2. International Economic Developments

After the publication of the July Inflation Report, economic activity in the Euro Area continued to decelerate. Sovereign debt and banking problems worsened and growth rates fell in the US and emerging economies. Against this background, decisions taken by the Fed and the ECB stood out as noteworthy developments, which will determine the global economic outlook in the forthcoming period.

In spite of the adopted fiscal measures in the Euro Area, borrowing rates followed a high course and the perception of improper functioning of markets prevailed in Spain and Italy during the last quarter, thus causing the ECB to adopt a policy that facilitates struggling countries to purchase unlimited bonds in the secondary market. However, certain conditions were imposed on bond purchases, bringing about concerns over the extent of the effectiveness of the policy decision.

Notwithstanding the positive growth rates in the US economy, unemployment rates have been elevated for a long time. What is more, the likelihood of these rates to cause a permanent deterioration in the labor market should they remain high for an extended period, led the Fed to announce the third quantitative easing package. Unlike the previous packages, Fed announced that should inflation stay below distressing levels, mortgage-backed asset purchases would be sustained without any notice of certain duration and quantity until the unemployment rate falls satisfactorily.

Owing to the rebound in the global risk appetite upon the mentioned policies, capital inflows towards emerging economies gained momentum. Monetary policies to be implemented by advanced economies are thought to largely determine capital flows towards emerging economies in the forthcoming period as well.

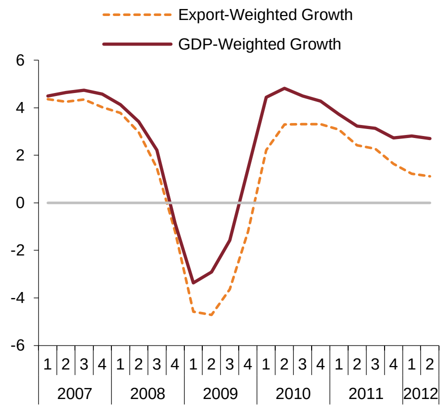
Commodity prices trended upwards in the last quarter due to supply-side problems both in energy and the agricultural sectors besides implemented expansionary monetary policies. Increasing commodity prices led declining inflation rates in emerging economies to follow a flat course in the last quarter, while causing stable inflation rates in advanced economies to increase. However, the slow course of global economic activity in addition to lingering uncertainties depress commodity prices.

In the second quarter of the year, growth rates went down both in advanced and emerging economies. Moreover, the third-quarter data do not signal for a recovery in global economic activity. In view of these developments, monetary policies in both country groups will remain loose in the forthcoming period in order to give a boost to the economy.

2.1. Global Growth

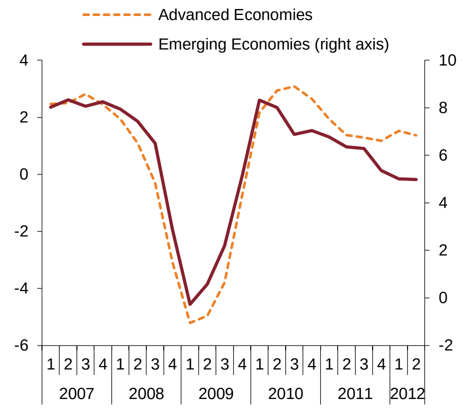
The optimistic atmosphere in the first quarter of the year was reversed in the second quarter upon the aggravation of the Euro Area debt crisis due to the financing requirement of the banking sector in Spain. As a result, global growth rate, which edged up in the first quarter of the year, lost pace in the second quarter, while the world trade maintained its limited rate of increase (Chart 2.1.1).

Chart 2.1.1.
Global Growth Rates*
(Annual Percent Change)



* Weighted by each country's share in Turkey's exports for export-weighted indices.
Source: Bloomberg, CBRT.

Chart 2.1.2.
Global Growth Rates*
(Annual Percent Change)

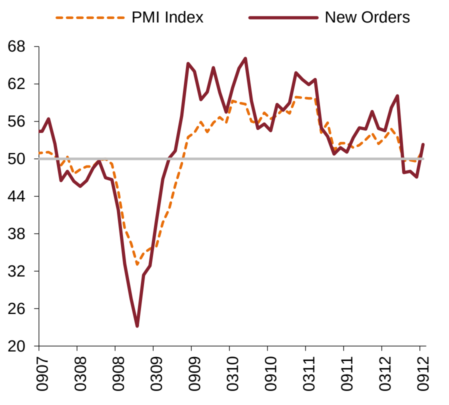


* Weighted by each country's share in global GDP.
Source: Bloomberg, CBRT.

Aggregated indices show that the growth rate of economic activity lost pace not only in advanced but also in emerging economies in the second quarter of 2012 (Chart 2.1.2). Sluggish domestic demand primarily in Asian and Latin American countries in addition to the Europe-originated external demand, which is yet to recover, had a restrictive effect on economic activity. As for advanced economies, the Euro Area and the UK continued to create an adverse impact on the growth rate of major economies in the second quarter. On the US and Japanese front, the positive contribution to growth rates of advanced economies continued, while US provided a lower support comparative to the first quarter of the year.

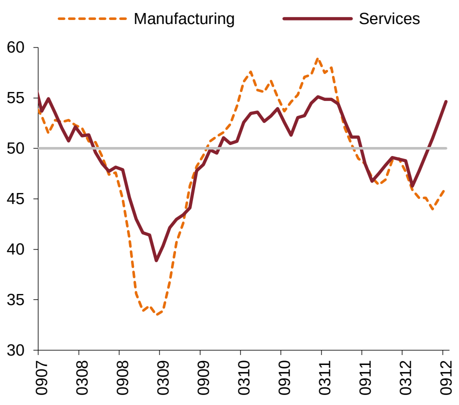
The US economy slowed down in the second quarter of the year, growing by a quarter-on-quarter 1.3 percent in annualized terms. Third-quarter PMI data in the US suggest that both the headline index and the new orders index were elevated in September following the decline in July and August (Chart 2.1.3). As for the Euro Area, which contracted further in the second quarter, PMI figures of the services sector went beyond the neutral level of 50 at the end of the third quarter. Nevertheless, it is projected that the contraction in the manufacturing sector will continue, and therefore, growth will remain limited in the third quarter as well (Chart 2.1.4)

Chart 2.1.3.
PMI Indices in the US



Source: Bloomberg.

