

EXCHANGE RATES AND CAPITAL FLOWS REVERSE DIRECTION

After a long period of strength, from the mid-1990s to its peak at the end of January 2002, the US dollar has been weakening. In nominal effective terms, it depreciated by over 10 percent between January 2002 and November 2003. The adjustment of the dollar was especially significant against the euro which appreciated 35 percent, reaching all-time highs of over \$1.20 by the end of November 2003. The euro gained about 15 percent in nominal effective terms over the period. The dollar also weakened against the yen, albeit to a lesser extent. In contrast, the yen continued to decline against the euro, from ¥117.12 in January 2002 to ¥128.

During the period of dollar strength, high actual and expected productivity growth had under-

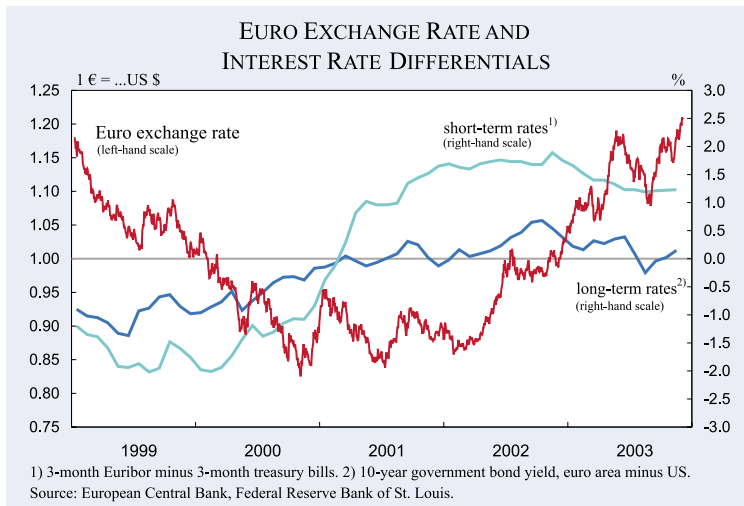
pinned a rapid increase in investment and an exceptional rise in US equity prices. The prospects of higher returns in the United States had attracted large portfolio flows, especially into equities and corporate bonds, as well as foreign direct investment flows. These capital inflows had fuelled a sizeable appreciation of the dollar which in turn weakened the current account balance.

By contrast, in the first half of 2002, both the direction and the composition of capital flows changed, as confidence in the US financial markets deteriorated. In addition, restrictive changes in US trade policy were interpreted as suggesting increasing official concern about the US current account deficit. In 2002, the deficit reached 5 percent of GDP and net foreign liabilities exceeded 20 percent of US GDP for the first time. Private portfolio and FDI flows from the euro area to the United States became negative, on a net basis. Moreover, international investors shifted still further away from portfolio equity and FDI into safer assets. The

share of the US deficit financed by official dollar reserves, mostly held by Asian countries, rose considerably.

Interest-rate differentials have re-emerged as an important determinant of capital movements and hence exchange rate changes. Having the highest interest rates among the three major economies, the euro area has been the prime destination of these yield-driven capital flows, underpinning the euro's appreciation.

H.C.S.



SHARP RISE IN PRIVATE CAPITAL FLOWS TO EMERGING MARKET ECONOMIES

The stock markets of the industrialized countries have bounced back. The S&P index of the United States, for example, increased by 35 percent from its low on October 9, 2002. But this is nothing compared to what has happened in the stock markets of emerging market countries. From the same date they have jumped by 60 percent, driven partly by investors from the industrialized countries. Despite losses sustained in the Asian crisis of 1997, these investors are back, believing that the emerging markets are more stable today, economically and politically, and that the returns are just too good to pass up.

In 2002, private net capital flows to emerging markets were less than half their mid-1990s peak. But they have been rising. This year, they are expected to increase to \$162 billion from last year's level of \$121 billion, a ten-year low. In 2004 private net capital flows to emerging markets are projected at \$185.7 billion (Chart).

Turnaround in net inflows of portfolio investment

Emerging market net portfolio equity investment is expected to shift this year to net inflows of more than \$13 billion from last year's net outflow of about \$1 billion. The Asia/Pacific region will account for nearly two-thirds of the turnaround in flows, as asset prices continue to rebound. In 2004, net portfolio equity inflows are projected to approach \$17 billion. Prospects for improved corporate profitability

against a backdrop of stronger macroeconomic conditions should be supportive of a further increase in flows. The Asia/Pacific region's portfolio equity inflows are expected to jump to more than \$11 billion in 2003, from \$2.6 billion last year. In 2004 net portfolio equity flows to the region are expected to reach \$13.3 billion. China and Korea are likely to account for \$10 billion of these flows.

