

Capital Flows to Emerging Market Economies: Illusory gains

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Net private capital flows to emerging markets accelerated sharply in 2004 to reach a seven-year high of \$279 billion, a 32 percent increase from the \$211 billion in net flows in 2003. These estimates were published by a recent publication of the Institute of International Finance (IIF).¹ In terms of the composition of capital flows, there was a solid rise in net direct equity investment (a jump of \$40 billion), which together with overseas commercial bank lending accounted for as much as 90 percent increase in net flows. Portfolio investment and non-bank credit flows also improved. Though on the official account net flows were negative due to repayments to bilateral and multilateral donors, attention is held entirely by the surge in private capital flows. The IIF projections for 2005 indicate that the overall net private flows would remain robust, roughly at the same level as last year. (see Table 1)

Table 1: Net Financial flows to Emerging Market Economies by Region
(in billions of dollars)

	2002	2003	2004e	2005f
Private flows	124.9	210.6	279.0	275.8
Latin America	17.3	25.2	26.1	39.4
Europe	45.6	65.6	97.4	101.1
Africa/Middle East	1.5	3.5	9.2	9.8
Asia/Pacific	60.5	116.3	146.3	125.6
Official flows	-5.4	-21.0	-18.5	-35.7
Latin America	5.9	0.0	-4.0	-11.6
Europe	2.2	-4.3	-5.4	-17.5
Africa/Middle East	-1.4	-2.4	-2.3	-2.5
Asia/Pacific	-12.1	-14.4	-6.8	-4.1

e=estimate, f= IIF forecast

Source: IIF (2005)

In terms of the destinations of private capital flows, many of the recipient economies are the ones that were seriously affected not so long ago by severe economic crisis. Leaving aside China and a handful of countries such as India and the East European transition economies, the major emerging market economies attracting private capital in 2004, Russia, Turkey, Brazil, Mexico, Argentina, Korea, Malaysia, witnessed capital outflows associated with financial crisis within the past 7-8 years. The revival of private investors' confidence thus is taken to signal the strength of economic recovery and return to sound 'fundamentals' supposed to guide long-term capital flows, particularly equity investments in emerging markets. IIF (2005) states, 'solid, albeit slowing, global growth, improving fiscal balances, strong trade surpluses, and higher reserve levels in emerging market economies have improved credit quality and lowered default risk.'(p.17) On the other hand, supply-side factors have spurred the process mainly through a weakening of the dollar with expectations of its further weakening, particularly vis-à-vis major emerging market currencies, as the latter liberalize their foreign exchange markets.²

Reversal of Net Resource Transfer

This story of return to normalcy and apparent strength of emerging market economies is punctuated by concern about the growing current account deficit of the United States, which might cause the US treasury to raise short-term interest rates, and thus detract

capital from moving into the emerging markets. US interest rates could also rise in response to inflationary expectations caused by oil price hike in the economy. (p.1 and 2) While the subject of 'major global external imbalance' has been brought up in the report, its relevance to the discussion is almost reduced to a positive agency, which has supported the flow of foreign capital into the emerging markets. And it is the resolution of the global external balance through higher interest rate and inflation in the US, the report warns, that might disrupt capital flows to these economies in the near future. This limited reading of the impact of global external imbalances, however, deliberately hides the fact that it is the emerging market economies surpluses that have financed the enormous current account deficit (\$513 billion in 2003) of the world's richest metropolitan country. Once this is factored in, it is obvious that from the emerging economies point of view, there is very little real movement of capital. The surge in private capital flows, at best, become redundant in such a scenario.

As the data presented in IIF (2005) shows, three of the emerging market sectors – Asia, Latin America and Africa & Middle East - have generated high current account surpluses in the past few years. Private capital flows to economies in these regions have added to pressures of exchange rate appreciation, to which the national Central Banks have responded by piling up massive stocks of international reserve currency. (see Table 2) Chandrasekhar and Ghosh (2004) argue that the international reserves of the emerging markets are being invested in US treasury bills thereby completing the loop of the capital's movement.³ Note that investments in US treasury bills earn a much lower return than the cost of private capital to the Southern states. It is an issue of current debate whether this obvious economic loss is worth the future 'fragile' insurance of stability, which the stockpiles of international reserves might provide in case of outflows of capital. Also, in the process of dealing with the excess supply of dollars, monetary authorities in the emerging markets are increasingly foregoing domestic monetary objectives. For instance, in India, the net domestic asset component of high powered money steadily declined over the 1990s, and by the end of the decade increments to high-powered money were constituted mainly by changes in net foreign assets.

