

VAKIFBANK GLOBAL ECONOMY WEEKLY

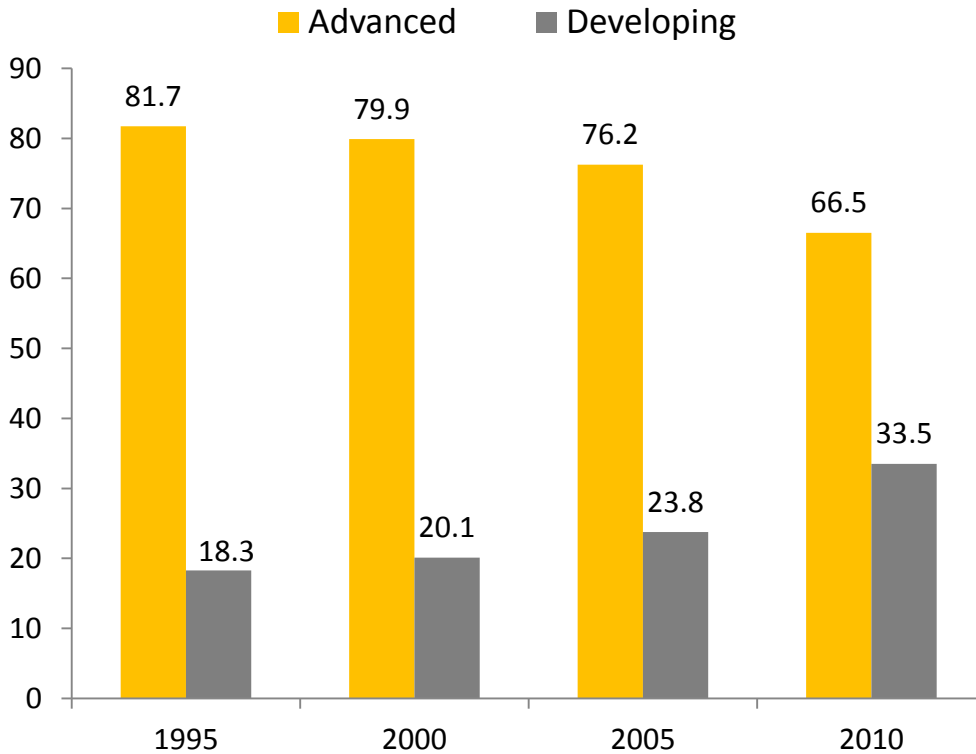
Capital Inflows Too Much to Feel At Ease






T. Vakıflar Bankası T.A.O



The Distribution of the World Gross Domestic Product (%)

