VAKIFBANK GLOBAL ECONOMY WEEKLY

Capital Inflows Too Much to Feel At Ease

T. Vakıflar Bankası T.A.O

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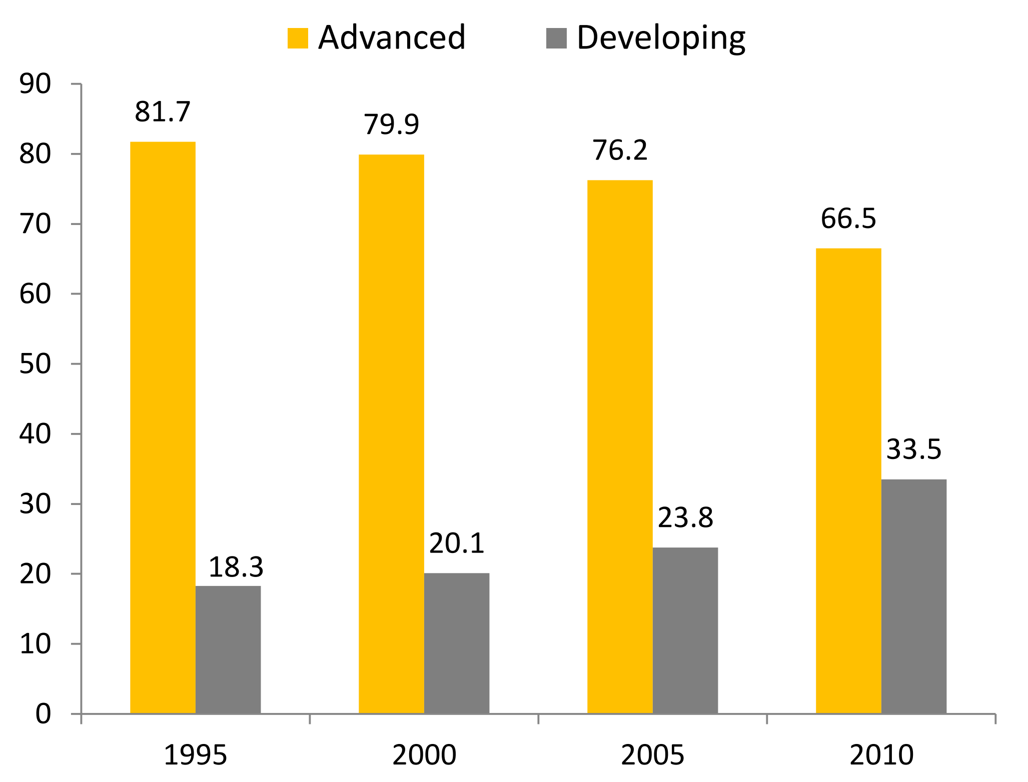
Vakıfbank Economic Research

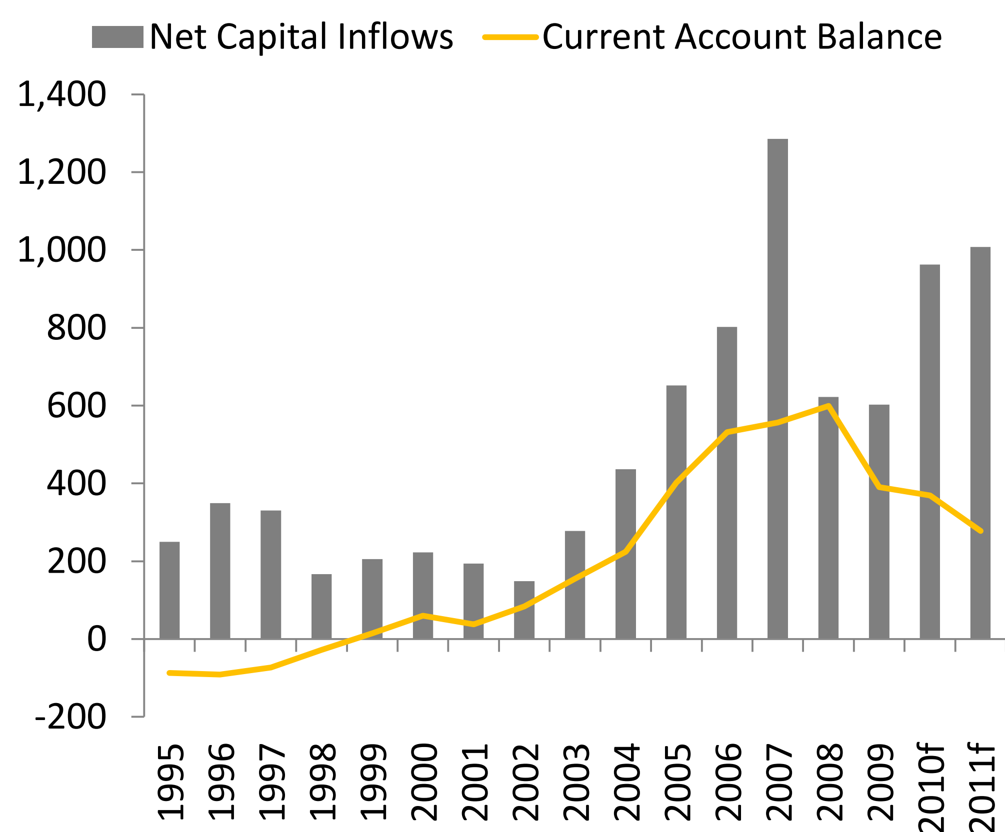
Increasing share of developing countries …



