Capital Flows to Emerging Markets from Australia: Facts [*]

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Abstract

With the passage of time now we have a clearer picture on what happened to capital flows in East Asia during the crisis period. This paper briefly summarises the available data, drawing primarily from the Australian Bureau of Statistics (ABS) and Axis Australia. It focuses on size and volatility of capital flows to emerging markets from Australia especially into Asia and in particular equity flows. The paper concludes with the evidence that the equity flows from Australia to Asian countries is picking up and the future prospects for equity flows to these countries look brighter.

Keywords: Capital Flows; Emerging equity markets; Australia;

[*] I would like to thank Garry Hobbes for his helpful comments.

I. Introduction

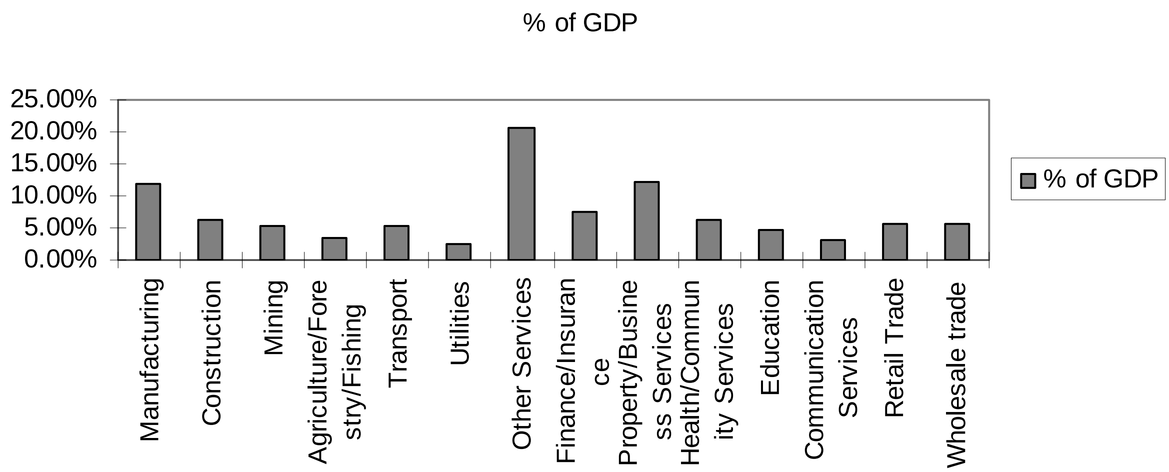
Over the past three decades equity markets over the world have experienced exceptional growth and expansion. Total market capitalization of the world equity markets have increased from a modest US$ 1 trillion in 1974 to in excess of US$ 16 trillion by the end of 1997[i]. The process of growth in the world markets could be because of improved macroeconomic and financial fundamentals or because of investors' enthusiasm, which may have distorted the relationship between market fundamentals and equity valuations. Net private capital inflows into Asia during the mid 1990's were exceptional in terms of the total dollar amounts and also in terms of the size of these economies (Grenville 1998). During 1998 when these countries ran into financial crisis this inflow of US$ 100 billion reversed into an outflow of US$ 55 billion. There have been numerous studies after the crisis providing a general overview of the crisis and to identify reasons of crisis to provide possible measures to prevent future crisis.

Asian crisis was different from other crises in the world (Gupta and Basu, 2005). With the passage of time now we have a clearer picture on the crisis and what happened to capital flows in East Asia during the crisis period. This paper briefly describes the Australian financial sector and summarises the available data, drawing primarily from the Australian Bureau of Statistics (ABS) and Axis Australia. It focuses on size and volatility of capital flows to emerging markets from Australia especially into Asia and in particular equity flows. The paper concludes with the evidence that the equity flows from Australia to Asian countries is picking up and the future prospects for equity flows to these countries look brighter.

