



**Emerging  
Markets  
Forum**

Global Imbalances and Capital Flows  
to Emerging Market Countries

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# GLOBAL IMBALANCES AND CAPITAL FLOWS TO EMERGING MARKET COUNTRIES

## CENTENNIAL GROUP: EMERGING MARKETS FORUM

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### I. OVERVIEW

The U.S. current account deficit continues its inexorable rise, set to hit US\$900 billion this year. However, the steady rise in that deficit masks a change in its composition, with the growing surpluses of oil exporting countries, mirroring the increase in oil prices, now accounting for nearly half of the counterpart to the U.S. deficit. This paper will raise a number of issues related to this changing profile of the global imbalances and ask what implications they may hold for the adjustment process and for global capital flows, especially to the emerging market countries (EMCs).<sup>2</sup> On the adjustment process:

- The (probably appropriate) caution of many of the oil exporting countries in increasing spending as oil revenues rise likely increases the burden of adjustment on the U.S.; and
- Similarly, the decreasing share of U.S. exports in the slowly growing import basket of oil exporting countries means further pressure on the U.S. to correct its trade imbalance.

These macroeconomic effects of the shifting profile of the U.S. deficit towards the oil exporters may also have implications for the ease with which the U.S. can fund both the current account deficit as well as its still sizeable fiscal deficits:

- The investment preferences of the oil exporting countries appear to be quite different from those of the countries that recorded the counterpart surpluses in the earlier period of the growing U.S. deficit;

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<sup>2</sup> The definition of EMCs used in this paper includes Argentina, Bolivia, Brazil, Bulgaria, Chile, China, Colombia, Costa Rica, Croatia, Czech Republic, Dominican Republic, Ecuador, Egypt, El Salvador, Hungary, India, Indonesia, Jordan, Malaysia, Mexico, Morocco, Pakistan, Panama, Paraguay, Peru, Philippines, Poland, Romania, Russia, Slovak Republic, South Africa, Thailand, Tunisia, Turkey, Ukraine, Uruguay, Venezuela, and Vietnam.

- In particular, U.S. treasuries and other U.S. assets may be less attractive as a destination for the resources generated by the oil surpluses;
- Deposits at international banks, as in earlier periods of oil exporter surpluses, appear relatively more attractive to these countries;
- And, with increased deposit inflows, the banks may have sought new outlets for their lending, contributing to the change in global asset allocation. This appears to have led, inter alia, to a rapid rise in lending to selected EMCs, including in Eastern Europe.

All of this has coincided with a broad based increase in the attractiveness of EMCs to foreign investors. This appears to have been driven by an underlying improvement in the fundamentals in many of these countries, but also by the long period of easy monetary conditions in much of the industrial world, and the consequent search for yield created by such policies. The result has been:

- An increase in private capital flows to EMCs to record levels;
- A shift in the composition of capital flows, with foreign direct investment (FDI) and commercial bank lending showing major gains; and
- A change in the composition of FDI, with south-south flows, i.e., FDI from emerging market and developing countries to other countries within those groups, sustaining foreign investment even as FDI from industrial countries has declined. This development has been coincident with a scramble to secure natural resources—energy and other commodities—needed to feed the rapid growth of countries such as India, China, Brazil, and others.

These latter developments raise questions about the sustainability of these capital flows:

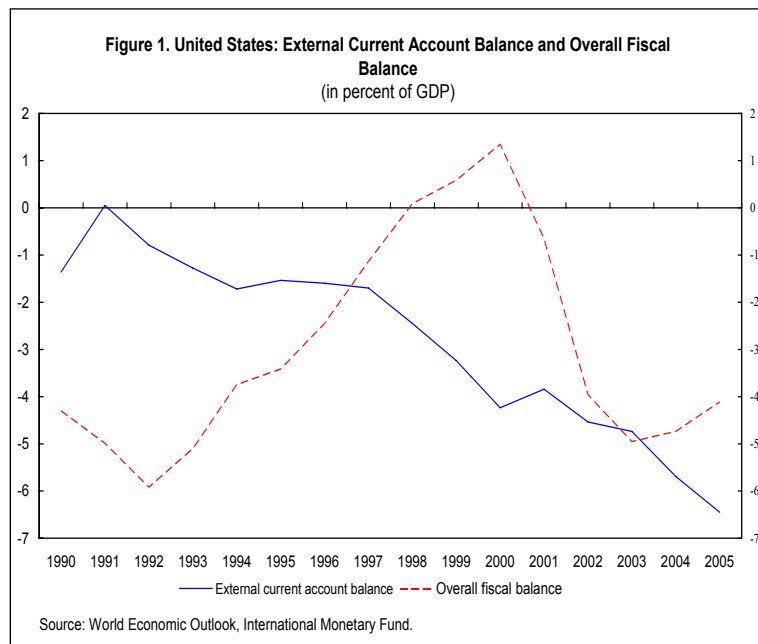
- Will the recent surge in bank lending end badly as it did in previous episodes of “recycling”?
- Will equity investors in the EMCs maintain their commitments to those markets if yields elsewhere improve? and
- Are there political and other risks associated with the increase in south-south FDI, at least that component driven by the scramble for natural resources?

This paper will try to present evidence on some of the factors behind each of these changes in the global financial system and to speculate on their implications.

## II. INTRODUCTION

1. A dominant factor in the international monetary and financial system over the last seven to eight years has been the almost continuous rise in the current account deficit in the balance of payments of the United States. From an average of about US\$90 billion a year throughout much of the 1990's, the deficit has increased almost every year from just over US\$200 billion in 1998 to over US\$800 billion in 2005 and, under current projections, will reach US\$900 billion, or 6.5 percent of GDP, this year.

2. As the U.S. deficit has widened, there have been ongoing debates about the forces driving this phenomenon. Some analysts put the blame primarily on the U.S. fiscal deficit and on the low, and recently negative, household saving rate in the country. On the former, however, the link between fiscal and current account balances is rather weak across most developed countries, including the U.S. In particular, while the U.S. fiscal balance has moved from large deficits to surpluses and back over the past fifteen years, the current account balance has mostly been in a trend decline (Figure 1).



3. This lack of relationship between the U.S. budget deficit and the current account deficit is used by some to argue that global imbalances merely reflect the classic case of comparative advantage—emerging markets specialize in global manufacturing and commodity extraction while the U.S. specializes in global capital allocation. It is argued, therefore, that in the context of rapid growth, EMCs are providing bigger and bigger savings spillovers to the rest of the world and, thus, contributing to a widening U.S. current account deficit.<sup>3</sup>

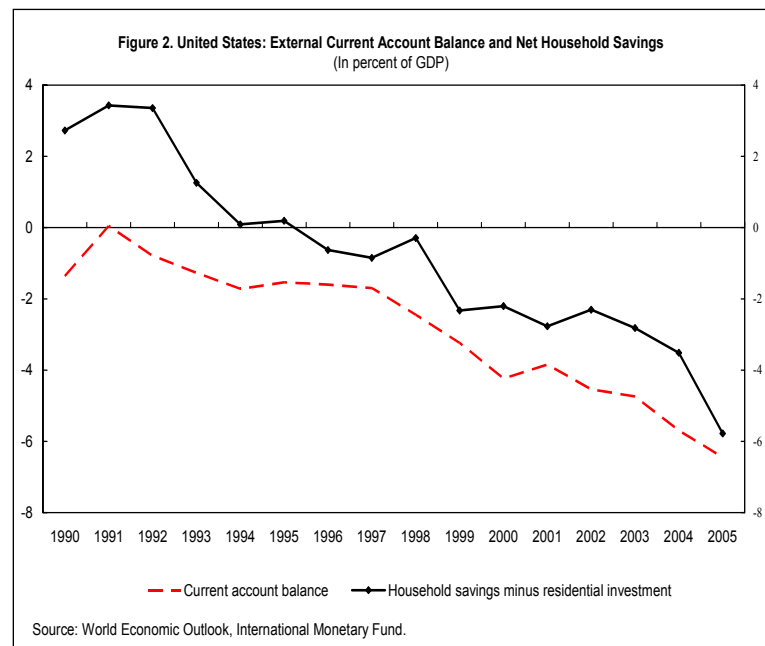
4. There is, no doubt, some validity to this view. However, with the U.S. deficits as large as they are, the global economy is in uncharted territory. The sustainability of both the current account deficit and the fiscal deficit depends on the willingness of foreigners to increase substantially their holdings of U.S. assets, including U.S. government securities, and the willingness of the U.S. to see greater foreign control

