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An excellent paper highlighting the various policy responses to capital flows emanating from different balance of payments pressure.

- Currently, we are witnessing an upswing in capital flows to EMEs, which is adding positive balance of payments pressure on the economy in the form of real appreciation and reserve accumulation.

- The appropriate policy response depends on the source of these balance of payments pressures.

- Develops a taxonomy of cases by considering a two dimensional representation of net capital flows and current account balance.

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- Enumerates the policy response under the various circumstances highlighting degree of exchange rate flexibility, monetary and sterilization policy, fiscal policy and capital controls.

- Illustrates some more complex policy decision trees by including other macroeconomic, financial and institutional factors.

- Evaluate empirically the extent to which countries actually respond to capital flows and positive balance of payments pressures.

- Conclude that the actual experience of the countries falling under Case I and Case 3 is consistent with the findings but there is some ambiguity regarding Case 2 countries.
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- How does the Indian experience match with the policy choices outlined in the paper?

- India with a capital account surplus exceeding the current account deficit is likely to be a Case 2 country.

- Allow limited nominal and real exchange rate appreciation.
  - Between July 2006 and December 2007, the export weighted REER showed 11.28% appreciation while the export weighted NEER rose by 12.16%.

- Do not sterilize reserve accumulation.
  - The Central Bank has heavily sterilized reserve accumulation — The ceiling on MSS bonds have been increased 5 times during the past year to Rs. 2.5 trillion ($64 billion).
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  - Between 2003 and 2007, the RBI raised the CRR 9 times, the reverse repo rate 6 times and the repo rate 7 times.

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- Relax controls on capital outflows.
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- Possibly impose controls on capital inflows.
  - Again, last year several measures like limiting the use of ECBs and investment through participatory notes were introduced.

- So India is currently following 4 out of 6 policy prescriptions outlined in the paper.

- Sterilized intervention is being followed keeping in mind RBI’s pursuit of twin objectives of competitive exchange rates and moderate inflation.

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- Exogenous increase in capital flows.
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Fiscal prudence, by reducing concerns about country’s future macroeconomic policy, may result in more rather than less capital flows.

While imposing restrictions on capital inflows can dampen exchange rate appreciation, they have to be temporary in nature.

Finally, there is a need to bring into greater consideration the macroeconomic fundamentals of an economy like GDP growth rate, inflation, fiscal deficit, debt to GDP ratio etc. while citing policy recommendations.
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Appendix Outline

Appendix

- Taxonomy
- Policy Response
Taxonomy Based on Total Capital Flows and Current Account Balances

- **CASE 1**: Positive BOP Pressures; Dominating Capital Outflows
- **CASE 2**: Positive BOP Pressures; Dominating Capital Inflows
- **CASE 3**: Negative BOP Pressures; Dominating Current Account Surplus
- **CASE 4**: Negative BOP Pressures; Dominating Current Account Deficit
- **CASE 5**: Pre-Crisis Region

Quadrant I: Positive BOP Pressures; Dominating Capital Inflows
Quadrant II: Positive BOP Pressures; Dominating Capital Outflows
Quadrant III: Negative BOP Pressures; Dominating Current Account Surplus
Quadrant IV: Negative BOP Pressures; Dominating Current Account Deficit

Note: 'x' indicates negative BOP pressures. Highlighted countries correspond to 2006. Transition economies depicted only from 1995 onwards.
Policy Response under various Cases

CASE 1
- Limit nominal and real exchange rate appreciation
- Sterilize reserves accumulation
- Tighten fiscal policy
- Do not tighten monetary policy
- Do not impose controls on inflows

CASE 2
- Allow limited nominal and real exchange rate appreciation (depending on CA)
- Do not sterilize reserves accumulation
- Tighten fiscal policy
- Do not tighten monetary policy
- Possibly impose controls on inflows

CASE 3
- Allow nominal and real exchange rate appreciation
- Sterilize reserves accumulation depending on inflation
- Do not tighten fiscal policy
- Do not tighten monetary policy
- Possibly relax controls on outflows

CASE 4
- Limit nominal and real exchange rate appreciation
- Sterilize reserves accumulation depending on inflation
- Tighten fiscal policy
- Do not tighten monetary policy
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CASE 5
- Limit nominal and real exchange rate appreciation
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Combination of Case 1 and Case 2
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Combination of Case 3 and Case 4
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