II. Australian Financial System

Changes in the international capital markets and deregulation of 1980s in Australia opened new possibilities for raising capital, investing and hedging risk. Australia has a highly developed financial sector. Australia historically was viewed, as a commodity-based economy has become a services based economy during the past decade. Currently Australian financial sector (including insurance industry) ranks third largest industry sector[ii]. Financial sector's contribution to economy during 2001-02 was around 7.4 percent of Australia's gross domestic product (GDP) for the year.

Figure 1



Source: Australian Bureau of Statistics, 2003

Australian financial market comprises of Banks, Investment bankers, Insurance industry, Capital markets, Foreign exchange market, Equities market, Debt securities market and Derivatives market.

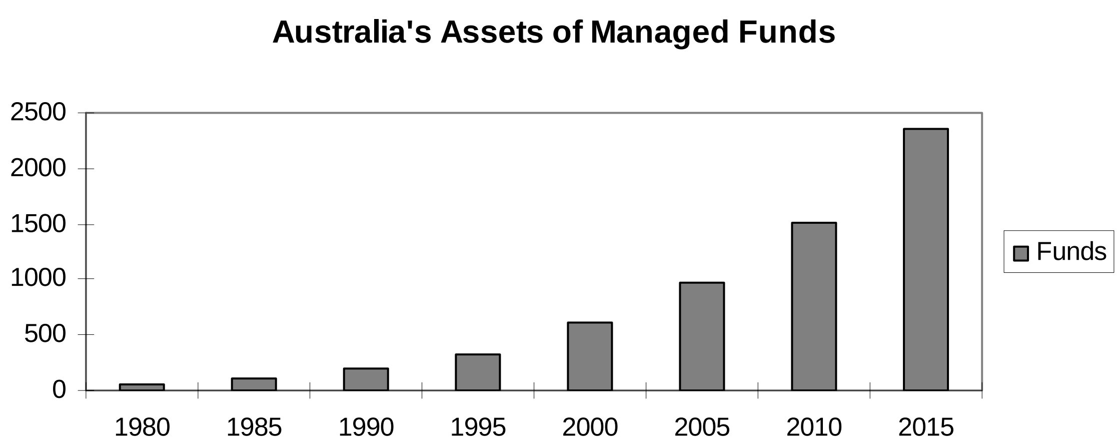
Banks: Australia has a competitive and technologically advanced banking infrastructure. Australian banks have sound capital backing, low levels of impaired assets and high levels of provisioning.

There are 50 authorised banks in Australia, 36 foreign owned, 14 domestic and 83 money market companies or merchant banks[iii]. Australian banking sector has established base in Australia after the deregulation of 1980s. Australian banks in June 2002 had total assets of A$ 958.1 billion which was 18.7% more than the assets in 2001.

Investment Management: Government backed retirement income policy helped the growth of the managed funds industry and the total funds pool at the end of 2002 is quoted as A$ 645 billion and is estimated to be A$ 2.3 trillion by the end 2015.

The funds management market in Australia grew owing to the government's compulsory superannuation policy and the growth has attracted foreign asset management companies to Australia. This growth in the size of the funds has given rise to the increased use of specialist investment managers. Increase in the funds placed with the professional investment managers is faster than the growth in the underlying investment funds pool itself, funds with the professional managers has increased from A$ 154 billion in June 1990 to A$ 628 billion in June 2002. Chart below shows the growth in Australia's pool of managed funds including the projections up to 2015 by Reserve Bank of Australia (RBA, 2003)

Figure: 2



Source: Reserve Bank of Australia, 2003

Insurance: Australia has a well-developed insurance industry, comprising of 200 firms including general, life and reinsurance businesses. As at December 2001, insurers held approximately A$ 265 billion in financial assets. Insurance industry is the second largest employer group after banks in Australia. Export of Insurance services earned A$ 680 million in 2001 (Axis Australia 2005).

Financial Markets: Australia is a key centre in Asia-Pacific region for capital market activity. Australian markets have deep liquidity in foreign exchange, equities, debt and derivatives market. Australian markets have benefited from the timely deregulation and high quality of institutional and operational infrastructure supported by highly skilled workforce.