<sup>3</sup> "Global Imbalances: Economic Myth and Political Reality: The U.S. Current Account Deficit, 16<sup>th</sup> Century Spain and 21<sup>st</sup> Century China," Stephen King, HSBC Global Research, May 2006.

over those assets. But how realistic is this? The ever-widening current account deficit portends exchange rate adjustments that could produce substantial capital losses on such holdings. Similarly, the recent debate over direct investment in certain industries in the U.S., from China and Dubai, among others, at least raises questions about the welcome that some of the needed investment may receive in the U.S. Thus, the apparently benign historical relationship between the current account and the fiscal deficit should be of little comfort.

5. The increasing deficits in the U.S. current account appear to be much more closely related to the decline in the savings-investment balance of U.S. households

(Figure 2). Many factors have been suggested as the cause for this decline, but surely one of the most important factors appears to be the impact of the housing boom, with capital gains being transformed into higher consumption (and higher imports). This then begs the question of whether monetary policy in the U.S. has helped perpetuate the global imbalances by being too loose for too long. There is, of course, an active, but unsettled, debate on the role



that monetary policy should play in countering emerging asset bubbles. A related issue in this context concerns the implications for emerging market financing of the low interest rate environment in the U.S. (and in much of the industrial world) and the disposition of current account surpluses accumulating in the oil exporting countries.

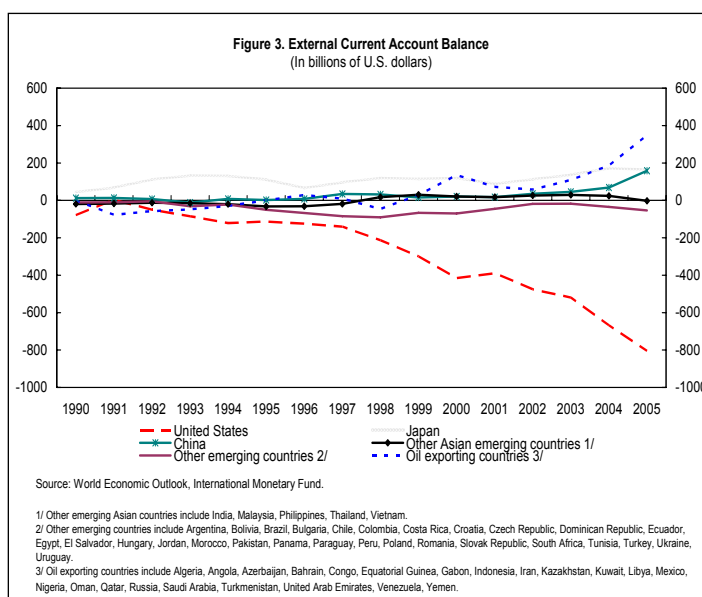
6. Finally, some observers, in explaining the rise of the global imbalances, put emphasis on the “excessive” savings rates and the insufficiency of investment or of consumer spending in other parts of the world, especially in Asia, and to structural rigidities—including inflexible labor markets—in Europe. In both cases, the lower rates of growth in those parts of the world, or the bias toward export production that may exist, aggravate the U.S. current account deficit.

7. Obviously, there will need to be greater agreement on the relative importance of these forces, and the prospects going forward, if an effective multilateral policy response is to be crafted to foster an orderly adjustment to what is agreed by most observers to be an unsustainable situation. This is an issue well beyond this paper.<sup>4</sup>

<sup>4</sup>This is the task recently charged to the IMF in the multilateral consultations that are now underway and that will be reported on at the IMF’s Annual Meetings in Singapore. The conclusions coming out of those

8. But, there are other questions raised by these global imbalances that are also important for the workings of the international monetary and financial system that are as yet receiving less attention. In particular, the changing profile of the current account surpluses that are the counterpart to the U.S. deficit, and the related patterns of reserve accumulation by the surplus countries, appear to be giving rise to important changes in financial flows in the global economy, including flows to the emerging market countries.

9. The most important factor behind these changing patterns is, of course, the rise in oil prices over the past few years. Such price increases have exacerbated the U.S. trade and current account deficits, accounting for between one half and three fifths of the further deterioration that has taken place over the last few years.<sup>5</sup> At the same time, the higher oil prices have produced sharply higher current account surpluses in the oil exporting countries—which at around US\$400 billion in 2005 amounted to about half of the U.S. deficit of



US\$800 billion (Figure 3). The higher oil prices have also reduced the surpluses of other oil importing countries, including some countries in Asia in which the largest share of the counterpart to the U.S. deficits had been recorded and from which a large proportion of the U.S. fiscal deficit appears to have been financed.

10. Against this background, this paper will examine three aspects of the changing profile of the global imbalances:

- i. The implications of the growing surpluses and the spending patterns of the oil exporting countries for the global imbalances and for the burden on the U.S. to correct its current account deficit;
- ii. The possible impact of the investment preferences of the oil exporting countries on global capital flows, including the ease with which the U.S. is able to finance its fiscal and current account deficits; and

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discussions and the policy choices made thereafter will have important implications for the extent to which the needed adjustment in the global imbalances will be more or less orderly.

<sup>5</sup> World Economic Outlook (WEO), International Monetary Fund; and Fathom, “Who’s Buying Treasuries?” May 16, 2006.



- iii. How the profile of capital flows to the emerging market countries is being affected by these and other recent developments.

11. Each of these issues will be taken up in the subsequent sections of this paper. It is important, however, to note that the examination of these issues is hindered by severe data problems. These problems will be identified and dealt with to the extent possible. But the data problems that remain temper the conclusions that can be drawn with confidence on these issues.

### **III. SOME IMPLICATIONS OF THE SPENDING AND INVESTMENT PATTERNS OF OIL EXPORTERS FOR THE GLOBAL IMBALANCES**

12. The large and growing surpluses of the oil exporting countries, even if they were only substituting for the earlier surpluses of some of the Asian and other emerging market countries, may have important implications for the prospects for global imbalances and the policy adjustments needed to address those imbalances. In particular, in the period 2001 (when oil prices began the rise that brought them to their current levels) through 2005, the U.S. current account deficit more than doubled from US\$390 billion to US\$805 billion while the surpluses of the oil exporting countries increased almost five-fold from US\$72 billion to US\$348 billion (Table 1). Over the same period, the current account surpluses of Asian countries increased from about US\$120 billion to US\$320 billion—more than accounted for by the rapid increase in the surpluses of Japan and, especially, China that offset the disappearance of the surpluses of other countries in the region. Elsewhere, the emerging market countries in Eastern Europe saw their current account balances deteriorate rather sharply over this period, while those of countries in other parts of the world actually improved, largely reflecting the boom in commodity prices.