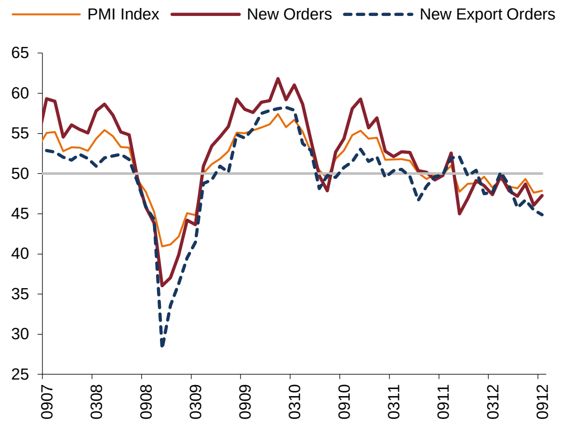
Chart 2.1.4.
PMI Indices in the Euro Area



Source: Bloomberg.

China, which was the largest contributor to growth in emerging economies during the recovery process following the global crisis, has been experiencing a slowdown in growth rate for the last 1.5 years that also continued into the third quarter of 2012, resulting in an annual GDP growth of 7.4 percent. Meanwhile, PMI indicators for the forthcoming period suggest that growth will remain limited (Chart 2.1.5).

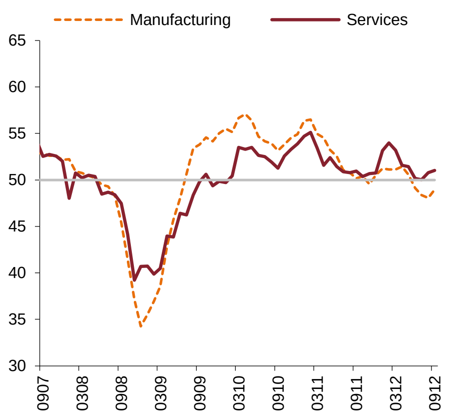
Chart 2.1.5.
Chinese PMI Indices



Source: Bloomberg.

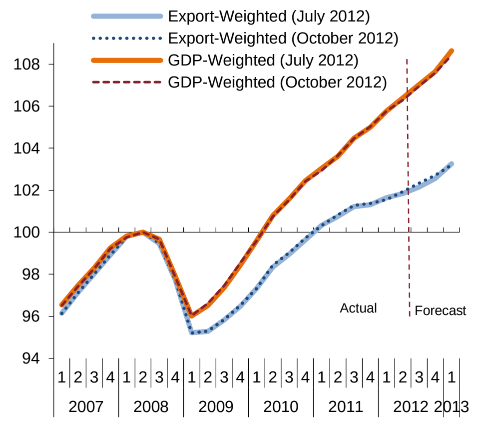
Third-quarter PMI figures point to a contraction in global economic activity both in manufacturing and services sectors, while edging up in September (Chart 2.1.6). The expectation that advanced economies will announce additional package of measures to bolster economic activity due to the deteriorating growth outlook in the third quarter is considered to play a role on this upward movement. Nevertheless, despite adopted measures and the loose course of the global monetary policy, factors to pose downward risks to global growth, primarily the aggravating Euro Area debt crisis, have accumulated compared to the previous period. In fact, Consensus Forecasts and the World Economic Outlook suggest that end-year growth forecasts for both 2012 and 2013 have deteriorated in the inter-reporting period (Table 2.1.1). In line with the outlook presented above, GDP and export-weighted global production indices revised by Consensus Forecasts in October also confirm that an evident recovery is not expected in external economies in the forthcoming period, and global uncertainties will continue to exert pressure on external demand (Chart 2.1.7).

Chart 2.1.6.
JP Morgan Global PMI Indices



Source: Bloomberg.

Chart 2.1.7.
Global Production Indices*
(2008Q2=100)



* Weighted by each country's share in Turkey's exports for export-weighted indices.
Source: Bloomberg, Consensus Forecasts, CBRT

