

## CAPITAL INFLOWS AND GROWTH IN EMERGING AND DEVELOPING ECONOMIES: EXPANSIONARY OR CONTRACTIONARY?

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### **Abstract:**

This study investigates whether the impacts of capital inflows and their main components (portfolio equity, FDI and other investment) are expansionary or contractionary in emerging and developing economies (EMDE). We also estimate the long-run relations, equilibrium correction mechanisms and short-run dynamics between the variables postulated to explain growth. To this end, we consider a conventional endogenous growth model augmented with variables representing de jure financial openness and global financial conditions. Our results indicate that all types of capital inflows are expansionary both in the short and long run, except portfolio equity. Portfolio equity inflows tends to enhance economic growth in the long-run whilst being contractionary in the short-run. Consistent with the endogenous growth literature, better structural domestic conditions (SDC), including governance and institutional quality, trade, de jure financial openness, human capital, financial development and domestic savings, are found to be leading to higher growth both in the long-run and (except human capital) short-run. The positive impacts of domestic and foreign savings (capital inflows) are in line with a view that they are complementary for growth. In accord with the financial cycle postulation, better global financial conditions proxied by VIX enhances growth. Contrary to the conventional Mundell-Fleming trade channel, real exchange rate depreciations are found to be contractionary. This result, however, is consistent with a financial channel which considers the appreciation of exchange rates due to capital inflows. The negative and significant equilibrium correction coefficients suggest that real income per capita adjusts to the deviations from the long-run equilibrium. This result provides an empirical support to the conditional income convergence by indicating that any differences in the long-run equilibrium are transitory.

**Keywords:** Capital Inflows, Emerging Market Economies, Developing Economies, Global Financial Conditions, Growth

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