**Table 1. External Current Account Balance**  
(in billions of U.S. dollars)

Country	1990	1991	1992	1993	1994	1995	1996	1997	1998	1999	2000	2001	2002	2003	2004	2005
United States	-78.97	2.90	-50.08	-84.82	-121.61	-113.67	-124.90	-140.91	-214.07	-300.06	-416.01	-389.46	-475.20	-519.68	-668.08	-804.95
Japan	43.94	68.38	112.33	131.98	130.55	111.40	65.74	96.55	119.07	114.53	119.60	87.79	112.61	136.24	172.07	163.89
China	12.00	13.27	6.40	-11.90	7.66	1.62	7.24	34.44	31.64	15.67	20.52	17.41	35.42	45.87	68.66	158.62
Other emerging Asian countries 1/	-18.89	-16.96	-12.58	-15.23	-19.83	-32.06	-31.16	-18.04	17.36	30.34	20.12	16.89	26.06	29.39	23.78	-1.82
Emerging Eastern European countries 2/	-5.82	-7.57	-0.90	-12.86	4.43	-6.40	-17.78	-20.74	-17.49	-21.91	-28.30	-12.77	-18.42	-30.05	-45.54	-54.31
Other emerging countries 3/	-5.62	-2.91	-3.55	-18.40	-26.55	-43.68	-49.87	-63.82	-73.24	-45.33	-41.66	-32.40	0.24	12.44	10.56	0.13
Oil exporting countries 4/	-1.78	-77.44	-57.35	-48.83	-29.54	-0.06	28.37	9.07	-45.63	28.64	135.01	72.04	57.63	108.62	185.61	347.77

Source: IMF, World Economic Outlook.

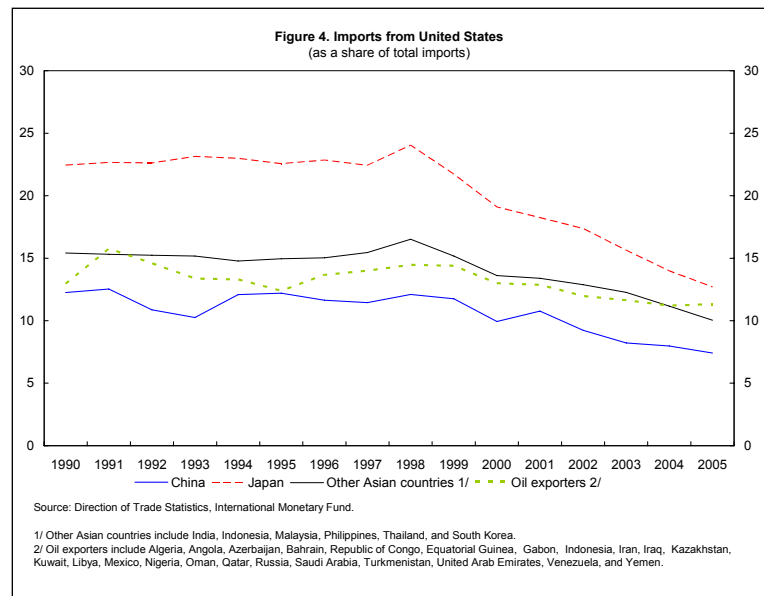
1/ Other emerging Asian countries include India, Malaysia, Philippines, Thailand, and Vietnam.

2/ Emerging Eastern European countries include Bulgaria, Croatia, Czech Republic, Hungary, Poland, Romania, Slovak Republic, Turkey, and Ukraine.

3/ Other emerging countries include Argentina, Bolivia, Brazil, Chile, Colombia, Costa Rica, Dominican Republic, Ecuador, Egypt, El Salvador, Jordan, Morocco, Pakistan, Panama, Paraguay, Peru, South Africa, Tunisia, and Uruguay.

4/ Oil exporting countries include Algeria, Angola, Azerbaijan, Bahrain, Congo, Equatorial Guinea, Gabon, Indonesia, Iran, Kazakhstan, Kuwait, Libya, Mexico, Nigeria, Oman, Qatar, Russia, Saudi Arabia, Turkmenistan, United Arab Emirates, Venezuela, and Yemen.

13. This pattern suggests that the U.S. (in contrast to many other countries, notably those in Asia) has been unable to tap into the higher import demand that oil producers have generated. This is reflected in the decline in imports from the U.S. as a share of the total imports of the oil exporting countries. Along with a more broad-based decline in the share of imports from the U.S. in total imports for several Asian countries since 1999 (Figure 4), this has contributed to the continued worsening of the U.S. current account balance. In the context of a



long-term decline in the oil exporters' marginal propensity to import (Table 2), the declining share of imports from the U.S. in their total imports has reduced the offset to higher oil prices in the trade balance of the U.S. To the extent that imports have been redirected to Europe and elsewhere, growth in those areas would be increased with positive implications for U.S. exports. But, that impact, too, has been limited as the overall propensity of the oil exporting countries to import has declined. The net effect then would seem to suggest a more difficult process of adjustment for the U.S. than would otherwise be the case.

	1973-75	1978-81	2002-05
GCC states	0.34	0.25	0.15
OPEC	0.52	0.42	0.24
Russia	1.37	1.08	0.2
Norway	...	-0.3	-0.13

Source: International Monetary Fund.

1/ Change in imports (net of non-oil exports) + investment income as percent change in oil export revenues.

14. More generally, the oil exporters appear to be more cautious in judging the permanence of the recent price increases, not least, perhaps, because of the unhappy experiences in earlier episodes wherein they expanded spending too rapidly, could not reverse that spending quickly, and suffered large fiscal and current account deficits and painful adjustment. This behavior, in particular, is

likely to further affect adversely the U.S. current account balance, and the impact could be substantial.

15. For example, the cumulative current account surplus of oil exporters in the Middle East and Central Asia<sup>6</sup> during 2003–05 was US\$400 billion. During the same period, US\$210 billion was saved by these countries through the accumulation of official reserves, which reached US\$360 billion at end–2005. An additional US\$200 billion or more was registered in “other asset accumulation” in the official sector<sup>7</sup> (Table 3). Similarly, the governments of oil exporting countries in the Middle East and Central Asia saved, on average, three-quarters of the increase in oil revenue accruing to their budgets since 2002,<sup>8</sup> while

	2000	2001	2002	2003	2004	2005	2006 Projections
Current account balance	156.6	92.6	75.2	132.5	220.6	397.0	480.9
External financing	78.0	35.8	52.4	81.5	129.6	148.8	139.1
From official sector	5.7	-10.6	-20.7	-1.9	-9.9	-36.8	-11.9
From private sector	72.3	46.4	73.1	83.4	139.4	185.6	151.0
FDI	37.4	51.9	39.3	49.6	70.6	72.8	80.6
Portfolio equity	-0.4	-0.2	-0.1	-0.9	-4.4	2.3	-0.8
Bonds	-4.7	-0.3	-0.5	8.0	27.1	40.4	7.8
Bank loans	-2.3	-0.9	-5.6	-2.6	-2.8	-2.8	-0.9
Suppliers' credit and others	42.2	-4.1	40.0	29.3	49.0	72.9	64.3
External Asset Accumulation	234.6	128.4	127.6	214.0	350.2	545.8	620.0
By official sector, reserves	73.8	33.1	26.1	77.3	129.7	210.8	197.8
By official sector, other	44.2	22.5	8.7	66.9	105.0	124.5	202.3
By private sector, FDI	14.7	6.3	10.2	13.5	22.9	45.3	46.9
By private sector, other	102.0	66.5	82.7	56.3	92.5	165.1	173.0

Source: WEO.