Table 2.1.1.
Growth Forecasts for end-2012 and end-2013

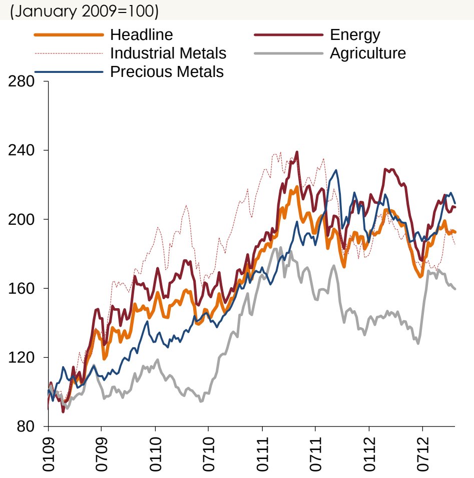
	Consensus Forecasts (Annual Percent Change)				World Economic Outlook (Annual Percent Change)			
	2012		2013		2012		2013	
	July	October	July	October	July	October	July	October
World	2.5	2.5	2.9	2.8	3.5	3.3	3.9	3.6
Advanced Economies	-	-	-	-	**1.4**	**1.3**	**1.8**	**1.5**
USA	2.1	2.1	2.3	2.0	2.1	2.2	2.2	2.1
Euro Area	-0.5	-0.5	0.5	0.2	-0.3	-0.4	0.7	0.2
Germany	0.9	0.8	1.3	0.9	0.9	0.9	1.4	0.9
France	0.2	0.1	0.7	0.3	0.3	0.1	0.9	0.4
Italy	-2.0	-2.4	-0.3	-0.7	-1.9	-2.3	-0.3	-0.7
Spain	-1.7	-1.6	-0.9	-1.6	-1.4	-1.5	-0.6	-1.3
Greece	-6.8	-6.7	-2.6	-3.6	-	-	-	-
Japan	2.5	2.3	1.4	1.3	2.4	2.2	1.5	1.2
UK	0.1	-0.2	1.6	1.2	0.2	-0.4	1.4	1.1
Emerging Economies	-	-	-	-	**5.6**	**5.3**	**5.8**	**5.6**
Asia-Pacific*	6.4	6.1	6.9	6.6	7.1	6.7	7.5	7.2
China	8.1	7.7	8.4	8.1	8.0	7.8	8.4	8.2
India	6.3	5.8	7.2	6.8	6.2	4.9	6.6	6.0
Latin America*	3.3	2.9	4.0	3.8	3.4	3.2	4.2	3.9
Brazil	1.9	1.6	4.0	3.9	2.5	1.5	4.7	4.0
Eastern Europe	2.7	2.8	3.4	3.3	1.9	2.0	2.8	2.6

* Countries making up the region differ between Consensus Forecasts and World Economic Outlook.
Source: Consensus Forecasts, World Economic Outlook.

2.2. Commodity Prices

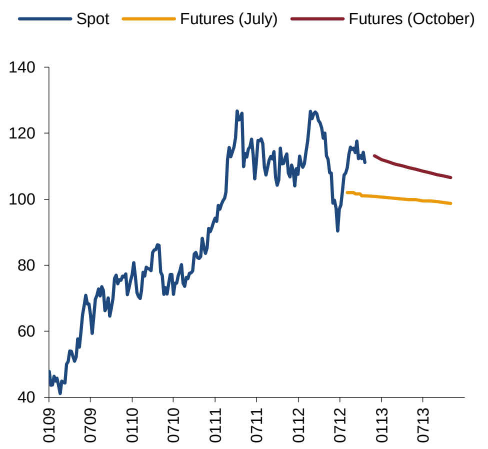
The headline commodity index went up in the third quarter of the year upon the upward movement of all sub-indices. Supply conditions in the energy market accompanied by demand conditions owed to new monetary easing packages announced by the Fed and the ECB posed an upward pressure on energy prices. Meanwhile, lingering uncertainties in the global economy alleviate this pressure. An analysis of sub-indices suggests that prices of agricultural products surged from the end of the second quarter to end-July due to supply-side problems, while having followed a flat course afterwards. Industrial metal prices remained unchanged during the third quarter, but have recently trended upwards on the back of monetary easing packages. Similarly, precious metal prices also displayed an upward movement in this period (Charts 2.2.1 and 2.2.2).

Chart 2.2.1.
S&P Goldman Sachs Commodity Prices Indices*
(January 2009=100)



Source: Bloomberg.

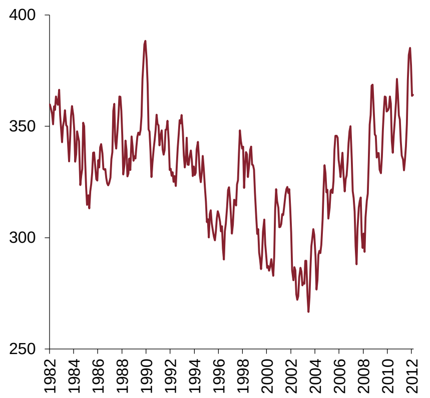
Chart 2.2.2.
Crude Oil (Brent) Prices*
(USD/bbl)



* Futures (July) and Futures (October) denote the arithmetical average of the prices quoted in futures contracts during July 1 and 23, and October 1 and 23, respectively.
Source: Bloomberg.

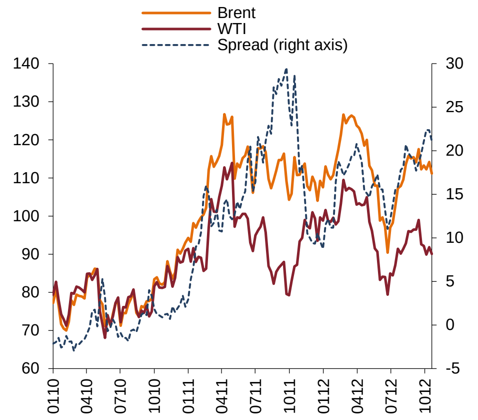
However much appreciated were the monetary easing packages for the US and the Euro Area, persisting concerns over global economic growth prevent an evident upward pressure on the demand side to be imposed on oil prices. On the other hand, supply-side developments continued to be influential on oil prices in the previous quarter. The embargo decision taken by Europe in January upon the nuclear crisis with Iran was enforced on July 1, 2012. This decision prohibited countries to avail themselves of insurance services in oil exports from Iran to the European countries and crude oil exports from Iran to other countries. Against these developments, crude oil production in Iran hit the lowest level of the last twenty years and the access of the international market to Iran's crude oil got restricted. On the other hand, oil production stations in the North Sea went under a maintenance period in September as contemplated; but this period was unexpectedly protracted, further depressing the supply in the market. Moreover, the Storm Isaac that hit the US also proved to be one of the developments to bring about an interruption in crude oil production in this period. In addition, the spread between WTI and Brent crude oil prices has recently seen the ever high level of the last year. This is attributed to the crude oil production that still remains at high levels owing to the presence of US crude oil inventories and the use of unconventional methods in production albeit a limited decline (Charts 2.2.3 and 2.2.4).