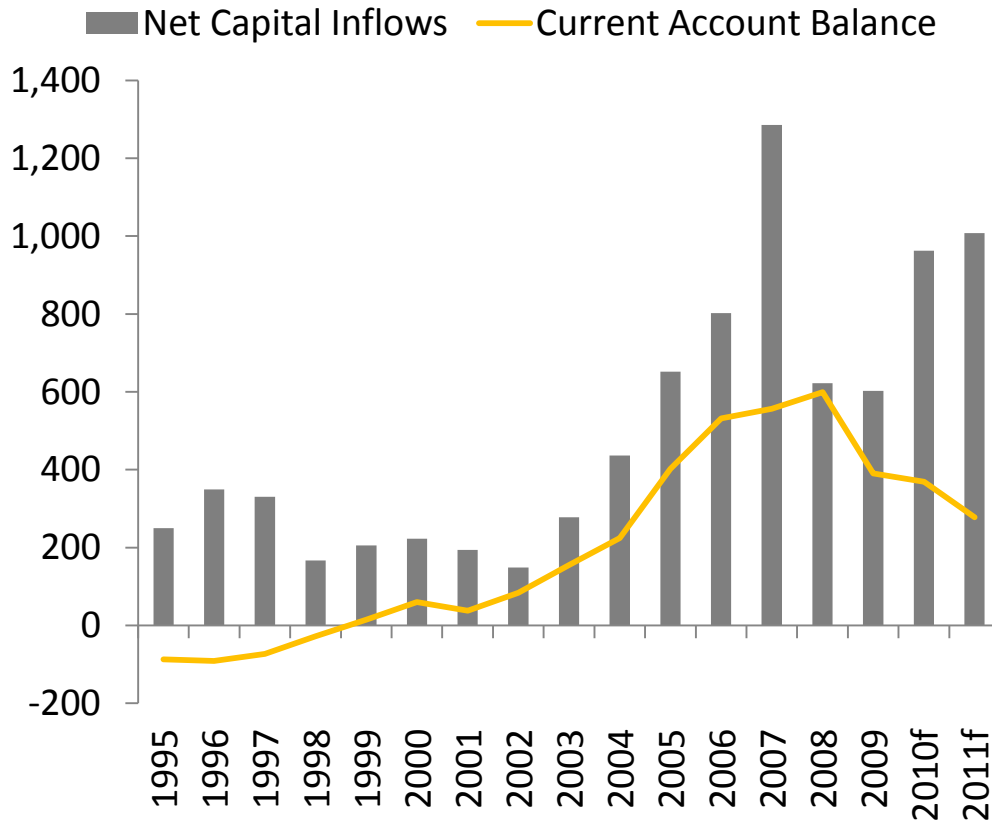


Source: IMF

-  *The distribution of the world Gross Domestic Product (GDP) across the different groups of economics has changed since 1995. While in 1995 developing countries accounted only 18.3% of world GDP, this share has reached to 33.5% in 2010.*
-  *International Monetary Fund (IMF) estimates that developing countries keep their high growing performance in 2011 and 2012.*
-  *The rising contribution of developing countries on world output growth makes these countries policy more important for advanced ones.*

The net capital inflows to developing countries have increased ...

Net Capital Inflows to Developing Country and Current Account Balance



Source: IIF

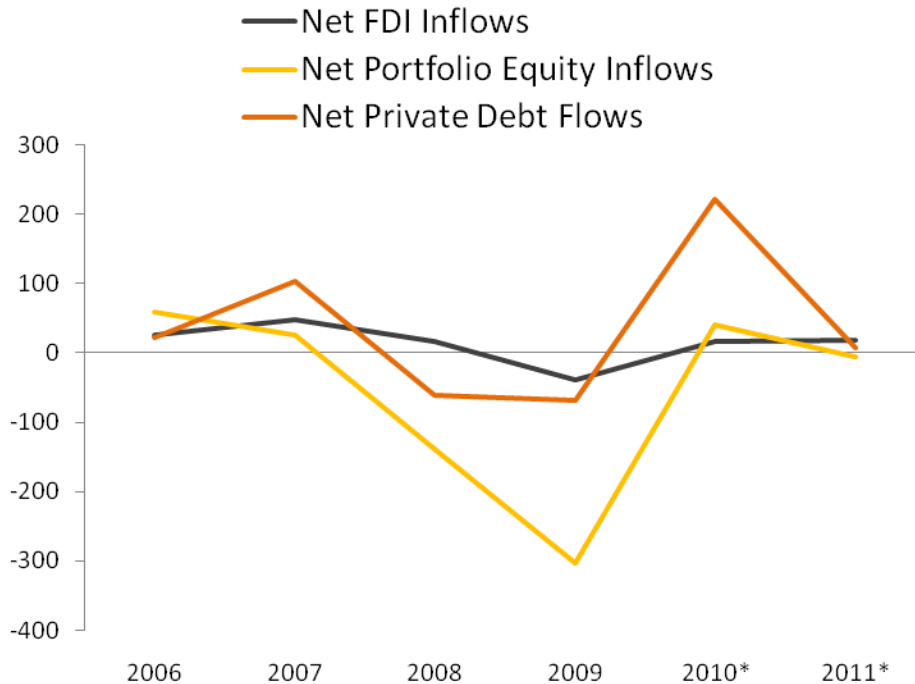
- ▣ The net capital inflows to developing countries have increased gradually during 2003-2007 and reached to its all time high (1.2 trillion dollars) in 2007.
- ▣ The global financial crisis caused considerable decreasing net capital inflows to emerging economies.
- ▣ International capital flows to emerging economies recovered in 2010.
- ▣ Net private capital inflows to developing countries are estimated to be \$960 billion in 2011 and \$1009 in 2012 by Institute Of International Finance.