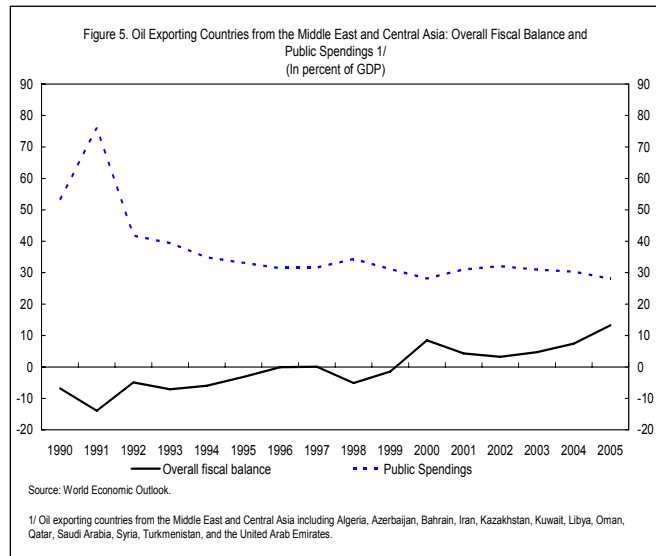
1/ Oil exporting countries from the Middle East and Central Asia region including Algeria, Azerbaijan, Bahrain, Iran, Kazakhstan, Kuwait, Libya, Oman, Qatar, Saudi Arabia, Syria, Turkmenistan, and the United Arab Emirates.

<sup>6</sup> Oil exporters from the Middle East and Central Asia region include Algeria, Azerbaijan, Bahrain, Iran, Iraq, Kazakhstan, Kuwait, Libya, Oman, Qatar, Saudi Arabia, Syria, Turkmenistan, and the United Arab Emirates (UAE). These oil exporters have witnessed particularly rapid increases in their current account balances, official reserves, and in other asset accumulation in the official sector.

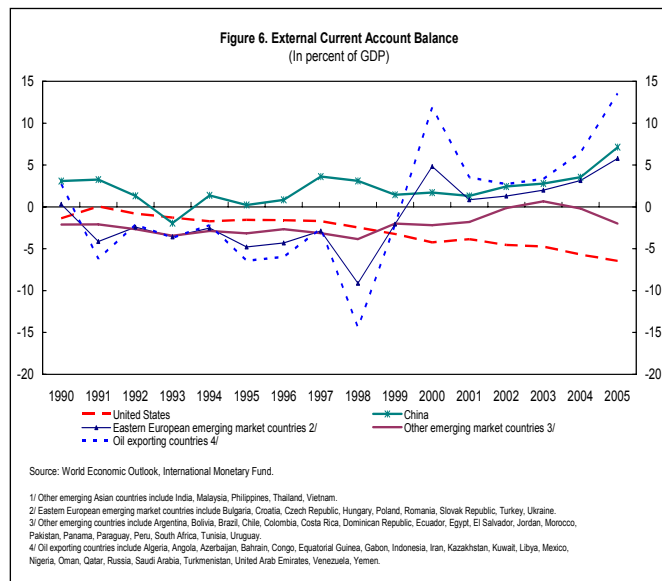
<sup>7</sup> *Regional Economic Outlook, Middle East and Central Asia, May 2006* and the *WEO*. This is a murky area, but “other asset accumulation” is believed to include oil stabilization funds, so-called funds for future generations, and the like.

<sup>8</sup> Measured as the ratio of the increase in the fiscal balance to the increase in the government’s oil revenues.

government spending as a share of GDP has declined.<sup>9</sup> As a result, the overall fiscal position of these countries changed from broad balance in 2002 to a surplus of 12 percent of GDP in 2005 (Figure 5).



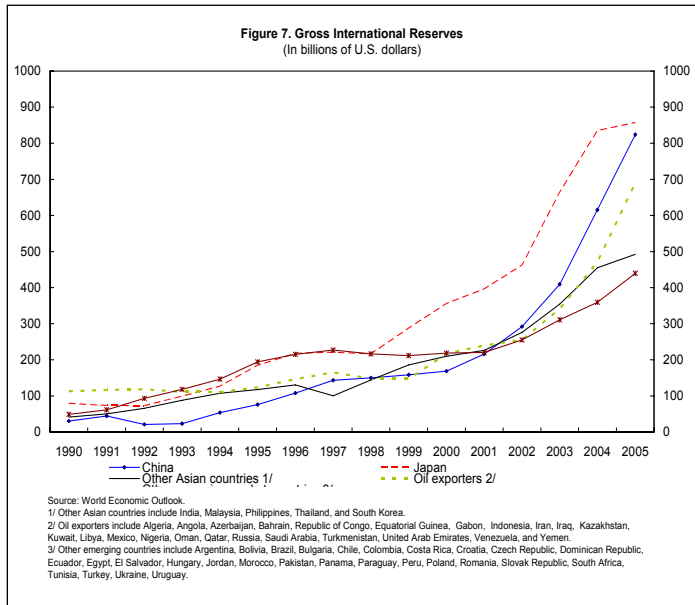
16. The corollary to the changing pattern of current account surpluses from some of the Asian countries and other non-oil exporting emerging market countries to the oil exporters (Figure 6) is the changing pattern in the disposition of accumulating official international reserves (Figure 7).<sup>10</sup> This, too, could have implications for the adjustment process. Asian and other surplus countries rather reliably bought U.S. securities, helping to finance



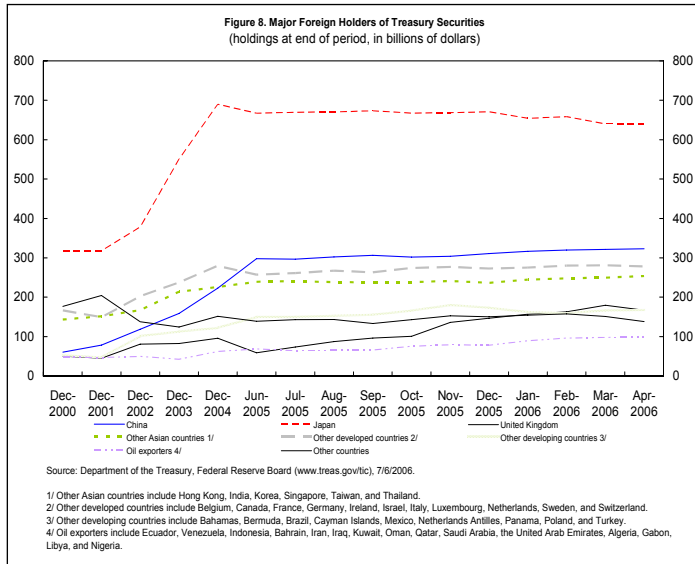
<sup>9</sup> In this context, it should be noted that policy advice from the IMF has underscored the importance of increasing spending on projects with high returns, particularly infrastructure, including with a view to help reduce global imbalances.

<sup>10</sup>As noted, estimates of oil exporters' foreign exchange reserves do not generally give a full and fair account of the current account surpluses that are accruing. This is because, while they include accruals to formal central bank reserves, they do not include increased holdings in oil stabilization or investment funds or accounts of other official agencies or institutions.

the U.S. current account deficit (without significant depreciation of the dollar) and the fiscal deficit (without significant increases in U.S. interest rates). In the current environment, both economic and political, it is not clear that oil exporting countries are similarly attracted to that option.



17. Major data problems confront the analysis of these changing patterns, but some conclusions, albeit tentative, can be drawn. The commonly used source of information on official holdings of short-term U.S. treasury securities by country is the so-called TIC data collected by the U.S. treasury. Those data are presented in for some individual countries and some groups of countries (Figure 8). One thing immediately evident is that the substantial increase in current account surpluses of the oil exporters is not mirrored in the accumulation of U.S. treasury securities by those countries. That said, however, these data appear suspect.



18. In particular, Japanese and Chinese holdings of U.S. treasury securities rise rapidly in the early years of the emerging U.S. (fiscal and current account) deficits but then remain flat after 2004. The patterns for some of the other country groupings look reasonable and correlate well with other data. However, the pattern for the U.K., which registers a surprisingly large accumulation of U.S. securities in recent years, and for the oil exporters, which registers only a very

modest increase in the face of rapidly increasing surpluses, raise significant questions.