Chart 2.2.3.
Crude Oil Inventories in the US
(Million Barrel)



Source: Us Department of Energy.

Chart 2.2.4.
WTI – Brent Prices
(USD/bbl)



Source: Bloomberg.

Drought in the US following the Latin America and Russia caused supply-side problems in agricultural products to become more pronounced. Forecasts for the production of cereal products were revised considerably downwards amid the extremely hot weather conditions in the US, thus generating an upward pressure on the prices of agricultural products (Table 2.2.1). However, cereal exporter countries remained reluctant to impose quota, thereby resulting in a favorable market outlook. Against this background, prices of agricultural products exhibited an upsurge until the end of July, and followed a flat course afterwards.

As a result, notwithstanding the additional measures enforced by major central banks, persisting uncertainties regarding global growth alleviate the upward pressure on commodity prices. On the other hand, gradually worsening geopolitical problems in the Middle East, especially in Syria, keep upward risks on oil prices brisk in the short and medium term. Moreover, supply-side setbacks in agricultural products stand out as another risk factor on commodity prices.

Table 2.2.1.
Production, Consumption and Inventory Forecasts for Agricultural Commodities*

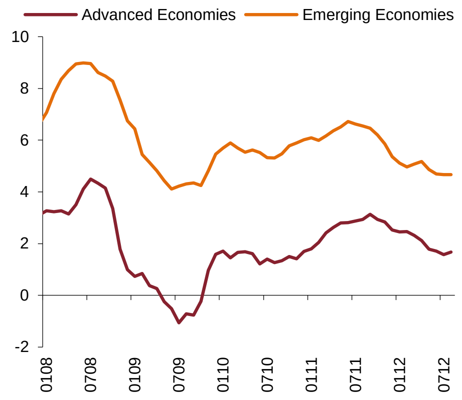
	2010/2011	2011/2012	2012/2013	
			July Forecasts	October Forecasts
WHEAT (million tons)				
Initial Inventory	200.7	197.9	197.2	198.2
Production	652.0	695.7	665.3	653.1
Consumption	654.7	695.5	680.1	678.2
Period-end Inventory	197.9	198.2	182.4	173.0
CORN (million tons)				
Initial Inventory	145.3	127.1	129.4	131.5
Production	830.3	877.8	905.2	839.0
Consumption	848.4	873.4	900.5	853.3
Period-end Inventory	127.1	131.5	134.1	117.3
COTTON (million bales)				
Initial Inventory	46.8	48.6	66.7	69.6
Production	116.4	124.1	113.8	116.3
Consumption	114.1	103.2	109.0	106.9
Period-end Inventory	48.6	69.6	72.4	79.1
SOYA BEAN (million tons)				
Initial Inventory	61.2	70.6	52.5	54.8
Production	264.7	238.1	267.2	264.3
Consumption	251.4	254.2	263.2	258.8
Period-end Inventory	70.6	54.8	55.7	57.6

* Figures may be inconsistent due to discrepancies among countries in terms of exports and imports data, as well as the loss and damage in the marketing network.
Source: US Department of Agriculture.

2.3. Global Inflation

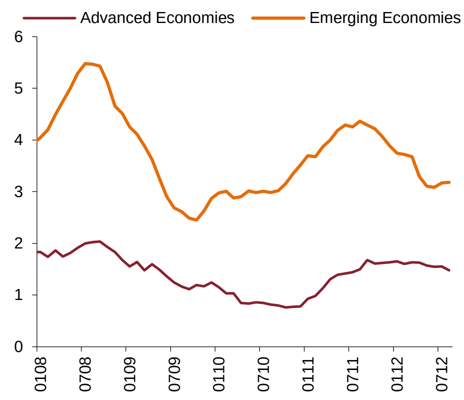
In the third quarter of 2012, annual consumer inflation rates edged up in advanced economies, while remaining unchanged in the emerging economies (Chart 2.3.1). In this period, the receding trend in inflation rates was interrupted by commodity prices that went up due to supply-side problems. Meanwhile, annual core inflation rates remained flat in emerging economies, while falling further in advanced economies (Chart 2.3.2).

Chart 2.3.1.
CPI Inflation in Advanced and Emerging Economies
(Annual Percent Change)



Source: Bloomberg, CBRT

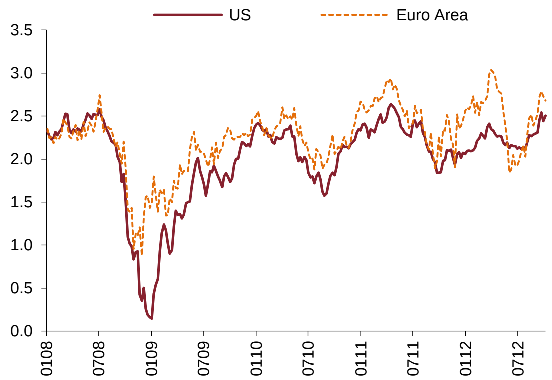
Chart 2.3.2.
Core Inflation in Advanced and Emerging Economies
(Annual Percent Change)



Source: Bloomberg, Datastream, CBRT

Notwithstanding the persisting negative economic conditions in the Euro Area, the new bond purchasing program announced by the ECB was reflected on inflation expectations in the previous quarter, thus adding considerably to inflation compensation. Similarly, the US, which announced a new monetary easing package in the previous quarter, also saw an increase in inflation compensation (Chart 2.3.3).

Chart 2.3.3.
Inflation Compensation in the US and the Euro Area
(Percent)



Source: Bloomberg.

Global inflation forecasts for year-ends of 2012 and 2013 edged up in the inter-reporting period (Table 2.3.1). Despite having been interrupted in the previous quarter, high-rated increases in agricultural prices across the year were one of the factors that pulled global inflation expectations. Moreover, expansionary policies by the ECB are also considered to be another risk factor to impose upward pressure on inflation rates in the Euro Area.

