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A Financial Technologies Group Initiative

MARKETS IN MOTION

developments that matter in financial markets

Recent Trends in Capital Flows to Emerging Markets

"More permanent increases in inflows tend to stem from more fundamental factors and will require more fundamental economic adjustment."
IMF's Global Financial Stability Report (GFSR), April 2010

Introduction

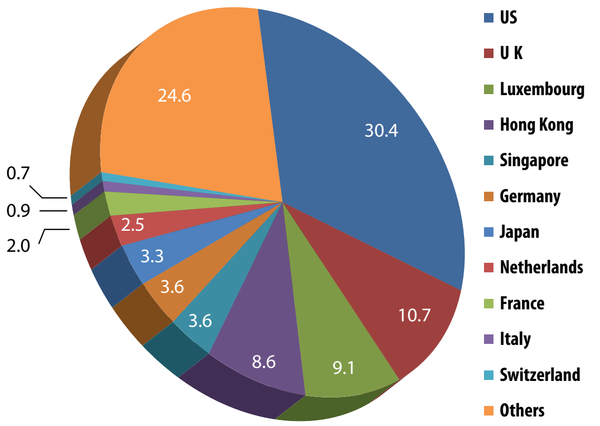
With increasing financial liberalization and cross-border capital flows, the world is becoming a smaller place and inter-linkages are on the rise. The West is increasingly looking at the East (read China and, to a lesser extent, India) to propel global growth. The appetite of emerging economies for finance has been growing exponentially and external finance has now become a crucial input in meeting the financial requirements of emerging markets. Conversely, the West is also on the look-out to secure safe markets to park funds and seek greater returns. While the economies are emerging from the aftermath of the global crisis, private external flows to emerging markets have come down to less than a third of the peak of $1,524 billion in 2007 and nearly halved from the flows in 2008.

Portfolio Investments

Portfolio investments into emerging markets bore the brunt of the crisis in 2008 with a substantial withdrawal of funds to the tune of $80 billion, at a time when the total worldwide portfolio flows were $1.3 trillion. The worst hit was the BRIC nations. Hong Kong and Singapore are the only two nations that allocate double-digit percentage of investment funds to emerging markets. The US invests a shade less than 10 percent of its investable resources of $4,268 billion into emerging markets. According to the IMF, only four percent of the global portfolio assets ($30,873 bn) were invested in emerging markets in 2008, a decline of two percent from 2007 levels and a marked drop from eight percent in 2006. In fact, the top 10 investing countries show a marked preference for investing more than 50 percent of the available funds among their own group. The US is most open to exploring markets outside this group—47 percent in 2008—while it is between 25 and 40 percent for European countries and Japan.

Geographically, 90 percent of Hong Kong's portfolio investment is directed to China while the US maintains a bias towards the Brazilian and Mexican markets; although Russia and India also command a substantial market share. The UK shows a bias towards investing in Indian markets. Of the total global portfolio flows, only the US invests more in equities among the top 10 investing countries in the world. Other countries exhibit a marked preference for long-term debt securities.

Sources of Portfolio Investments to Emerging Markets



Foreign Direct Investment

FDI, the largest contributor to private external resource mobilization, continues to power the fund flow. The share of global FDI flows into emerging markets has been on the rise, from 28 percent between 2005 and 2007 to 40 percent between 2008 and 2009. The BRIC nations alone cornered over 40 percent of the FDI flows in 2008, with China emerging as the most preferred destination for FDI investment, garnering $148 billion. FDI flows to Asia have doubled in the three-year period to 2008 to touch $241 billion. German investment directed into central Europe has ensured that FDI flows to the region trebled in the same period. UNCTAD estimates that the FDI flows in 2009 declined year on year by 35 percent to $430 billion.

Capital flows to the emerging market economies (EMEs) can be attributed to a variety of push and pull factors. The pull factors include overall improvement in macroeconomic management and macroeconomic stability accompanied by reduction in inflation and opening up of the capital account in varying degrees. The major push factor is the stance of monetary policy in the advanced economies characterized by low interest rates, perceived low financial returns, and the resulting risk mispricing. Thus, swings in monetary policy in the advanced economies have led to cycles and volatility in capital flows to and from the EMEs over which the EMEs have little control.

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