19. At least two problems surface in reviewing these data. First, the coverage is too narrow. For example, the flattening of Chinese holdings of short-term U.S. treasuries appears to coincide with a shifting preference on the part of the Chinese away from increasing such holdings toward higher yielding and longer maturity securities, including mortgage-backed and other U.S. agency securities not included in these data.<sup>11</sup> Second, the data do not track well the holdings of securities registered in individual country data and are challenged by anecdotal evidence. Taking such data at face value also raises questions about how much of the U.S. fiscal deficit has effectively been financed by official—as opposed to private—sources from overseas. Some have speculated that the continued funding of the U.S. deficit with little pressure on interest rates suggested that private investors overseas were stepping in as official purchases leveled off. This argument was bolstered by the high level of purchases by U.K. entities. However, this interpretation may have overstated the appetite of private investors overseas for acquiring U.S. assets.

20. More recently, data have become available based on a new custody survey which shows the ultimate owner of securities. These custodial data show that in the 12 months through June 2005, for example, official purchases of U.S. treasuries amounted to US\$339 billion. This is significantly higher than data from the TIC series, which indicated that official buying of U.S. securities over the same period amounted to only US\$162 billion. The custodial data appear to explain most of the discrepancy between reported official reserve accumulations by individual countries and the accumulated monthly TIC data.

21. At the same time, while the custodial data show much higher levels of official accumulation of U.S. assets, the broad total of foreign investment in U.S. securities is roughly comparable in the two sets of data. The higher levels of official investment in the custodial data were offset by lower private investment when compared with the accumulated monthly flows. Also, foreign investment in highly liquid instruments, including treasury securities, is lower in the custodial data in favor of less liquid bonds (including mortgage backed securities and corporate bonds). The new data would also seem to solve the mystery behind the large increase in holdings of U.S. securities by private parties in the U.K. In fact, analysts suggest that these probably reflect holdings by official agencies, most likely of the oil exporters in the Middle East, purchased through London dealers. This may be an example of a more pervasive problem in interpreting these data on the allocation of reserve holdings. Some countries have outsourced reserve management to specialized institutions, resulting in the securities held being recorded as belonging to those institutions.

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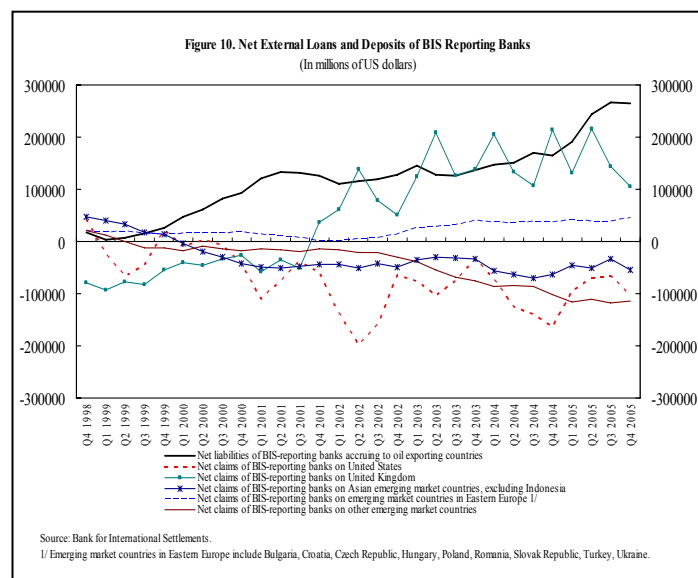
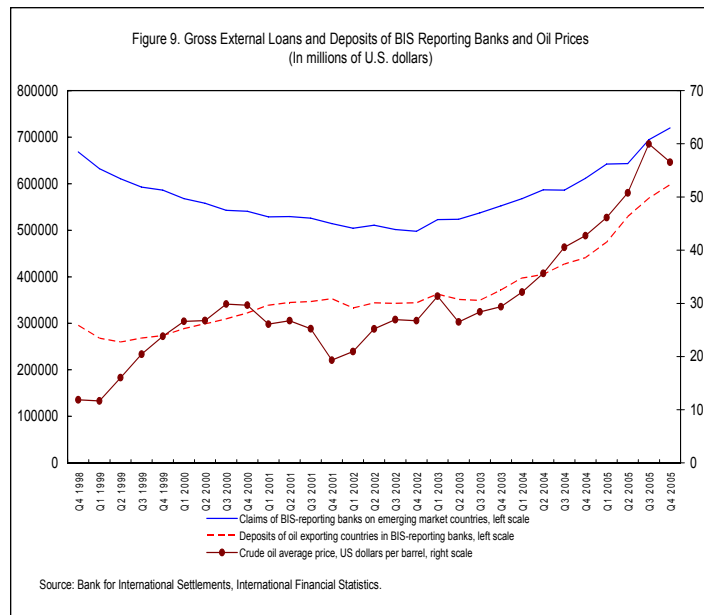
<sup>11</sup> *Global Financial Stability Report*, World Bank, April, 2006.

22. In short, the custodial data appear to give a more accurate picture of U.S. securities accumulation by foreign official holders. But they do not provide

anything like a complete picture of the disposition of reserves by the oil exporting countries. BIS data help here. These data show a significant rise in oil exporters' deposits in BIS-reporting banks roughly coincident with the sharp rise in oil prices (Figure 9). This would seem to suggest a similarity between this and the earlier episodes of rapidly rising oil prices. During the earlier episodes of major

increases in the price of oil, particularly in the 1970's, a large portion of the reserves of the oil exporters took the form of bank deposits that were then "recycled" as bank lending, much of it to emerging and developing economies, especially in Latin America. This is the familiar story of the prelude to the debt crisis of the 1980's.

23. This time around, however, the evidence is not conclusive. On the one hand, the net liabilities (deposits minus lending) of BIS-reporting banks accruing to the oil exporting countries has increased rapidly in recent years (Figure 10)—indeed the increase in deposits of oil exporting countries in BIS-reporting banks accounts for more than 50 percent of their total reserve accumulation





during 2001 through 2005.<sup>12</sup> On the other hand, net claims (lending minus deposits) of BIS-reporting banks to the entire group of emerging market countries appears to remain almost flat. At the same time, however, lending by BIS-reporting banks to a selected group of EMCs, particularly in Eastern Europe, has increased sharply over the same time frame. Furthermore, it is possible that the rapid rise in net claims of BIS-reporting banks on the United Kingdom is indicative of institutions in that country being a conduit for oil exporters to secure greater exposure to EMCs.

24. To summarize, the U.S. current account balance is likely to worsen further and the adjustment process made even more difficult as a result of the combined impact of the increase in oil prices and the relative decline in the propensity of oil exporters to import from the U.S. This is further aggravated by the caution of most oil exporters in increasing overall spending, including on imports. This, then, raises questions as to whether the financing of the U.S. current account balance and the U.S. fiscal deficit will continue unabated without an increase in U.S. interest rates, notably because of the changing pattern in the accumulation of official reserves and the lower proclivity of oil exporters to hold their assets in the form of U.S. treasury securities. The boom in equity markets in many of the emerging market countries, as well as the sharp rise in real estate prices in some of those countries, may also be related both to the flow of resources from the oil exporting countries through the banks, as well as to direct purchases by entities within the oil exporting countries.

25. Moreover, to the extent that oil exporters (and EMCs) are more inclined to use their reserves to purchase real assets by acquiring equity stakes through FDI, for example, it would be highly problematic for the unwinding of global imbalances if advanced economies, notably the U.S., were to succumb to pressures of economic nationalism and limit access to real assets. For purposes of diversification, oil exporters and emerging market creditors will want to invest in assets other than government or corporate debt, such as “south-north” FDI. If that is not politically feasible in the U.S. on the scale required, oil exporters and EMCs are likely to explore other mature markets and also pursue greater “south-south” FDI. It is to the changing world of capital flows to EMCs that we now turn.