Foreign Exchange: Australia has a large, liquid and open foreign exchange market. In a survey by Bank for International Settlements (BIS), Australia was ranked eighth largest centre for foreign exchange trading. During the period 1998 to 2001 Australia's daily turnover on foreign exchange grew by 11%, over the same period the world market declined by 19% (Axis Australia, 2005).

Debt Securities: Australian debt market accounts for less than 1% of the global outstanding. During the period, 1997-98 to 2001-02 Australian debt market has experienced a growth of 27%. With the decrease in budget deficit in Australia during the period and resulting decline in the government debt, there has been a rise in the issuance of non-government debt securities. In 1996, non-government debt issuance accounted for 12% of total debt issuance, which rose to 46.2% in 2002 (Axis Australia, 2005).

Derivatives: Sydney futures exchange (SFE) along with Australian stock exchange (ASX) provides markets for traders to trade in the derivatives. A wide variety of derivative products is available at these markets and these products provide significant risk management benefits to the participants. In 2001, 35.8 million contracts were traded on SFE; this represents a notional value of US$ 5.8 trillion, (Axis Australia, 2005).

An active over-the-counter derivative market also exists in Australia, mainly trading in swaps and repos.

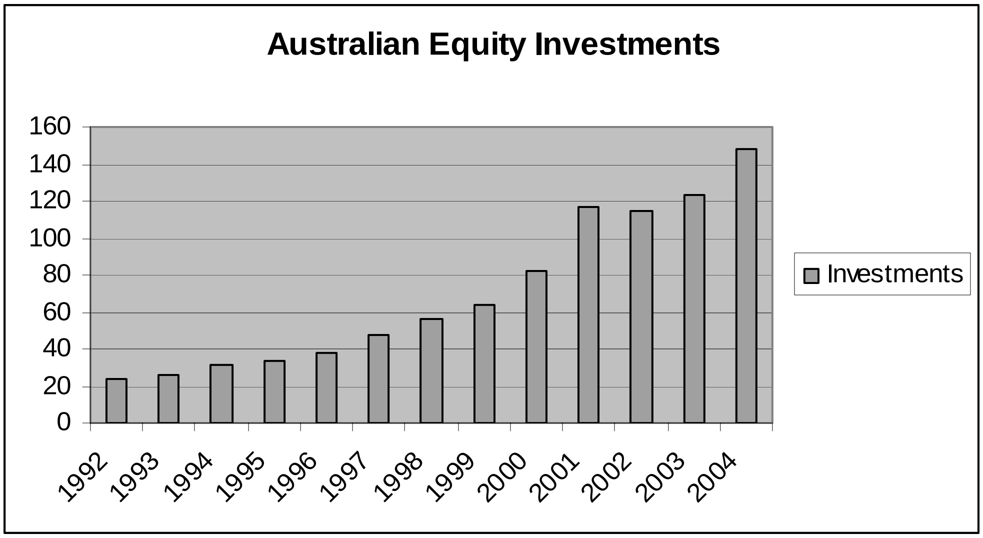
Equities: In terms of market capitalisation, the Australian Stock Exchange (ASX) is currently the twelfth largest stock exchange in the world and third largest in Asia-pacific region after Japan and Hong Kong. In 2001, Australia had a weighting of 1.5% in Morgan Stanley Capital Index (MSCI), (Axis Australia report (2005)). In terms of MSCI Asia-Pacific ex-Japan index, Australia has a weighting of approximately 35%. During the same period, market capitalisation of domestic securities was approximately A$ 732.8 billion and of overseas based equities A$ 376.8 billion (Axis Australia, 2005).

Reserve Bank of Australia bulletin (2004), document the inflow and outflow of capital between 1952 and 2002. The comparisons show that up to about 1980, the current account deficit was around 2% of GDP and there was a similar inflow of capital. After 1980, the current account deficit jumped to approximately 4% and the capital inflow to a similar level. During the same periods, the report document there was a negligible outflow of capital due to the capital controls, these controls were specifically designed to restrict these flows. After the removal of the controls in 1983, the outflow of capital from Australia has averaged around 3% of GDP and the capital inflows increased to 7%.