Direct Investment to bottom out this year

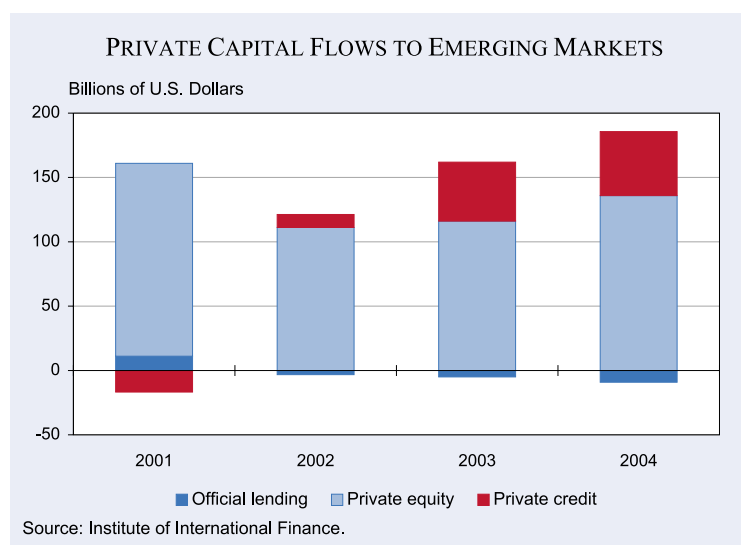
Although direct investment is likely to fall to \$103 billion this year, the lowest level since 1996, these flows still represent nearly two-thirds of total net private capital flows to emerging markets. The trough expected in FDI this year is attributable in part to weak growth trends in the world economy since 2001 and the lingering effects of the bursting of the technology and IT bubble. A decline in mergers and acquisition activity has also dampened direct investment as has a reduction in privatization of state-owned enterprises. An expected pick-up in emerging market growth in 2004 should help provide a boost to direct investment again.

Progressive recovery of net private credit flows

The willingness of investors to purchase emerging market bonds has increased sharply this year, reflecting a search for yield outside mature markets where equity prices remained weak early in the year and accommodative monetary policy pushed down bond yields. Net financing from non-bank private creditors, primarily in the form of bond purchases, is expected to double in 2003 from last year's \$16 billion. A further increase is expected in 2004. The capacity of emerging markets to absorb more debt will continue to improve as the ratios of overall external debt and debt service to exports fall further from their peak in the late 1990s.

Commercial Bank Lending turning positive again

Net commercial bank lending in 2003 will be positive again for only the second time in six years. It is projected to exceed \$13 billion, mostly flowing to emerging Europe, following net repayments of \$5.7 billion in 2002. In 2004, net lending by commercial banks to emerging market countries could fall below \$10.5 billion, as net lending to Asia is expected to fall.



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ENORMOUS GROWTH OF FOREIGN EXCHANGE RESERVES IN ASIA

Global foreign exchange reserves have risen sharply over the past decade, with the build-up accelerating over time and the bulk of the increase occurring in emerging markets. According to the Bank for International Settlements, reserves almost doubled from 4.1 percent of world GDP in 1990 to 7.8 percent in 2002, and rapid reserve accumulation continued in 2003. The share of emerging market countries rose from 37 percent in 1990 to 61 percent in 2002, with emerging markets in Asia accounting for much of the increase.

While the rapid accumulation of reserves between 1997 and 2001 was broadly in line with fundamentals, the surge in reserves in 2002 and 2003 was excessive by any measure. It has been driven by

increases in the current account rather than capital flows.

From a multilateral perspective, the current account surpluses in many emerging market countries are the largest counterpart to the US current account deficit. In 2002, the current account surplus for emerging economies in Asia was \$133 billion, larger than that of Japan (\$113 billion) or the euro area (\$72 billion). Neither the euro area nor Japan appear particularly well placed to generate faster growth of domestic demand in the short run. Thus, an eventual narrowing of the US current account deficit from its current (unsustainable) level will most likely require the emerging economies in Asia to share in the adjustment.

However, during the recent period of US dollar weakness, the relative price adjustments have in fact fallen mostly on the euro area, whereas in emerging economies in Asia, the rapid reserve build-up and stability of exchange rates against the US dollar have meant that real exchange rates have actually depreciated.

From both the domestic and the multilateral perspectives, a slowdown in reserve accumulation in emerging economies in Asia appears desirable. Growth there should become more reliant on domestic demand, accompanied by a steady reduction in current account surpluses over the medium term. One key aspect in this would be to allow greater exchange rate flexibility.

H.C.S.