#### **IV. CAPITAL FLOWS TO EMERGING MARKET COUNTRIES**

##### **A. Recent Trends in Overall Capital Flows**

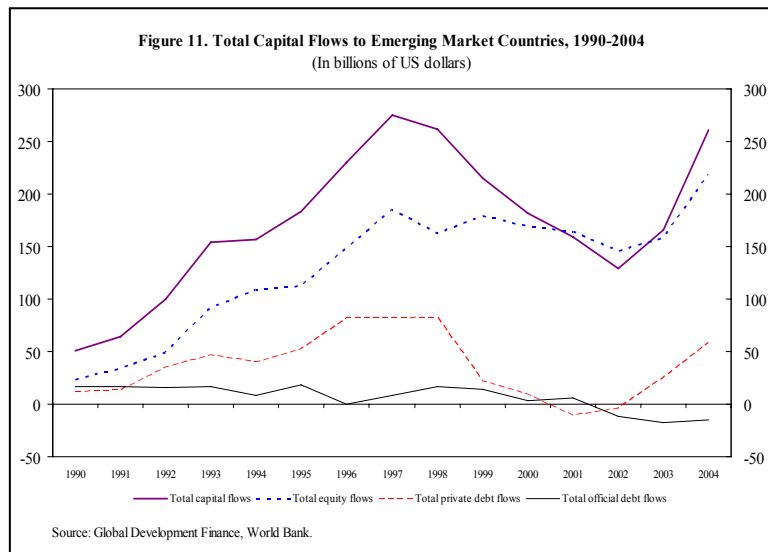
26. A by-product of the low interest rate environment, and generous liquidity conditions, in the U.S. (and most of the industrial world) and, more recently, of

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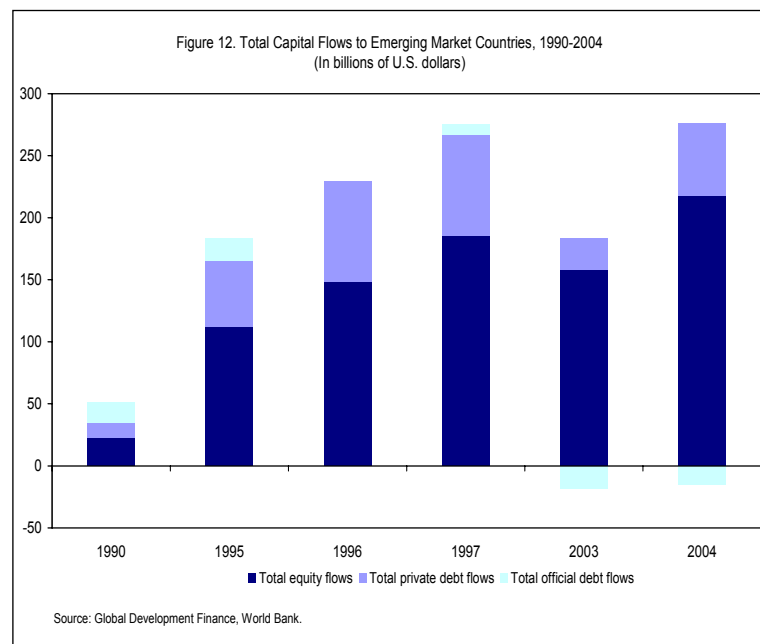
<sup>12</sup> The remainder has likely taken the form of greater holdings of U.S. treasury and agency securities, including through dealers in the U.K. (as noted above), a variety of other investments, including in regional equity markets, and debt repayments.

the rapid asset accumulation of oil exporters, has been a rapid rise in private capital flows to EMCs over the past several years.

- Private capital flows to EMCs are currently at record levels (Figure 11). While equity flows had become increasingly important relative to debt flows in the years following the Asian crisis, more recently, debt flows have been increasing rapidly, coincident with the rise in oil prices and the growing surpluses of the oil exporting countries. (Figure 12).



- Net bond issuance is only a small fraction of net external financing—suggesting, inter alia, that the vulnerability of EMCs to market sentiment has



been reduced, and access of many EMCs to international capital markets could close without significant immediate effects on the balance of payments. The potential near-term vulnerability of these countries appears to have been further reduced through the significant prefinancing that has been arranged. In addition, EMCs have made large debt payments to the official sector in the past two years, including to the international financial institutions and official bilateral creditors, especially the IMF and the Paris Club. This presumably implies increased access to such financing,

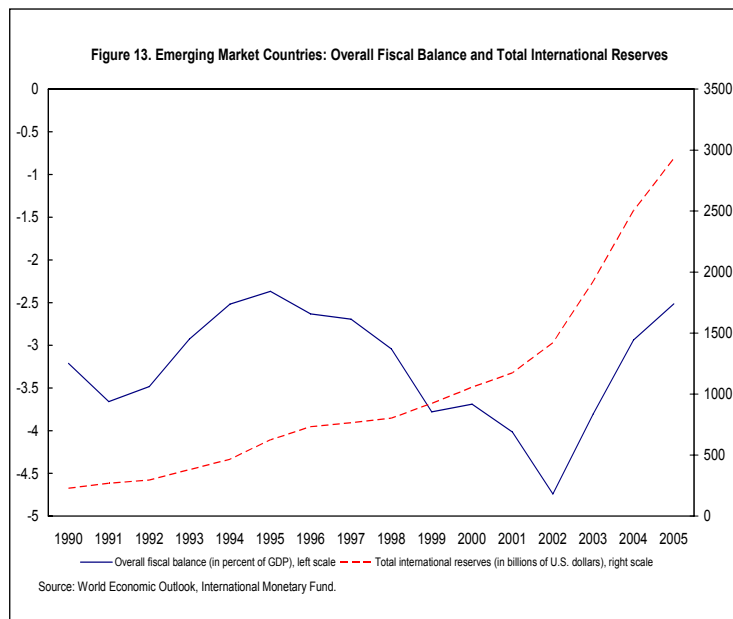
especially from the IMF, should conditions in the global economy become less benign.

27. The rapid rise in capital flows to EMCs, driven, inter alia, by the quest for yield and the windfall gains associated with the rise in oil prices, has been supported by fundamental improvements in many of these countries. In particular:

- Since the Asian crisis, many EMCs have strengthened macroeconomic policy frameworks and improved their assessment and management of vulnerabilities. Moves toward more flexible exchange rate regimes, strengthened surveillance over financial systems, including in the context of efforts led by the official sector (FSAPs and FSSAs), improved understanding of balance sheet interlinkages, and the rapid accumulation of foreign exchange reserves have contributed to making economies more robust and less vulnerable to crises.

- Fiscal management and overall fiscal performance has improved substantially in many EMCs (Figure 13).