Table 2.3.1.
Inflation Forecasts for end-2012 and end-2013
(Annual Percent Change)

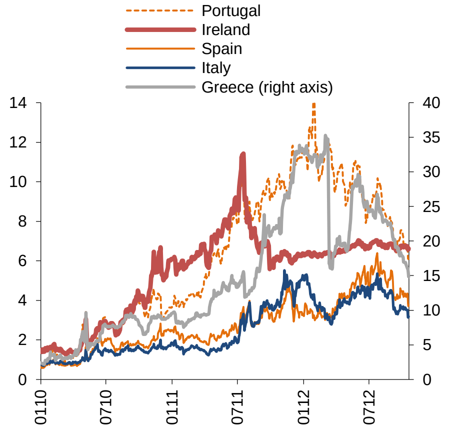
	2012		2013	
	July	October	July	October
World	2.9	3.0	2.8	2.9
Advanced Economies				
USA	2.0	2.1	1.9	2.0
Euro Area	2.3	2.4	1.7	1.9
Germany	2.0	2.0	1.8	1.9
France	2.0	2.1	1.6	1.7
Italy	3.0	3.2	2.0	2.3
Spain	1.8	2.4	1.5	2.4
Greece	0.6	1.3	1.9	2.3
Japan	0.1	0.0	0.0	-0.1
UK	2.7	2.7	2.0	2.2
Emerging Economies				
Asia-Pacific	3.8	2.6	4.0	2.7
China	3.0	2.8	3.5	3.4
India*	8.4	9.1	7.6	7.5
Latin America	5.9	5.9	6.4	6.4
Brazil	4.9	5.3	5.4	5.3
East Europe	6.4	6.4	5.3	5.4

* As of the fiscal year starting in April.
Source: Consensus Forecasts.

2.4. Financial Conditions and Risk Indicators

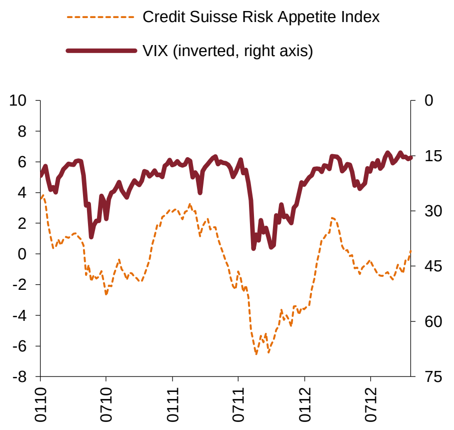
Global risk appetite, which started to recover in the previous quarter upon the partial removal of concerns over the Spanish banking sector, continued to recover further on the back of statements by major central banks as well as the adopted policy measures. The declaration by the ECB Governor Draghi in late July that euro would be saved at all costs played a significant role in the alleviation of concerns over the crisis. Bond purchasing scheme via outright monetary transactions (OMT) announced in the September meeting also reinforced this outlook, bringing about a decline in bond returns in debt-ridden countries (Chart 2.4.1). On the other hand, the monetary easing package signaled by the Fed Governor Bernanke at the Jackson Hole speech was announced in September meeting, which stood out as another factor to bolster risk appetite (Chart 2.4.2). Despite these developments, especially the concerns over global growth that are still brisk coupled with Spain, which is yet to apply for an rescue package, occupy the agenda as factors that may bear an adverse impact on the risk appetite in the forthcoming period.

Chart 2.4.1.
Yield Spread over German Bonds in GIIPS Countries*(Percent)



*GIIPS countries are Greece, Ireland, Italy, Portugal and Spain.
Source: Bloomberg.

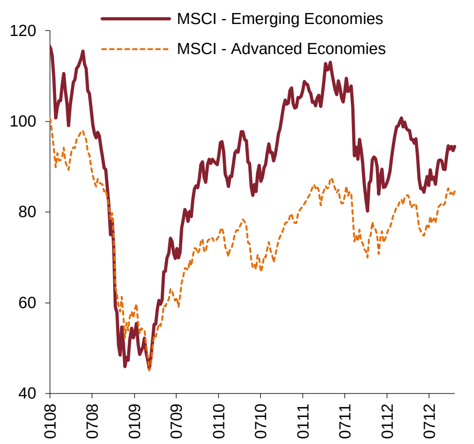
Chart 2.4.2.
Global Risk Appetite



Source: Bloomberg, Credit Suisse.

Stock markets performed well in the inter-reporting period. It is worth noting that the uptrend in stock markets got more pronounced subsequent to the declarations by the ECB and Fed governors. Exchange rates in emerging economies appreciated slightly in the said period (Charts 2.4.3 and 2.4.4).

Chart 2.4.3.
Global Stock Markets
(USD, 2007=100)



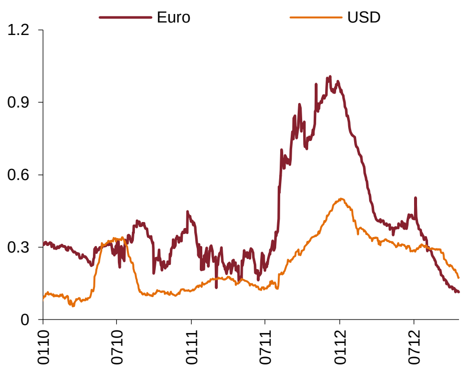
Source: Bloomberg.

Chart 2.4.4.
Emerging Market Currencies*(2003=100)

* Arithmetical average of the exchange rates of Turkey, Poland, Hungary, South Africa, Romania, Brazil, Mexico, Chile, Indonesia, India, Thailand, Peru, Colombia and Phillippines against the currency basket of 1 USD and 1 euro. Equals 100 on June 2007 and an upward movement denotes depreciation of the emerging market currencies.
Source: Bloomberg.

