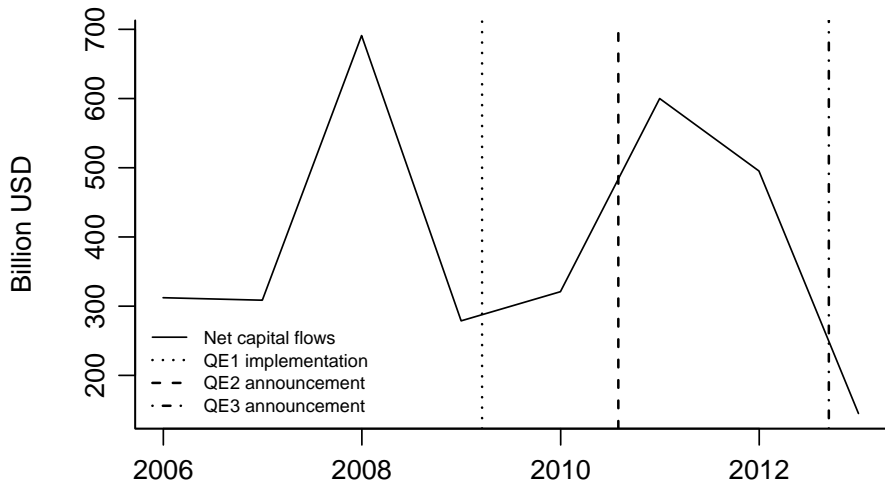


# Possible impact of tapering

Ila Patnaik

November 18, 2013

## Net capital flows to EMs

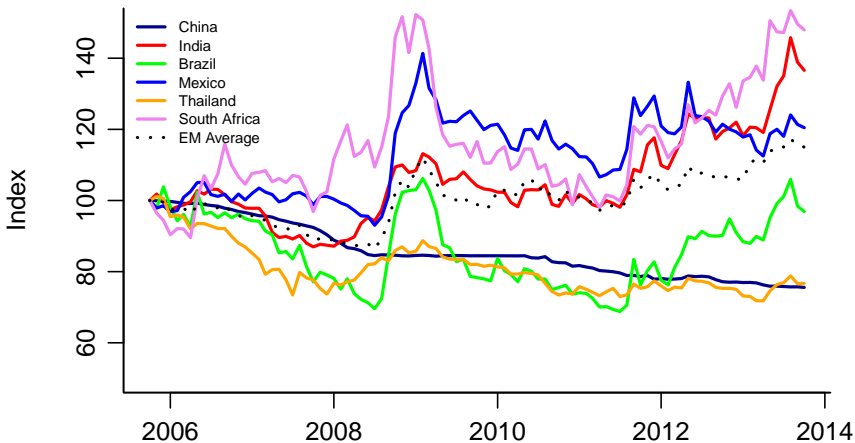


## Main channels of adjustment are...

1. Allowing exchange rate movement,  $\Delta e_t$
2. Central bank intervention,  $I_t$
3. Interest rate changes,  $\Delta(i_t - i_t^*)$
4. Capital controls

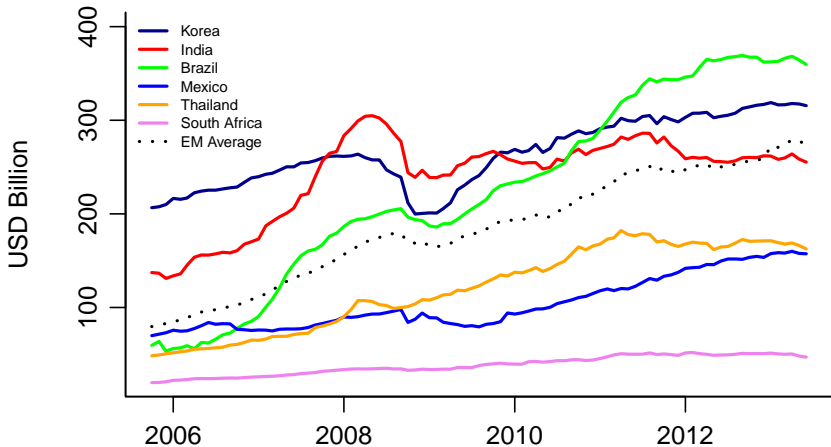
# Exchange rates appreciated for some time