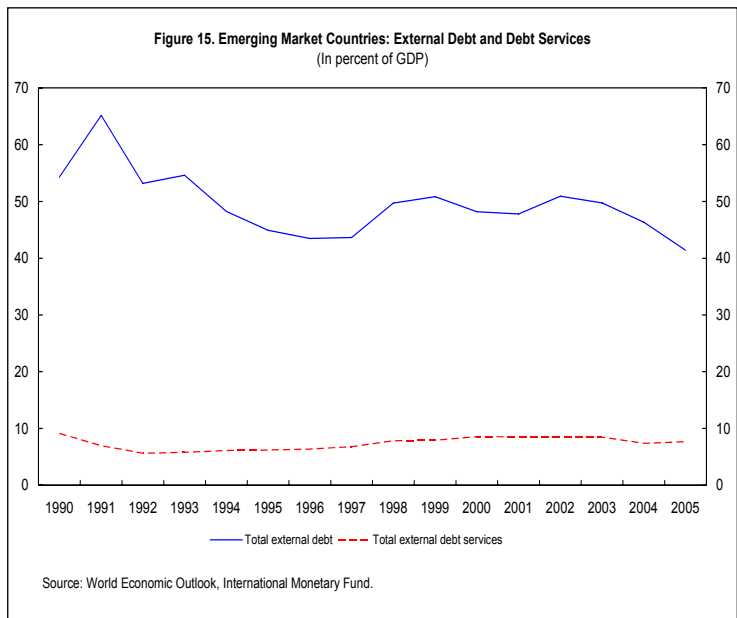
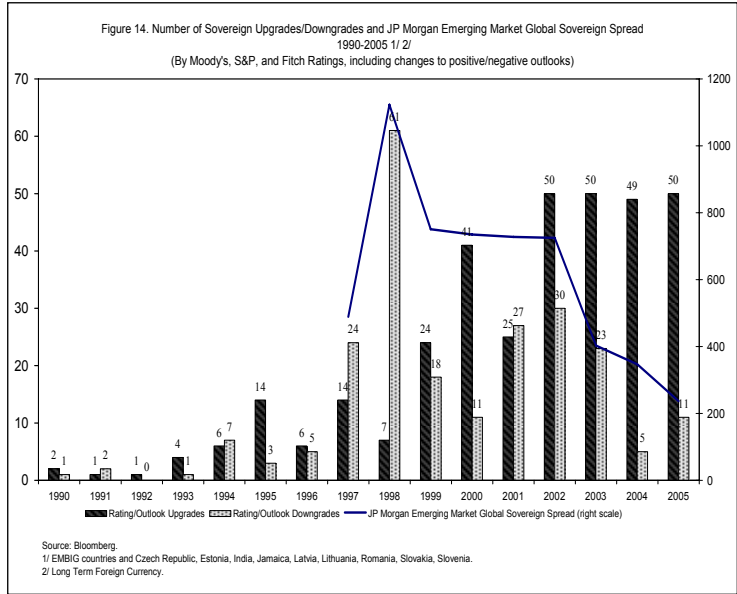
- And, with the aim of improving the environment for private sector decision making, these fundamental improvements have been accompanied by better and more timely data



provision and greater transparency. At the same time, regulation and supervision of financial sectors—and the assessment thereof—have improved markedly in many countries. These changes may be among the most important achievements of the initiatives taken to improve the international financial architecture that began in the wake of the Mexican crisis a decade ago.

28. Collectively, these developments have improved the credit ratings of EMCs and compressed their sovereign spreads (Figure 14), which, together with low global interest rates, have helped reduce their debt and debt-service burdens (Figure 15).

Capitalizing on these favorable trends, many EMCs have improved their overall debt management operations and capacity with a view to reducing exchange rate, interest rate, and rollover risks.



29. In particular, sovereign debt as a share of GDP for a large (albeit not exhaustive) sub-group of EMCs has declined from 44 percent in 2002 to 39 percent in 2004 (but this is still higher than the pre-Asian crisis level of 27 percent).<sup>13</sup> Similarly, based largely on experiences gained from previous crises, EMCs have actively sought to reduce exposure to foreign exchange risk, notably by retiring/repaying international bonds and increasing issuance of domestic currency debt. As a result, for the sub-group of EMCs, external debt has declined to 10 percent of GDP after peaking at 16 percent in 1999. At the same time, the share of local-currency denominated bonds in marketable sovereign debt of EMCs in the sample increased by 9 percentage points between 1996 and 2004, to around 82 percent. Furthermore, the maturity of EMCs' sovereign debt issues has increased in recent years. While international issuance has typically been in the form of fixed-rate medium-term bonds, the average maturity of international issuance by the EMCs in the sample has increased further to 13 years in 2005 from about eight years in 2001.

30. These positive developments notwithstanding, it needs to be noted that benign external conditions may mask underlying balance sheet vulnerabilities. The recent turbulence in the equity markets, first in early-May and subsequently in June, has been a reminder on this score. The associated sell-off in EMCs appears mainly to have reflected an adjustment in the pricing of risk, not a wholesale reassessment of the fundamentals in these countries. In particular, in the first phase of the recent correction in markets, EMCs with significant investment flows and valuation gains, and local markets with concentrated foreign investors' positions, corrected strongly; however, in the second phase of the correction, some EMCs with better fundamentals suffered much less than those with weak fundamentals. In particular, EMCs with large current account deficits, reflecting domestic consumption-led growth, that were financed by portfolio inflows, were the most seriously affected.

31. Clearly some EMCs may be at risk. A number of countries in Eastern Europe, including the Baltic countries, have relatively large—and, in some cases, worsening—external imbalances that appear to be driven primarily by rapid credit growth to the private sector (a development characteristic of some of the countries in East Asia before the crisis of 1997). A few of these countries also have large fiscal deficits and have built up large short-term external debt positions, most of it in foreign currency, and large net international investment liabilities. A key question here is whether these developments have made these countries vulnerable to sudden stops in the flow of foreign capital. It is worth remembering that before the Asian crisis, some of the countries most seriously affected—like many of those currently in Eastern Europe—enjoyed good credit ratings, which then dropped sharply as foreign capital flows reversed.

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<sup>13</sup> See *Global Financial Stability Report*, International Monetary Fund, April 2006.

32. Going forward, external risks—including an abrupt or unexpected rise in global interest rates, supply side shocks to the oil markets, or a disorderly unwinding of global current account imbalances—could prove challenging. In the face of such developments, investors may increasingly differentiate among EMCs. In particular, as external financial conditions become less benign, EMCs with macroeconomic imbalances and that still rely heavily on external financing face a narrower margin for policy slippages. Similarly, EMCs that still have sizeable vulnerabilities in the fiscal position and/or public sector balance sheets are more susceptible to pressures in their external accounts and to crises more generally.

33. In addition, policy makers in both mature markets and in EMCs face renewed challenges. Central banks need to communicate effectively to financial markets their assessment of inflation risks and their resolve to contain inflation. Moreover, supervisors and financial institutions need to redouble their efforts to monitor and manage risk, especially counterparty risk vis-à-vis hedge funds and those selling credit default swaps. Active debt management policies should continue as part of an overall plan to develop and strengthen local capital markets and deepen the institutional base.

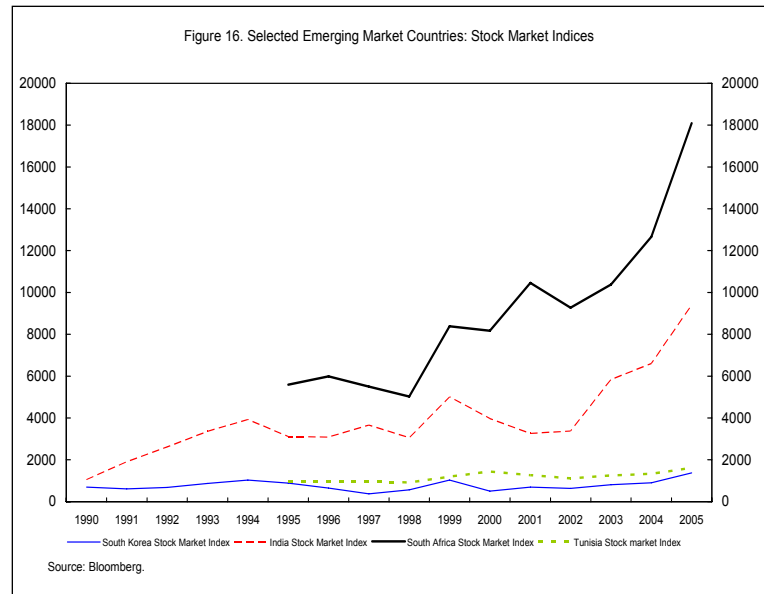
## **B. Foreign Direct Investment in Developing and Emerging Market Countries**

34. Notwithstanding the ever-present risks, most of the recent trends in emerging market financing are clearly welcome. They have improved the attractiveness of EMCs as an asset class, and have helped broaden the investor base toward more dedicated and longer-term investors. This is best reflected in the dramatic increase in FDI inflows to EMCs. In particular:

- FDI flows to EMCs have increased more than ten-fold from a modest US\$20 billion in 1990 to more about US\$237 billion in 2005. This trend, however, masks the sharp decline FDI flows to EMCs in the period following the Asian crises through 2003 and the equally dramatic rebound in 2004 and 2005.