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 …



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.*

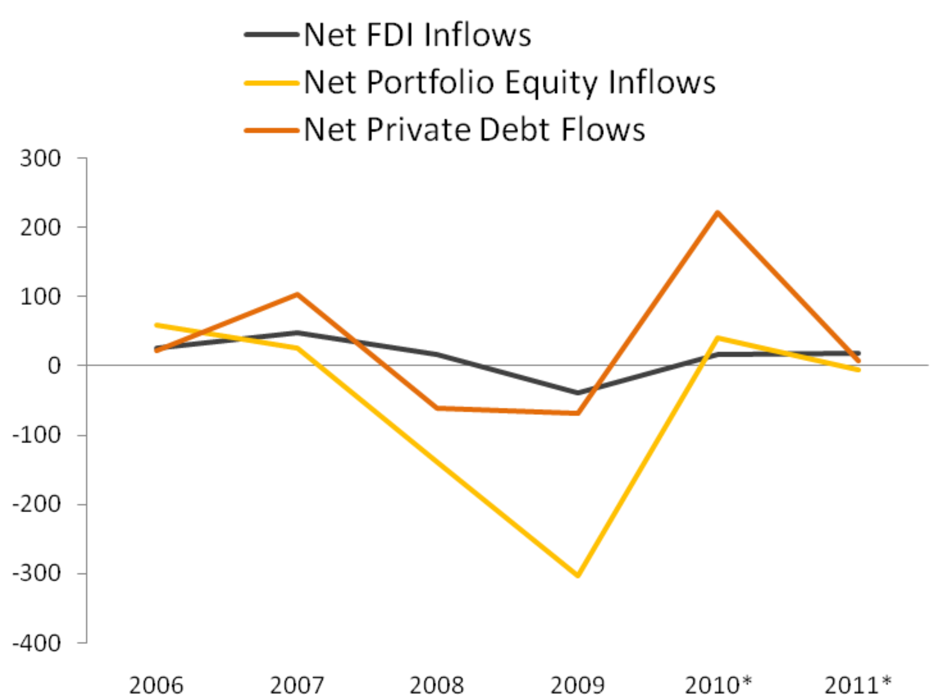
Main reasons of increasing capital inflows to emerging economies…

- ***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...



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 (%)

Medium-Long Term — Short Term

1400
1200
1000
800
600
400
200
0
-200
-400

2006 2007 2008 2009 2010*

Source: World Bank
*World Bank Forecasts

International Capital Flows ($ billion)

FDI — Portfolio Equity — Bank Lending — Bonds

1000
800
600
400
200
0
-200

2006 2007 2008 2009 2010*

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	•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	•Intermittent $20m daily purchases in spot market for 4 months •Reduced tarrifs •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	•Increased daily foreign exchange purchase auction limits to $140m •Increased bank reserve requirements •Reduced short-term interest rates
South Africa	•Intervention in foreign exchange market to build reserves •Residual exchange controls on residents will be relaxed further

Source: The World Bank

Serkan Özcan
Chief Economist
+ 90 312 455 7087
Serkan.ozcan@vakifbank.com.tr

Cem Eroğlu
Senior Economist
+ 90 312 455 8480
Cem.eroglu@vakifbank.com.tr

Nazan Kılıç
Economist
+ 90 312 455 8489
Nazan.kilic@vakifbank.com.tr

Ümit Ünsal
Economist
+ 90 312 455 8418
Umit.unsal@vakifbank.com.tr

Elif Artman
Researcher
+ 90 312 455 8490
Elif.artman@vakifbank.com.tr

Senem Güder
Researcher
+ 90 312 455 8476
Senem.guder@vakifbank.com.tr

T. Vakiflar Bankasi T.A.O
Ataturk Bulvari No: 207
Kavaklidere 06683 Ankara, Turkey
www.vakifbank.com.tr

Vakifbank Economic Research
ekonomik.arastirmalar@vakifbank.com.tr

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