The reserve bank report shows that the as a percentage of the GDP the outflow of portfolio capital from Australia on an average has stayed constant over the last 10 years (approximately 2%). An important point, which the reserve bank report highlights, is the increase in investment by the superannuation funds into overseas equities (currently 25% of the total of superannuation funds are invested in the overseas equities).

The level of Australian investment reached $ 649.7 billion at 31 December 2004, an increase of $ 110.2 billion on the previous year, an increase of 16.96%. Equity has been the main form of Australian investment abroad, as at 31 December 2004, total equity investment abroad was $ 403.6 billion out of which portfolio investment was $ 147.7 billion, balance in foreign direct investment (Australian Bureau of Statistics, 2004). Following chart shows the growth of Australian investments abroad during the period.

Figure 3



Source: Australian Bureau of Statistics; International Investment Position (2005)

Flow of equity from Australia into overseas markets has grown consistently over the period from 1993 to 2004 (except during the year 2002). Table 1 shows the break up of these equity investments into different emerging markets despite the missing data for some of the emerging market countries, sufficient data is available to infer that emerging markets are an important destination for the equity investments for Australian investors.

Around the Asian crisis of mid 90’s Asian emerging markets were out of favour and international investors were withdrawing from the emerging markets in general; more importantly from Asian markets. Data shows that around 2000 this reversed and equity investments again started to flow into emerging markets.

Table 1

Equity Investments into emerging markets 1999-2004 (millions of AUD)

Year	Chile	Greece	India	Malaysia	Philippines	Thailand	EM Total
1999	6	55	n.a.	139	n.a.	n.a.	200
2000	2	n.a.	n.a.	152	n.a.	81	235
2001	6	39	n.a.	109	13	41	208
2002	7	n.a.	n.a.	65	36	45	153
2003	5	n.a.	539	100	19	139	802
2004	5	n.a.	787	173	26	188	1179

Source: Australian Bureau of Statistics; International Investment Position 2005; all figures in million Australian dollars. [iv]

When dealing with the emerging market data, there is a problem of missing values and incomplete data. Even the incomplete data set is sufficient to show that the equity investments to emerging market economies have risen and more countries are being added to the data set, which suggests that emerging markets are in favour. Table 2 shows the proportion of Australian equity investments into emerging markets as percentage of total investments abroad. Australian equity investments into emerging markets were at its highest around the Asian crisis. Asian crisis may have caused the withdrawal of these investments and now the flow of investments into emerging markets has started to rise from 2000, with a slight fall in the year 2002.

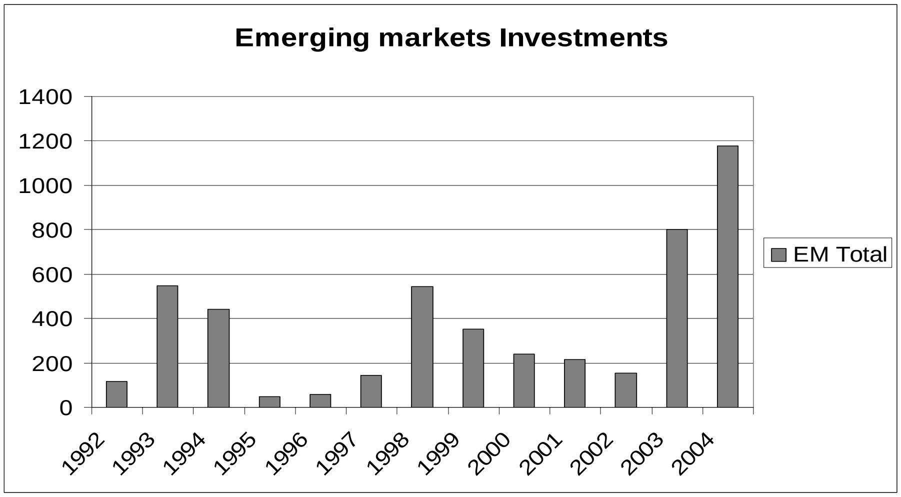
Table 2

Year	EM Total	% of Total	Year	EM Total	% of Total
1992	115	**0.48**	1999	354	**0.56**
1993	547	**2.09**	2000	240	**0.29**
1994	440	**1.40**	2001	214	**0.18**
1995	47	**0.14**	2002	153	**0.13**
1996	58	**0.15**	2003	802	**0.65**
1997	144	**0.30**	2004	1179	**0.80**
1998	545	**0.97**			