Main reasons of increasing capital inflows to emerging economies...

- ✓ Improving macroeconomic structure:** *Better monetary and fiscal policies, lower inflation and growth volatility, and higher international reserves provide more feasible investment opportunities.*
- ✓ Ample global liquidity:** *The global liquidity that is increased by quantitative easing policy of advanced economies is important external factor for capital flows to emerging economies in the high financial integrated world.*
- ✓ High saving rate:** *Some emerging economies, especially China, have run high current account surpluses, thanks to high domestic saving rate. This provides lower sudden stop risk.*

The nature and term structure of capital flows to developing countries have changed...

Net Capital Flows to Developing Countries (%)

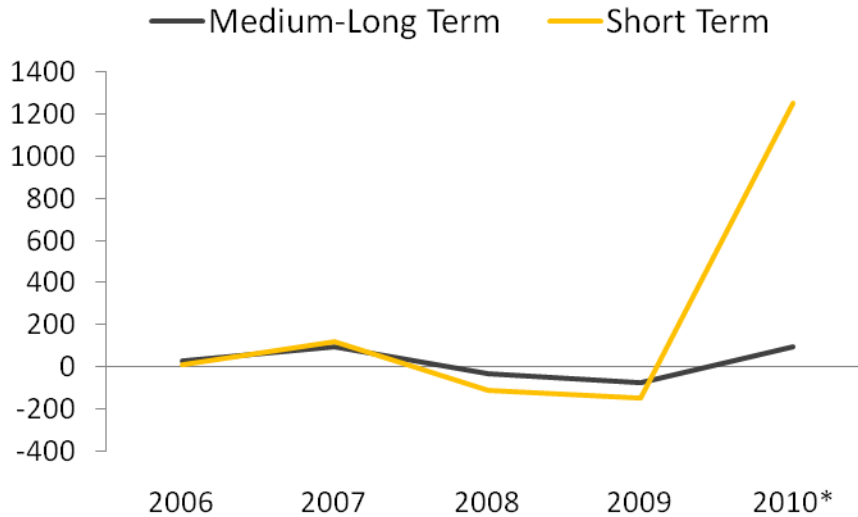


Source: World Bank
*World Bank Forecasts

- Net private capital inflows to developing countries increased about an estimated 45% in 2010 after a 27% drop in 2009.
- Net FDI inflows are estimated to reach \$409.6 billion in 2010 and have the highest share in total capital flows to these countries.
- Net FDI inflows to developing countries increased from an average of 3.36% of their GDP in 2006-2007 period to an estimated 2.18% in 2010. This doesn't imply a significant increase after a drop to 2.09% in 2009 from 3.57% in 2008.
- Net portfolio inflows on the other hand surpassed the pre-crisis level of \$135.1 billion reaching an estimated \$153.4 billion in 2010.

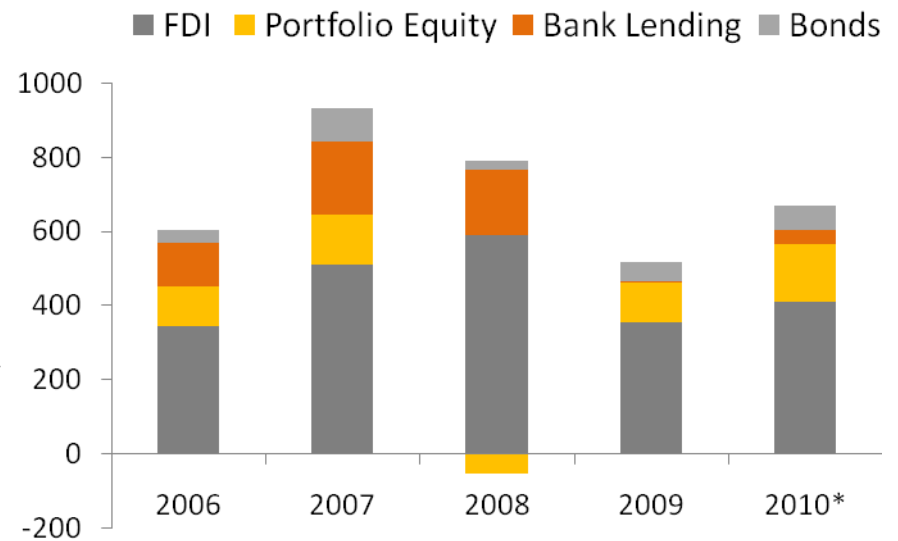
Sharp increase in short term debt flows...

