

Box 2

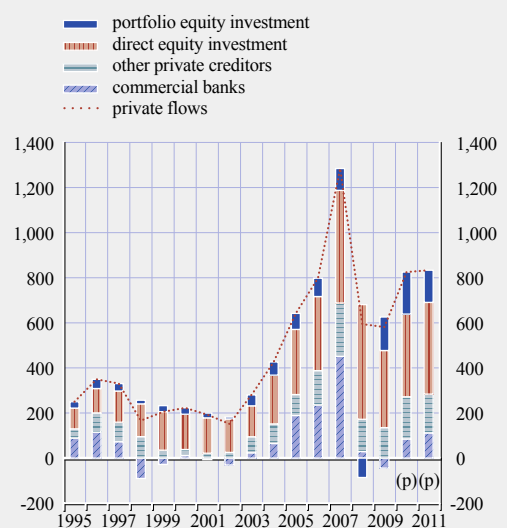
CAPITAL FLOWS TO EMERGING MARKETS

Private capital inflows into emerging economies have rebounded well from the trough experienced in 2009. The International Institute of Finance (IIF) estimates that the net private capital flows to emerging economies will total USD 825 billion in 2010 and USD 834 billion in 2011, significantly higher than the USD 581 billion recorded in 2009 (see Chart A). The most significant changes are expected in private creditors' (commercial banks and non-bank financial institutions) net inflows into emerging markets. Moreover, net portfolio investments in emerging markets are expected to continue to be sizeable in the medium term, totalling USD 187 billion in 2010 and USD 143 billion in 2011. In fact, using high-frequency data from a survey among fund managers (Emerging Portfolio Fund Research – EPFR) shows that portfolio inflows into emerging market assets, particularly into emerging market debt securities, started to rebound as early as the second quarter of 2009. In cumulative terms, inflows into emerging market equity markets exceeded the outflows recorded during the crisis by mid-2009, while bond markets have registered net inflows in cumulative terms since the second quarter of 2010.

Many fundamental factors, such as better economic growth prospects and sounder fiscal positions compared with advanced economies, as well as favourable conditions for carry trades, have contributed to the prompt recovery of private portfolio inflows into emerging markets. In addition, the revival of risk appetite among global investors has been an important driver (see Chart B) of private portfolio flows into emerging market assets. Strong capital inflows can have an impact on

Chart A Net private capital inflows into emerging economies

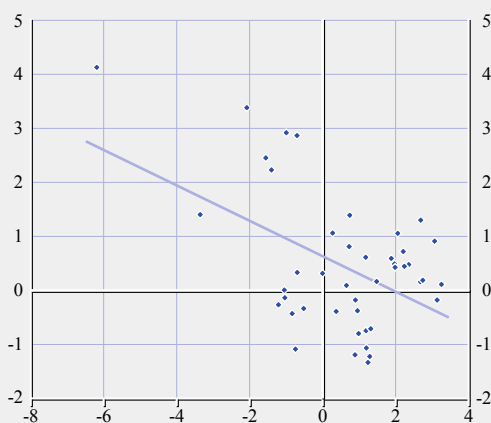
(1995 – 2011; USD billions)



Source: Institute of International Finance.
Note: (p) stands for projected.

Chart B Global risk aversion and capital inflows into emerging markets

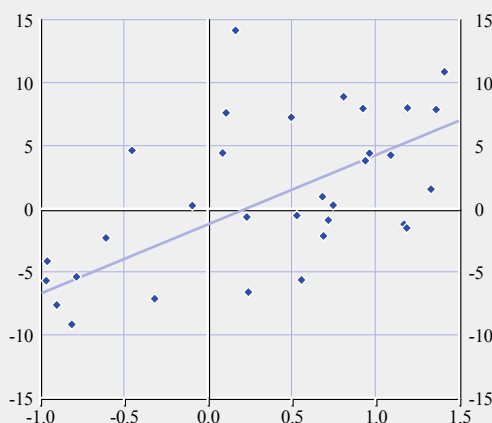
(Jan. 2007 – Sep. 2010; x-axis: total net portfolio flows; as a percentage of assets under management; y-axis: risk aversion; index)



Sources: EPFR, Bloomberg and ECB calculations.

Chart C Equity returns and capital inflows into emerging markets

(Jan. 2007 – Sep. 2010; x-axis: equity net portfolio flows; as a percentage of assets under management; y-axis: emerging market equity returns; percentage)



Sources: EPFR, Bloomberg and ECB calculations.

domestic financial and monetary conditions in emerging market economies. The link between net portfolio inflows and domestic asset prices is reflected in the strong correlation between net equity portfolio inflows and returns in the domestic equity market (see Chart C).

The fact that the risk appetite of global investors is an important driver of capital flows into emerging markets raises financial stability concerns. This is because swings in risk appetite can make capital inflows volatile and this can have severe implications for domestic capital markets and the real economy or indeed globally due to contagion and portfolio effects.

On the one hand, if there were to be a rise in risk aversion, sparked by a weakening macroeconomic outlook for example, this might contribute to a sudden stop of capital flows to emerging economies. This could have negative implications for asset price developments and increase the cost of funding or reduce its availability. In addition, there might be negative feedback loops between the financial sector and the real economy. On the other hand, if there were to be a rise in risk appetite, it might trigger significant capital inflows searching for higher yields. This could raise concerns about overheating, the potential build-up of asset price bubbles, increased asset price volatility and pressure on exchange rates.

At present, choosing the right policy mix to confront the potential destabilising impact of volatile capital inflows is a challenging task. The policy dilemma that many emerging economies face is that domestic conditions call for monetary policy tightening, whereas interest rate hikes can attract further capital inflows. The dilemma explains the increasing recourse to macro-prudential policies, especially in emerging Asia, and in some cases to capital controls. As regards macro-prudential tools, measures to control mortgage lending, such as requirements for downpayments or loan-to-value ratios, have been introduced in China, Hong Kong and Singapore to moderate property price increases. The recent moderation in the region points to a certain degree of success in the implementation of these measures, at least in the short term. Capital controls to curb portfolio inflows have also been adopted as another way of preventing macro-financial

risks. Limitations have been placed on short-term capital inflows in Brazil, Korea, Taiwan and Indonesia. The empirical evidence on the effectiveness of capital controls is inconclusive, however. There is therefore no clear outcome of a cost/benefit analysis between the benefits of a potential containment of an overheating economy and the costs of capital controls in terms of distortions in capital allocation and hindering the process of global financial integration.