(EM figures are Australian investments into emerging markets (millions Australian dollars) and % shows the emerging markets investments as a percentage of total equity portfolio investments from Australia during the period.)

Figure 3 shows Australian equity investments into emerging markets and Australian investments into emerging markets as a percentage of total equity portfolio outflows from Australia during the years.

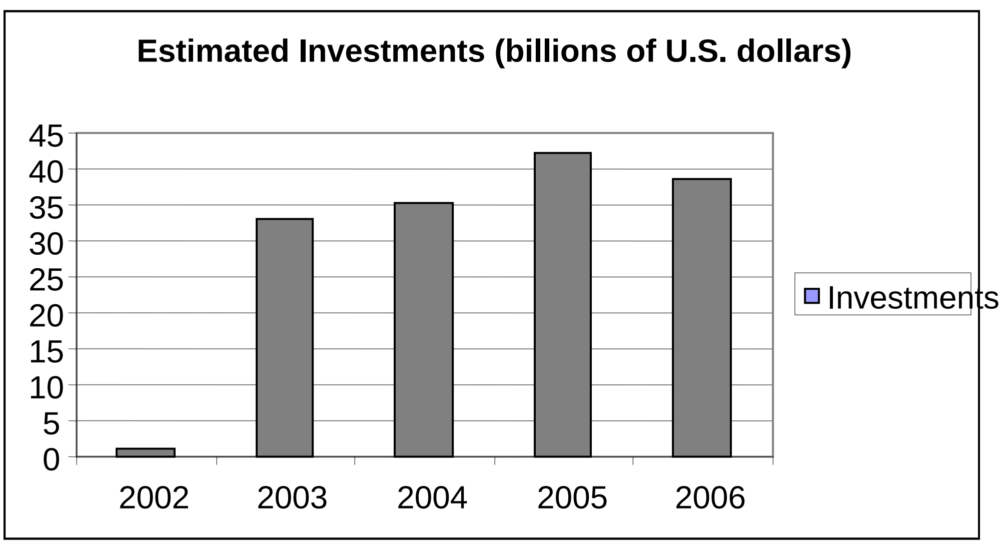
Figure 3



Source: Australian bureau of Statistics, 2005.

Following figure shows equity portfolio investment into emerging markets from rest of world. Investments into emerging markets from rest of the world are consistently rising with a small decline in 2006 estimated figures.

Figure 4



Source: Institute of International Finance, September 2005.

III. Conclusions

This review shows emerging markets have been and are becoming more important for equity portfolio investments from the rest of the world. As the heat from the Asian crisis settles the flow of portfolio investments is returning to the emerging markets. In Australia, since the removal of exchange controls and other financial deregulation the flow of equity capital has been consistently rising to the emerging markets; except for the period surrounding the Asian crisis, which caused a reversal in the flow of equity investments to the emerging markets. Further despite the reservations expressed by some researchers and practitioners the flow of equity to the emerging markets is in the interest of Australia. Further the growth in equity investments into emerging markets and improved sentiment towards the investments into emerging markets will reflect in portfolio strategies pursued by the portfolio managers seeking international diversification.

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[i] Li (2002)
[ii] Axis Australia, Executive Briefing, 2005, Financial Services in Australia.
[iii] Axis Australia, Executive Briefing, 2005, Financial Services in Australia.
[iv] EM market total is the total of the data available from ABS. Actual figures may vary as figures for some of the emerging markets is not available with the ABS.