Table 2: Emerging Market Economies' BOP: Selected Indicators
(in billions of dollars)

	2002	2003	2004e	2005f
Current Account Balance	79.0	120.8	159.9	127.5
Latin America	-9.1	11.2	22.6	7.7
Europe	8.2	-1.1	3.1	-6.7
Africa/Middle East	6.4	9.9	13.7	13.4
Asia/Pacific	73.6	100.7	120.4	113.1
Net Resident Lending/other*				
Latin America	-11.5	-2.7	-29.0	-18.6
Europe	-27.0	-24.4	-38.3	-41.5
Africa/Middle East	0.0	1.4	3.0	-1.8
Asia/Pacific	-8.4	32.5	20.6	5.7
Reserves (- = increase)				
Latin America	-2.5	-33.7	-15.7	-17.0
Europe	-29.0	-35.9	-56.8	-35.4
Africa/Middle East	-6.5	-12.4	-23.6	-18.9
Asia/Pacific	-113.5	-235.1	-280.5	-240.3

e=estimate, f= IIF forecast

* including net lending, monetary gold, and errors and omissions.

Source: Compiled from IIF (2005)

In an empirical study covering 26 developing economies, Boratav(2004) poses the present problem within an overall framework of dependency and exploitation through capital flows, which shows that historically relations of dependency and exploitation have been forged through processes that require metropolitan capital to move to the periphery, which gradually become the means for surplus extraction and net resource transfer back to the metropolis.⁴ The present juncture is one where the net resource transfer to the periphery is clearly negative. Here net resource transfer is defined as the sum of current account balance minus net income earnings as profit and interest income. In the early 1990s, after capital account liberalization in the South became widespread, net resource transfer was positive, which was reflected in rising current account deficit, though there were leakages in the form of outflows by residents. Beyond 1997, and especially in the most recent years 2001 onwards, net resource transfer turned positive as emerging market economies, even Ghana, Kenya, Cote d'Ivoire have moved into current account surplus. Boratav's estimates reflect that the US economy benefited upto \$563 billions in net resource transfers from the rest of the world in 2003.

A current account surplus for developing countries is not bad, if it is accompanied simultaneously by buoyant growth of these economies. However, an improved current account of a peripheral economy which emerges due to declining growth and/enforced servicing of external obligations corresponds to a position of weakness. Structural current account surplus under high growth appear to have emerged definitely only for China in the recent years. For the rest, the surpluses in the aftermath of financial crisis indicate a position of weakness. The IIF projections for 2005, therefore, do not come as a surprise:

"Emerging markets' import growth is expected to edge down this year as economic activity slows in these countries. The balance on services, income, and transfers is projected to continue to weaken. Interest payments are projected to rise from \$110 billion last year to more than \$124 billion in 2005." (p.9)

The only silver lining for the South that emerges from the IIF report is the new feature of South-South foreign direct investment expanding rapidly. The intra-emerging market flows now account for more than 30 percent of total foreign direct investment to emerging market economies, which is nearly double the share in 1995. Could this beginning mark a 'real' change in shifting global balances towards the South?

[1] Institute of International Finance (2005) Capital Flows to Emerging Market Economies, January 19, 2005

http://www.iif.com/verify/data/report_docs/cf_0105.pdf

[2] The decision of the Russian authorities to adopt a more flexible exchange rate policy for the ruble, departing from a long-held policy of keeping it stable, attracted large amounts of foreign capital. Similarly, the unexpected liberalization of lending rates in China was interpreted by investors as a significant step in the financial reform program and a crucial pre-condition before the adoption of a more flexible exchange rate, which would ultimately cause a revaluation of Renminbi.

[3] C.P. Chandrasekhar and Jayati Ghosh (2004) The New Structure of Global Balances http://networkideas.org/news/nov2004/news11_Global_Balances.htm

[4] Korkut Boratav (2004) 'Net Resource Transfer and Dependency: Some recent changes in the world economy' Paper presented at the IDEAs Workshop on The Agrarian Constraint and Poverty Reduction: Macroeconomic Lessons for Africa, Addis Ababa, 12-16 December, 2004.