Nominal exchange rates, Indexed to 100 in 2006



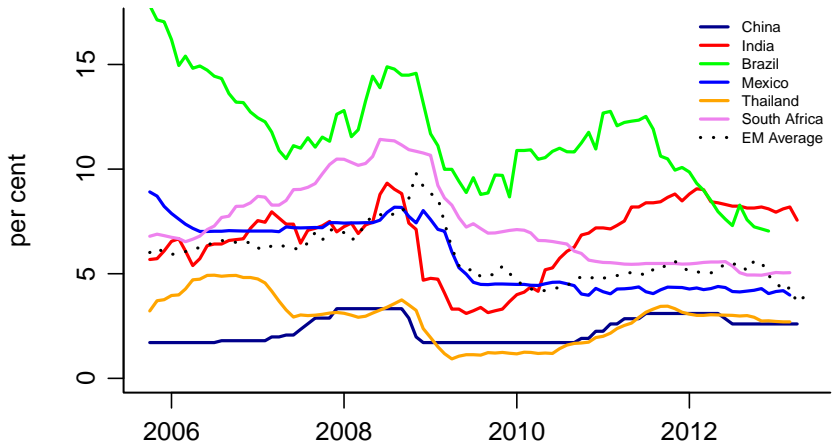
# Many EM central banks intervened

Foreign exchange reserves



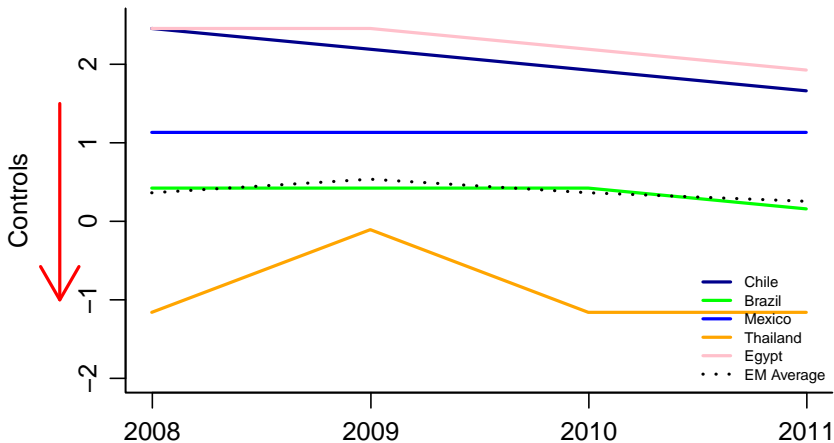
# Initially, they cut interest rate

EM treasury bill rates, 3M to 6M



# Not all EMs imposed capital controls

Chinn-Ito Score



# 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?

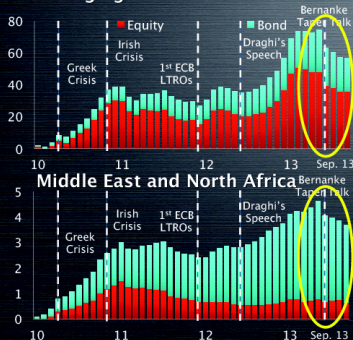


# Capital Flows to EMs have fallen

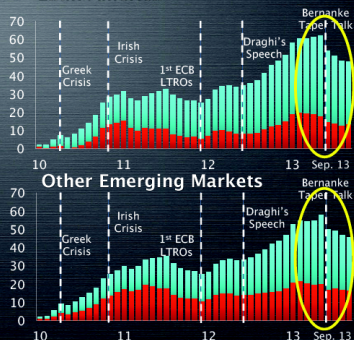
## Capital Flows to EMs

(cumulative inflows since January 2010; billions of U.S. dollars)