Net Private Debt Flows Maturity Composition (%)



Source: World Bank
*World Bank Forecasts

International Capital Flows (\$ billion)



Source: World Bank

- After a sharp dropdown due to the contraction in credit markets in 2008-2009 period, private credits had the biggest rebound but remained far from the pre-crisis level of \$467.2 billion with an estimated \$190 billion in 2010, signifying that the credit markets couldn't achieve a full recovery yet and still very sensitive to uncertainties.
- This is effective on the shortening of the term structure of the capital flows and can be seen in the estimated private credit figures for 2010.
- The short term credits are estimated to fold up the 2009 level about 14 times in 2010 against a 97% increase in the long term credits.

Rising capital inflows can lead to macroeconomic imbalances in developing countries...

- ✔ Capital inflows ease credit expansion.***
- ✔ And the resulting credit growth may trigger inflationary pressures.***
- ✔ The shortening of the maturity of capital inflows as well as the decrease in the share of FDI raises vulnerability to capital flows.***
- ✔ Excessive capital inflows induces the overvaluation of the exchange rate.***
- ✔ The probability of a sudden stop in capital inflows is higher for the relatively shallow and unregulated markets.***
- ✔ Increasing demand for the assets of the developing countries may create asset bubbles which subsequently dampens the resistance of these countries to financial crisis.***
- ✔ Developing countries in general are currently in a post crisis rapid growth period and under these circumstances there are significant long term costs of huge capital inflows such as overheating in the economy and asset bubbles.***

Measures taken and capital controls...

- ✔ After the crisis, rapidly increasing in capital inflows to EM's has led to an escalate in risk factors.*
- ✔ The countries policy makers are forced to take various measures.*
- ✔ Aforementioned measures are different from the traditional implements.*
- ✔ Sample measures: Increasing reserve requirement ratios, decreasing policy interest rates, intervening banks' loans size.*
- ✔ This measures are used to excess liquidity in the markets.*
- ✔ Adjusted short-term interest rates have become more favorable than long-term's.*
- ✔ The countries, who have unsustainable current account deficit and financing this deficit with short term capital inflows, must take measures for their financial stability.*
- ✔ The countries having taken the essential measures curtail their financial risks.*
- ✔ Exporting countries are negatively affected by the appreciation of local currency.*
- ✔ Local currencies appreciation causes an increase in domestic demand, and aforecited demand manipulate inflation to upcast.*

Implemented measures to control capital inflows...

Countries	Measures Taken
Brazil	<ul style="list-style-type: none"> • Increased IOF tax on bond inflows from %2 to %6 • IOF tax rate on nonresidents' margin deposits for derivative contracts was hiked from %0.38 to %6
Chile	Reduced exporters' transaction costs
Colombia	<ul style="list-style-type: none"> • Intermittent \$20m daily purchases in spot market for 4 months • Reduced tariffs • Proposed elimination of tax exemption for foreign borrowing
Mexico	Central bank selling dollar put options of \$600m per month for reserve accumulation
China	Eased restrictions on foreign banks' investments in yuan-denominated Chinese bonds held offshore
Indonesia	Implemented a 1-month minimum holding period for central bank money market certificates
Korea	Implemented caps on size of banks' FX derivatives books
Thailand	Imposed a %15 tax on interest income and capital gains earned by foreign investors
Russia	The central bank abolished the ruble's R26-41 fluctation band against the 0.55\$/0.45€ currency basket in place
Turkey	<ul style="list-style-type: none"> • Increased daily foreign exchange purchase auction limits to \$140m • Increased bank reserve requirements • Reduced short-term interest rates
South Africa	<ul style="list-style-type: none"> • Intervention in foreign exchange market to build reserves • Residual exchange controls on residents will be relaxed further

Source: The World Bank

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