Being evident via the decline in OIS spread, counter-party risk in both USD and euro markets declined further in the last quarter (Chart 2.4.5). On the other hand, the euro – USD cross currency swap rates continued to contract during the last three months (Chart 2.4.6).

Chart 2.4.5.
OIS Spread
(Points)



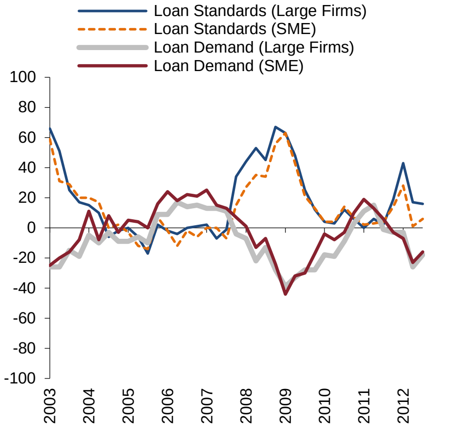
Source: Bloomberg.

Chart 2.4.6.
Euro/USD Cross Currency Swap Rate
(1-Year, Basis Points)

Source: Bloomberg.

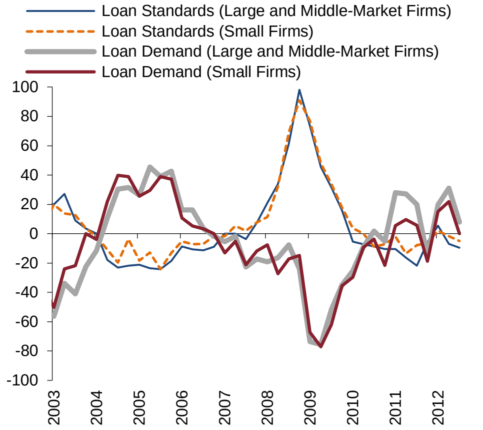
The Euro Area problems continue to have an adverse impact on the loans extended to the real sector. The latest lending survey published by the ECB points that tightening in lending conditions continues, especially for large firms. Similarly, the contraction in loan demand continues, albeit at a slower pace (Chart 2.4.7). In the meantime, the last lending survey published by the Fed puts forward that the US diverged from the Euro Area in terms of credit dynamics. Banking sector in the US continues to ease lending conditions and loan demand from large and medium-sized firms display an increase, albeit at a diminishing pace. As for the small-sized firms, loan demand remains unchanged (Chart 2.4.8).

Chart 2.4.7.
Euro Area Lending Survey*
(Percent)



* Upward movements indicate tightening in credit conditions.
Source: ECB.

Chart 2.4.8.
US Lending Survey*
(Percent)

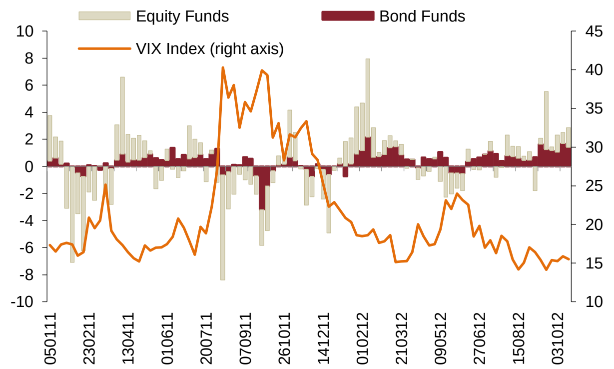


Source: Fed.

2.5. Capital Flows

Owing to the improvement in the global risk appetite in the third quarter of 2012, capital inflows towards emerging economies gained momentum (Chart 2.5.1). In regional terms, the Latin America displayed the best performance, leaving behind emerging Asian countries, which used to be mostly favored by investors. Emerging European economies, on the other hand, experienced a rise in their shares from emerging country funds compared to the first half of the year.

Chart 2.5.1.
Portfolio Flows to Emerging Economies
(Billion USD)



Source: EPFR, Bloomberg.

As for portfolio investments, a stable fund flow occurred in bond funds in this period, which were much preferred in the post-crisis period as opposed to the pre-crisis period (Box 2.1). Equity fund outflows in the second quarter of the year were largely compensated in the third quarter (Table 2.5.1).

Table 2.5.1.
Fund Flows to Emerging Economies in 2012
(Billion USD)

	Total	Equity Funds	Bond Funds
Quarter 1	32.9	22.7	10. 2
Quarter 2	-4.7	-8.7	4.0
Quarter 3	18.2	7.2	11.0

Source: EPFR.

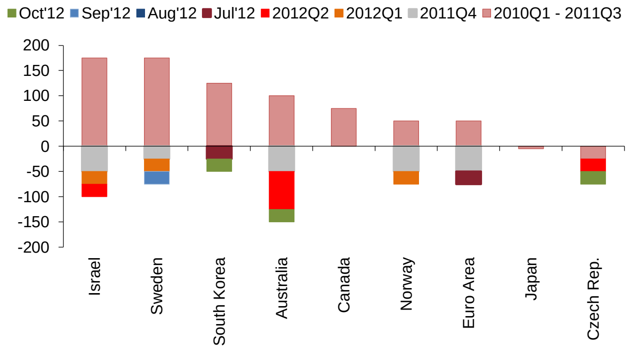
Latest easing measures taken by major central banks to bolster economy are thought to be the leading elements to determine capital flows towards emerging economies in the forthcoming period.

2.6. Global Monetary Policy Developments

Due to global growth, which exhibited a negative outlook following the worsening in the second quarter of 2012, monetary policy maintained a loose course, not only in advanced but also in emerging economies.

