks which account for about one third of total inflows.

Table 1

Capital flows to emerging markets

($ billion)	2010	2011e	2012f	2013f
Total inflows, Net	**1,157**	**1,093**	**959**	**1,045**
Private flows, net	1,088	1,030	912	994
Equity investment, net	607	545	560	577
Direct equity investment, net	459	524	499	481
Portfolio equity investment, net	148	21	61	96
Private Creditors, net	481	485	353	417
Commercial banks, net	159	143	73	123
Non banks, net	322	342	279	294
Official flows, net	69	63	46	51
International financial institutions	31	25	15	17
Official bilateral creditors	38	39	31	34

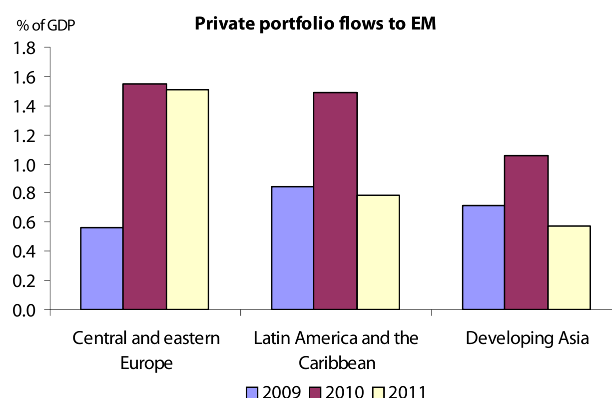
Source: Institute of International Finance

The impact of a sudden reversal of capital inflows on EM economies

As we have already mentioned, since 2009, EM economies have attracted a substantial amount of foreign portfolio and bank related capital. The increased uncertainty and risk aversion surrounding the global economic backdrop, along with the likelihood of an intensification of the debt crisis in Europe has brought to the spotlight concerns about the potential impact of a sudden reversal of capital flows on EM economies. Generally, under a scenario of abrupt reversals in EMs' capital inflows towards safer economies and assets, the main consequences for EM would be a loss of access to international funding, currency depreciation and rising financing costs which would most likely translate into a rapid slowdown in credit growth. Moreover, an abrupt turn of portfolio inflows would mean a significant initial shock to asset prices that would negatively affect bank balance sheets, leading to a significant GDP loss. In contrast, if capital inflows slow down gradually, economies might be less vulnerable, as they would be able to deal with reversing capital flows in a relatively smooth way. According to IMF[1], if total net inflows to EM in the period 2009-2011 are reversed suddenly over a single quarter, credit growth will decline by 2 to 4 percent, and GDP growth will fall by 1.5 to 2.0% on average.

Countries that have attracted significant amounts of hot money are among the most vulnerable to such a shock as these kind of flows tend to depart first in the face of heightened market volatility and waning risk appetite (Figure 5). Additionally, countries with high external financing requirements (notably Eastern Europe and Central Asia) would also be the most exposed to an abrupt slowdown or reversal of capital inflows. This is particularly true for countries that accumulated high short-term external debt, since there is a greater risk that the debt may not be rolled over (Figure 6).

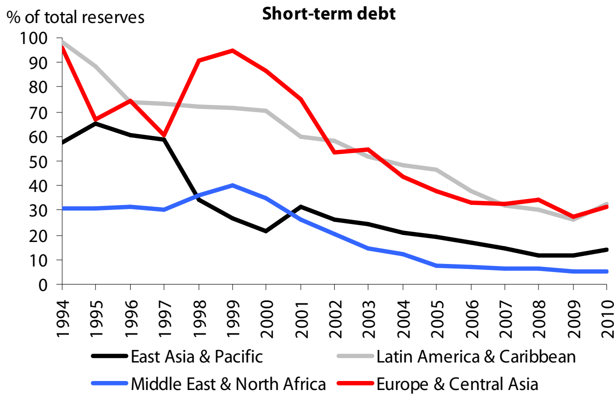
Figure 5



Source: IMF

[1] *IMF, Global Financial Stability Report, April 2012*

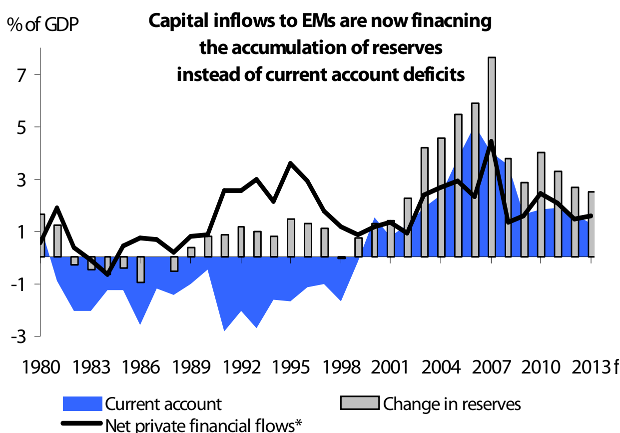
Figure 6



Source: World Bank

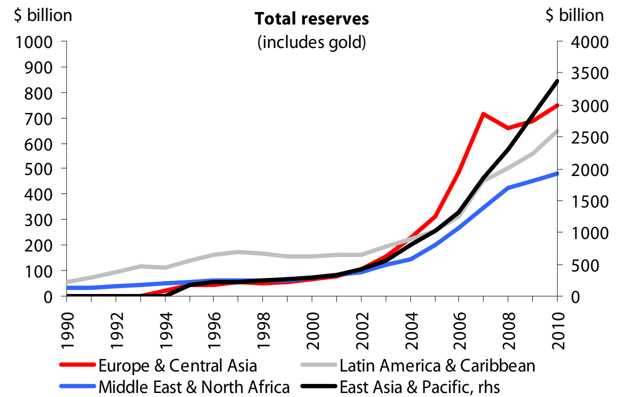
It is important however, to look at the stock of foreign exchange reserves and remittances. EM economies that have high foreign exchange holdings have greater insurance against tail risks, as significant official reserves would allow these countries to ride out a sudden stop in capital inflows. Generally in emerging markets as a group, over the past decade sizeable capital inflows have been financing the accumulation of reserves instead of financing current account deficits, as it was the case during the 1990s (Figure 7). East Asia and Pacific is the region with the largest accumulation of foreign exchange reserves (Figure 8), which in fact are three times as large as the region's external debt. What's more, remittances flows have remained relatively resilient (Figure 9) and are expected to rise in 2012 despite increased volatility in the global economy. According to the World Bank, remittance flows to developing countries are projected to reach $399bn in 2012, up from $372bn in 2011.

Figure 7



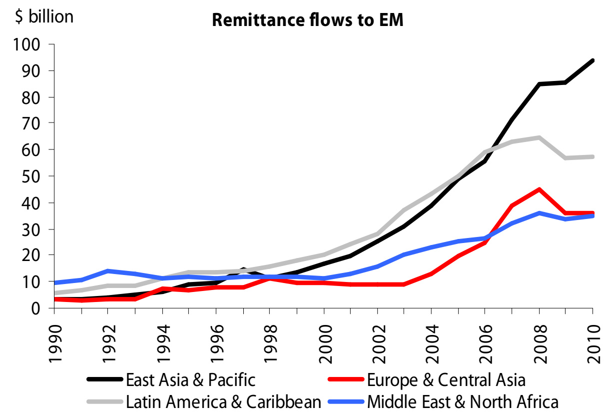
** Net private financial flows comprises net private direct investment, net private portfolio flows, and net other private financial flows.*
Source: IMF

Figure 8



Source: World Bank

Figure 9



Source: World Bank

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