- The increase in FDI flows to EMCs from US\$162 billion in 2003 to US\$237 billion in 2005 was part of the global increase in FDI to US\$959 billion in 2005. However, the more noteworthy element in this context is that FDI (as well as capital flows more generally) between EMCs—south-south flows—are growing more rapidly than north/south FDI.

- Along with the increase in FDI, there has been a surge in external flows into the equity markets in EMCs. This has contributed to the unprecedented rise in market indices since the late 1990's (Figure 16).



35. A number of factors underpin the overall expansion of FDI, and equity flows more generally, into EMCs. These include the continued robust global economic growth and its offshoot in the commodity price boom; strong corporate profits in EMCs and the consequent reinvestment of a large proportion of those profits in the host country; the changing nature of the multinational corporation from home-country centric to what some call “the globally integrated enterprise” (reflected, for example, in the greater willingness of multi-national companies to fund R&D in subsidiaries in the EMCs);<sup>14</sup> the much improved macroeconomic climate in many of the EMCs; and the generally improved investment climate. These positive developments have been complemented by significant financial innovations, including structured financial instruments, such as credit default swaps and other derivatives, that have facilitated the management of risk exposure in the EMCs; the development of local financial markets that have created a synergy with FDI inflows; increased privatization and cross-border mergers and acquisitions; and the ongoing scramble for natural resources.

36. Notwithstanding the rapid increase in FDI flows to EMCs, there remains a significant concentration of flows to the top ten recipient countries, which account for about 65 percent of total FDI flows to EMCs (less than the 75 percent of the

<sup>14</sup> Palmisano (IBM).

late 1990's). While East Asia and the Pacific remain the largest regional destination for FDI, both Latin America and, even more so, the developing and emerging countries of Europe and Central Asia have seen a surge in FDI inflows, in the latter from about US\$30 billion earlier in this decade to over US\$75 billion in 2005. The Middle East, South Asia, and Africa continue to attract only a modest share (about 15 percent of the total), but that share has increased by over 50 percent since 2000 and looks set to increase further.

37. As noted, an important feature of recent developments is the rapid increase in “south-south” FDI flows. It is, however, important to underscore that the paucity of data, and its imprecision, limits the extent to which the trends, and the factors behind them, can be precisely identified. The *2006 Global Development Finance Report* does a good job in gathering information from numerous sources to try to describe recent developments in this area.<sup>15</sup>

- South-south FDI flows increased from US\$14 billion in 1995 to US\$47 billion in 2003, partly offsetting the decline in north/south FDI (from US\$130 billion in 1999 to US\$82 billion in 2003), and raising the share of south-south FDI in total FDI to developing countries from 16 percent to 36 percent over that period.<sup>16</sup> These flows easily dominate both syndicated bank lending and cross border equity listings between developing countries.
- These changes are driven by many of the same factors that have led to closer integration across much of the globe in the last decade.<sup>17</sup> For example, the majority of developing countries—led by the EMCs—has become more open to foreign investment over the past 10 years. But these changes also reflect the increasing share of world trade that takes place between developing countries (up from 15 percent to 26 percent of total world trade between 1991 and 2004) and the even more rapid growth of trade between developing countries within the same region—spurred, in part, by the explosion in regional trade arrangements.<sup>18</sup> The evidence suggests that FDI follows, or at least runs parallel with, trade.<sup>19</sup>

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<sup>15</sup> As data are scarce, the report calculates south-south FDI as a residual, subtracting FDI outflows from high income to developing countries from total FDI inflows to developing countries.

<sup>16</sup> Paucity of data does not enable a further disaggregation to analyze South-South FDI flows, although the bulk of the flows appear to be to EMCs.

<sup>17</sup> By one measure, the vast majority of developing countries—76 out of a total of 84 rated developing countries—have become more open to FDI, both inward and outward flows, in the past 10 years.

<sup>18</sup> From 2000 to 2004, south-south trade grew at an annual rate of 17.6 percent, faster than south/north and north/south exports (12.6 percent and 9.7 percent, respectively (GDFR, 2006)).

<sup>19</sup> By way of example, while 30 percent of all FDI in telecommunications in developing countries was south-south, more than 85 percent of that was inter-regional.



- It is also likely that, as the 2006 *Global Development Finance Report* notes, “Developing country multinationals enjoy some advantages over industrial country firms when investing in developing countries because of their greater familiarity with technology and business practices suitable for developing-country markets.” In fact, the forces driving south-south FDI appear sufficiently powerful to overcome the greater impediments sometimes faced by developing country multinationals in their home country, including bureaucratic and financial constraints on outward investment.

38. While south-south FDI has increased rapidly in recent years, it has, like FDI more broadly, remained fairly highly concentrated among a group of countries that account for the bulk of such flows. Moreover, it has generally been the case that south-south FDI tends to be between developing countries within the same region. More recently, however, China, India, and some other developing countries are breaking this mold as the search for natural resources becomes a more and more important motivation for FDI. In 2004, for example, fully one-half of China’s outward FDI was directed towards natural resource projects in Latin America. In China, and increasingly in other developing countries, these results are being driven, in part, by the increasing role played by state enterprises, or by inducements provided by export-import banks and various subsidy mechanisms, in the search for natural resources. As the search for oil and for resources in the non-oil mining sectors increases, this broadening of south-south FDI beyond the usual regional constraints is likely to continue, further increasing the competition by investors in these sectors. Moreover, countries that are significant oil and gas producers are investing heavily in other developing countries as they integrate their downstream operations such as refining, distribution, and retailing.

## V. ISSUES FOR CONSIDERATION

39. The changed profile of capital flows, induced in part by the investment preferences of the oil exporting countries, and by their apparent caution in increasing spending in pace with the higher oil revenues, poses a number of critical questions:

- Will the ability of the U.S. to finance its fiscal deficit with only modest changes in interest rates and in the exchange rate of the dollar be compromised by the apparent investment preferences of oil exporters?
- Has the adjustment required to reduce the U.S. current account deficit been made more difficult? Has this increased the possibility of a hard landing in the global economy?

40. The emerging pattern of capital flows in the global economy, including the substantial increase in flows through the international banks, raises the specter of a repeat of the problems that developed in the wake of the recycling of the 1970’s or the crises in East Asia following the credit boom of the mid-1990’s. For sure,

the fundamentals in many of the EMCs appear much stronger now than was the case during those earlier periods but there are regions that look vulnerable, including Eastern Europe, and there are risks that may be little understood, especially from the exploding use of new and innovative financial instruments.

- Should these developments be viewed with concern?
- Are the monitoring mechanisms in place sufficient to encourage better risk analysis than was the case in earlier periods?
- Again, are there elements in these developments that could increase the possibility of a hard landing if the needed adjustments to the underlying imbalances are not made quickly and in an orderly manner?

41. While the increased flows of FDI to EMCs, including the rapid growth of south-south flows, are to be welcomed from many perspectives, the possible risks in these developments should not be ignored.

- Are there political/strategic risks from the increasing competition to secure natural resources? For example, will the kind of tensions and competition that was seen between the U.S.—or the West, more generally—and the former Soviet Union, which gave rise to so much proxy conflict in Africa, arise again as the countries seeking natural resource supplies confront each other in the (oil and non-oil) resource-rich states?
- Are there risks to the initiatives of recent years to pressure developing and emerging market countries to improve their governance? For example, does Angola care any more about this pressure—if it ever did—when China alone has loaned the country US\$3 billion in just the last two years, and as most oil companies continue to resist calls for greater transparency in their operations in these countries?





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