Two most notable developments regarding the monetary policies of advanced economies have been the third monetary easing package announced by the Fed and the bond purchasing scheme enforced by the ECB in the inter-reporting period. In this period, Sveriges Riksbank, Bank of Korea, the Czech National Bank and the Reserve Bank of Australia also opted for loosening their monetary policies by a 25-basis point reduction in their policy rates (Chart 2.6.1).

Chart 2.6.1.
Policy Rate Changes in Advanced Economies from Jan. 2010 to Oct. 2012* (Basis Points)

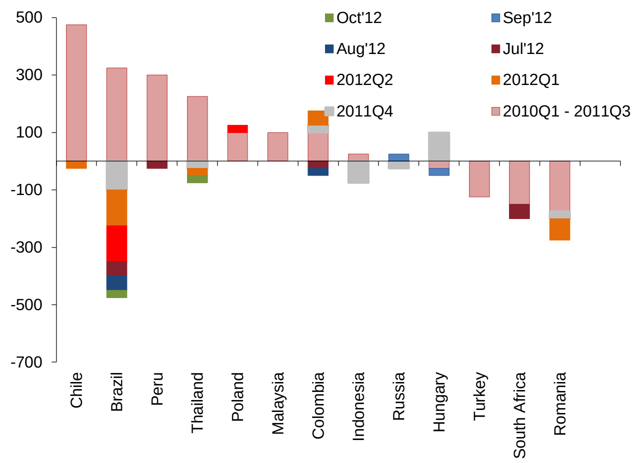


* As of October 22, 2012 .
Source: Bloomberg, CBRT.

The third monetary easing package announced by the Fed in the previous quarter envisions mortgage-backed asset purchases of USD 40 billion on a monthly basis. In addition, the swap operation between long-term and short-term bonds (Operation Twist), which was announced to continue, will result in bond purchases of USD 85 billion until end-2012. The comparison of the third easing package with previous ones suggests that there are no time limitations in bond purchases, and purchases will continue until a satisfactory level of recovery in growth and employment is accomplished. In addition to the easing package, the Fed supported the loose monetary policy implementation by announcing to the public that policy rates would stay at low levels until midst 2015. This loosening in monetary policy was mainly attributed to the possibility of the extension of the negative course of employment to render permanently high unemployment rates by giving way to structural problems. As for the ECB, it was declared that the purchasing scheme announced for short-term bonds of debt-ridden countries was a precaution against the excessively high bond yields in these countries. It is noteworthy that this scheme puts no upper limit for the amount to be purchased.

In the third quarter, central banks of emerging economies loosened their monetary policies by delivering sizeable policy rate cuts. Along with the reduction in October, Banco de Brasil reduced the policy rate by a total of 125 percent; while Peru, Colombia and South Africa reduced their policy rates by a total of 25, 50 and 50 basis points, respectively in the third quarter of the year. Policy rate cuts were generally associated with the unfavorable global growth outlook and the weak demand, which is non-inflationary. However, Russia raised its policy rate by 25 basis points in the same period on account of the increase in medium-term inflation expectations and diverged from other emerging economies (Chart 2.6.2).

Chart 2.6.2.
Policy Rate Changes in Emerging Economies from Jan. 2010 to Oct. 2012*
(Basis Points)



* As of October 22, 2012.
Source: Bloomberg, CBRT.

Owing to the uncertainties in the global economy, policy rate expectations for both advanced and emerging economies have been revised downwards since the first quarter of the year. In line with the projections laid down in the July Inflation Report, the expectation for a decline in global policy rates for the third quarter of the year was realized to a large extent. Nevertheless, the ECB did not opt for the expected policy reduction, which led the average policy rate of advanced economies to remain 3 basis points beyond the July expectation by the end of September. However, the expectation that the ECB will introduce the said reduction in the next quarter led the policy rate expectations of advanced economies to be revised downwards for the year end. On the emerging economies front, policy rates in the third quarter decreased more than envisioned in the previous reporting period, and year-end expectations were revised downwards (Charts 2.6.3 and 2.6.4).

Chart 2.6.3.
Expected Policy Rates in Advanced Economies

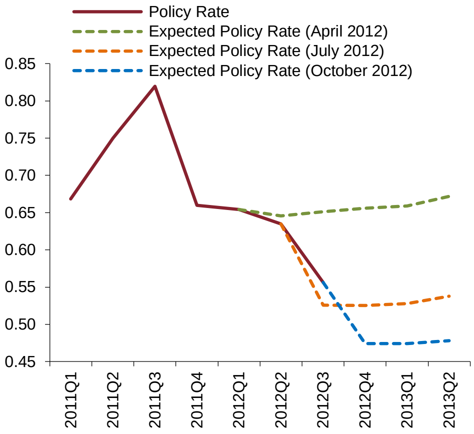
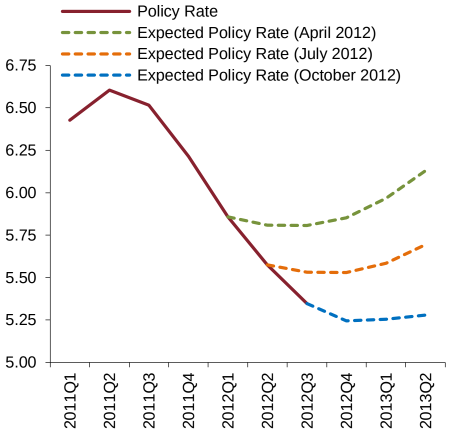


Chart 2.6.4.
Expected Policy Rates in Inflation-Targeting Emerging Economies



Source: Bloomberg, CBRT.

