Possible impact of tapering

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Net capital flows to EMs

2006 2008 2010 2012
200 300 400 500 600 700
Billion USD

- Net capital flows
- QE1 implementation
- QE2 announcement
- QE3 announcement
Main channels of adjustment are...

1. Allowing exchange rate movement, $\Delta e_t$
2. Central bank intervention, $l_t$
3. Interest rate changes, $\Delta(i_t - i_t^*)$
4. Capital controls
Exchange rates appreciated for some time

Nominal exchange rates, Indexed to 100 in 2006
Many EM central banks intervened

Foreign exchange reserves

USD Billion

- Korea
- India
- Brazil
- Mexico
- Thailand
- South Africa
- EM Average

2006 2008 2010 2012
Initially, they cut interest rate

EM treasury bill rates, 3M to 6M
Not all EMs imposed capital controls

Chinn-Ito Score

Controls

2008 2009 2010 2011

Chile
Brazil
Mexico
Thailand
Egypt
EM Average
What lies ahead?

- The US Fed has to start tightening sooner or later.
- Two possibilities:
  - Markets have already factored in tapering?
  - Another round of high volatility?
Capital Flows to EMs have fallen
Concerns from capital outflows

- Currency exposure
- Inflation
- Macro vulnerabilities
Unhedged currency exposure in EM’s

Gain from appreciation

Gain from depreciation

per cent of firms

2010 2011 2012 2013

0 10 20 30 40 50
Poorly Anchored Expectations?

- Then, depreciation leads to inflation
- Implication: increase in i, compared to baseline
- Key: are expectations generally fragile?
Inflation Expectations

Inflation Expectations, 5-year (percent)

Sources: Consensus Forecasts; and IMF, World Economic Outlook.
1/ Data in Apr. 1996 for Russia and Turkey is from the May 1996 WEO.
Macro Vulnerabilities?

Key EMs Under Pressure Today vs. 1997 Asian Financial Crisis EMs (percent)

- Fixed ER regime (% of total)
- External debt (% of GDP)
- Short-term external debt (% of reserves)
- Interest on external debt (% of total exports)
- Short-term external debt (% of GDP)

Sources: IMF, World Economic Outlook, April 2013.
1/ Indonesia, Korea, Thailand, Malaysia, and Philippines. Data shown for 1996.
2/ Brazil, Indonesia, India, Turkey, and South Africa. Data shown for 2012.
EM policy frameworks

- EM world has changed since the 1990s
- Many central banks target inflation
- Exchange rates are largely floating
- Macro stability has improved
- Low unhedged currency exposure
How can India prepare?

- Avoid knee-jerk reactions or capital controls.
- Lower inflationary expectations.
- Consolidate fiscal deficit.
- Allow currency flexibility for macro adjustment.
Thank you.