### Emerging Asia



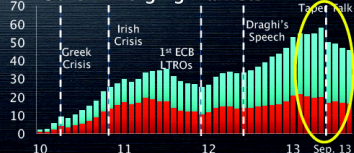
### Latin America



### Middle East and North Africa



### Other Emerging Markets

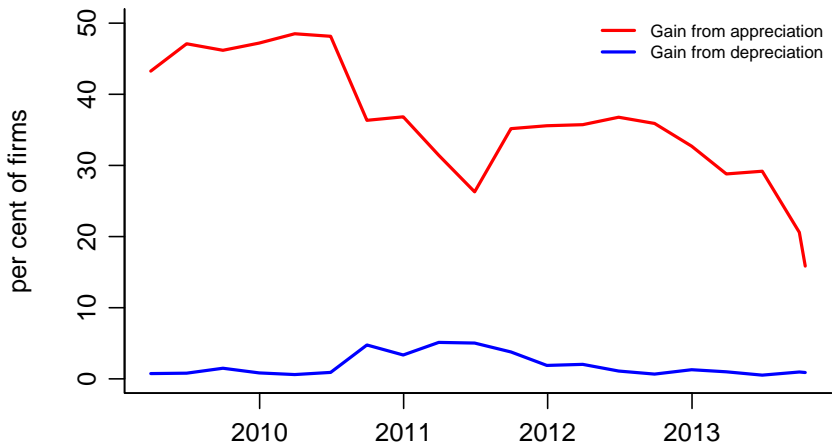


Source: IMF, EPFR database.

# Concerns from capital outflows

- Currency exposure
- Inflation
- Macro vulnerabilities

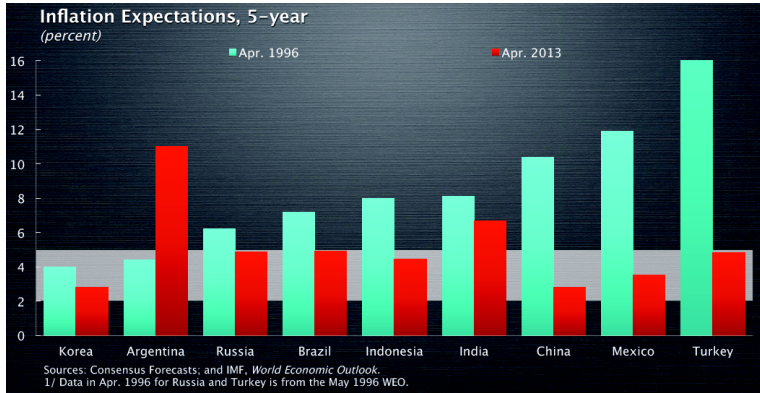
## Unhedged currency exposure in EM's



# Poorly Anchored Expectations?

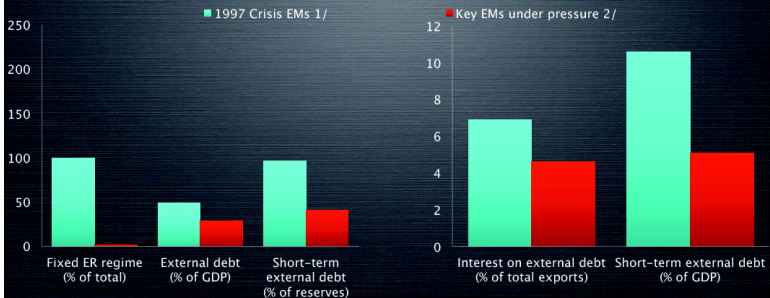
- Then, depreciation leads to inflation
- Implication: increase in  $i$ , compared to baseline
- Key: are expectations generally fragile?

# Inflation Expectations



# Macro Vulnerabilities?

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



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.