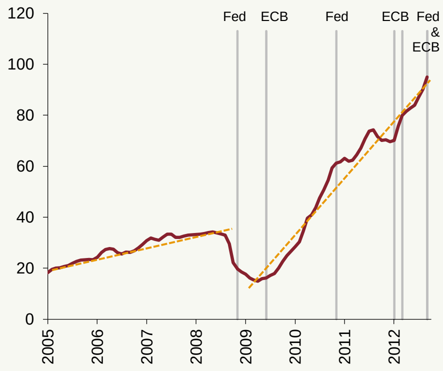
Box 2.1 Determinants of Recent Portfolio Flows

Monetary easing policies implemented by major central banks during and after the global financial crisis led to excess liquidity at a global scale, and stimulated particularly short-term capital flows towards emerging economies, rendering them more volatile. This poses a significant threat against financial stability in these countries. Against this background, this Box analyzes how monetary policies implemented by advanced economies have influenced capital flows towards emerging economies with regard to portfolio preferences, and examines the determinants of portfolio flows.

Following the global financial crisis, determining portfolio preferences has been increasingly challenging. Investors preferred channeling their funds to relatively safer heavens on the one hand, and searched for alternative investment tools with higher yields against extraordinarily receding interest rates in advanced economies on the other. In addition, being ignited by debt issues in peripheral countries, hurdles in the Euro Area gradually deepened, resulting in more pronounced downside risks on the global growth outlook and more volatile risk appetite by fuelling uncertainties.

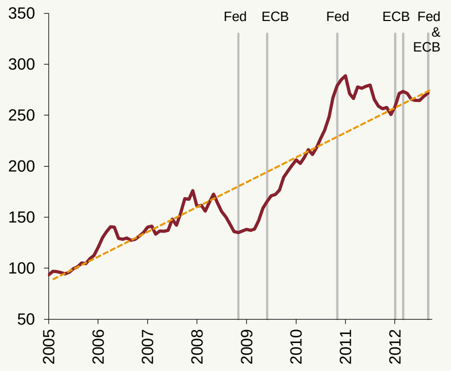
However less the global crisis hampered economic activities of emerging economies compared to advanced ones, the worsening global growth outlook coupled with escalated uncertainties led investors to avoid investing more than usual in the stock markets of emerging economies in this period. Therefore, flows towards growth-oriented equity funds of emerging economies, which have a higher volume than bond funds and are highly preferred in long-term investments, remained considerably unchanged from their pre-crisis levels. Meanwhile, soaring spread between advanced and emerging economies led investors to favor bond funds of emerging economies, with higher yields and shorter maturities as an alternative. In fact, Charts 1 and 2 clearly show that bond funds trended considerably upwards upon the enforcement of accommodative measures, while equity markets did not exhibit a structural break alike.

Chart 1. Bond Funds of Emerging Economies*
(Stock, Billion USD)



* Adjusted for exchange rate and price effects. Vertical lines denote the dates of quantitative easing and long-term asset purchases announced by the Fed and the ECB, respectively.
Source: EPFR.

Chart 2. Equity Funds of Emerging Economies*
(Stock, Billion USD)



* Adjusted for exchange rate and price effects. Vertical lines denote the dates of quantitative easing and long-term asset purchases announced by the Fed and the ECB, respectively.
Source: EPFR.

In order to scrutinize this decoupling in investors' recent portfolio preferences, simple equations are estimated for bond and equity fund flows. The relevant literature analyzes the main determinants of capital flows under two headings as push and pull factors. Global excess liquidity and investor risk appetite are indicated as the main push factors, while country-specific factors like growth, yield spread and inflation are qualified as pull factors. In order to capture the structural break in portfolio flows driven by the excess global liquidity that occurred since November 2008 - the announcement of the first easing package in advanced economies - a dummy variable is used in equations. VIX is treated as a global risk appetite indicator. Pull factors are represented by growth rate of industrial production, policy rate and inflation rate. These variables are GDP-weighted and aggregated for 23 emerging economies in emerging Asia, Europe, Latin America, Middle East and Africa.[1] Estimated equations, starting from 2005, are presented in Table 1.

[1]Brazil, Mexico, Colombia, Peru, Chile, Venezuela, China, Indonesia, Malaysia, Philippines, Thailand, South Korea, India, Taiwan, Russia, Turkey, Poland, Hungary, Kazakhstan, South Africa, Israel, Lebanon and Egypt are included in the analysis. In 2012, these countries make up 95 and 89 percent of bond and equity fund flows in emerging economies, respectively.

Table 1. Determinants of Portfolio Flows †

	Bond Flows	Equity Flows
Constant	7.543*** (2.996)	2.992 (1.311)
D(VIX index)	-0.419*** (-5.369)	-0.361*** (-5.098)
Growth rate	0.455*** (3.728)	0.193* (1.750)
D(Policy rate)	10.874** (2.276)	-7.042 (-1.626)
Inflation rate	-1.964*** (-5.611)	-0.630** (-1.986)
Dummy variable	3.397*** (4.355)	-0.084 (-0.118)
Number of Observations	92	92
Adjusted R^2	0.617	0.294

† Values in parentheses denote t- statistics.
* , ** and *** denote statistical significance at confidence levels of 10 , 5 and 1 percent, respectively.

The obtained results are in favor of the above-mentioned discussions, and suggest that excess global liquidity driven by monetary easing packages have led to a significant structural break in bond flows, while the same conclusion does not apply to equity flows. Moreover, variables such as risk appetite, growth, interest rate and inflation are significant for bond fund flows in the expected direction, while the most significant pull factor is the change in interest rates. Conversely, these variables do not suffice in accounting for the equity fund flows.

In conclusion, not only the excess global liquidity driven by expansionary policies of major central banks following the global financial crisis, but also the investors' search for short-term instruments with high yields due to the stagnant growth outlook and the atmosphere of uncertainty has recently led to a sizeable increase in bond flows to emerging economies. Parallel to this, the latest easing measures announced by the Fed and the ECB in September 2012 brought about the risk of a new capital wave towards emerging economies. Therefore, it is assessed that, particularly fund flows will continue to steadily be geared towards emerging economies in the upcoming period.