Possible impact of tapering

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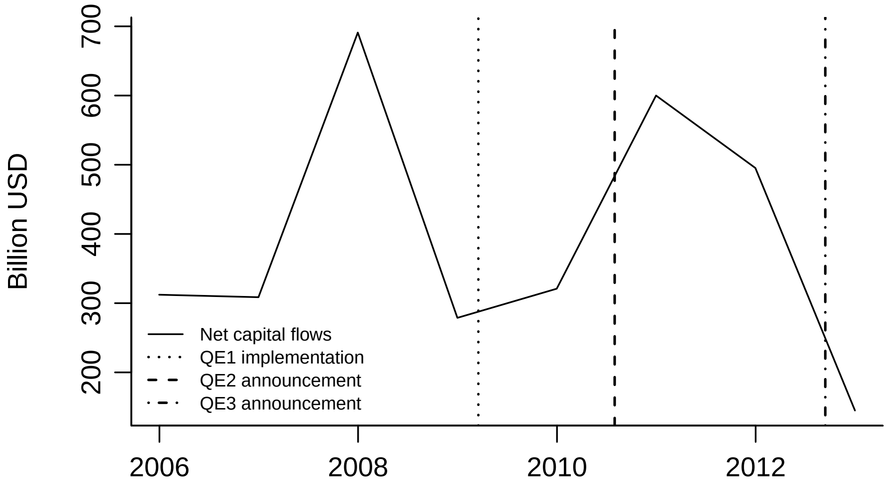
Net capital flows to EMs

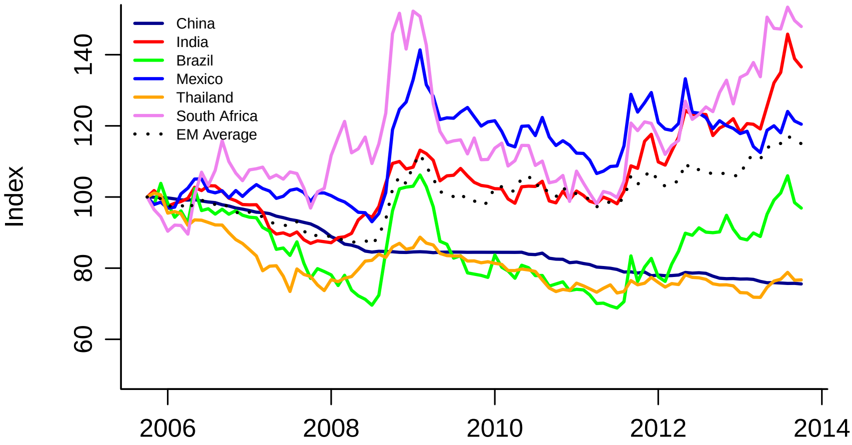


Main channels of adjustment are...

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

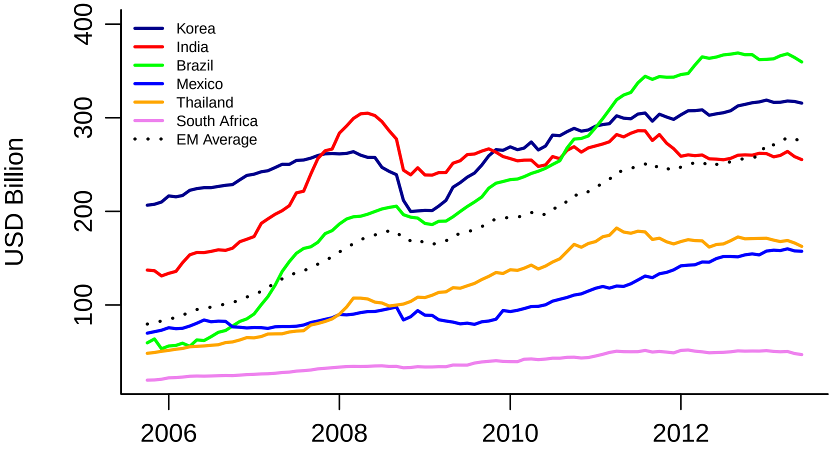
Exchange rates appreciated for some time

Nominal exchange rates, Indexed to 100 in 2006



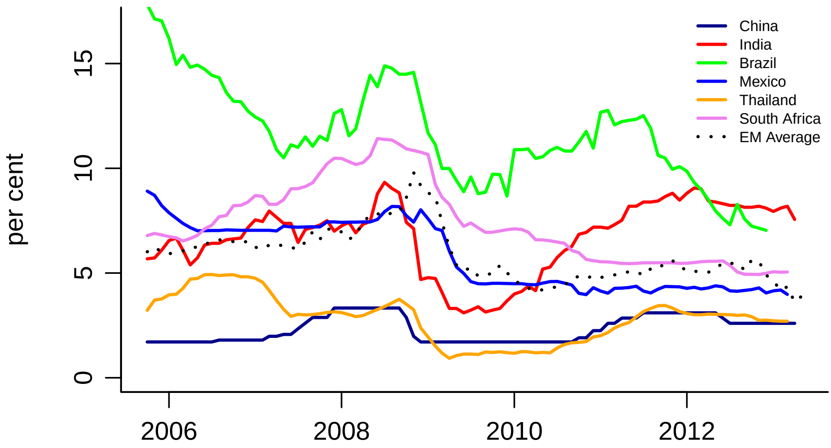
Many EM central banks intervened

Foreign exchange reserves



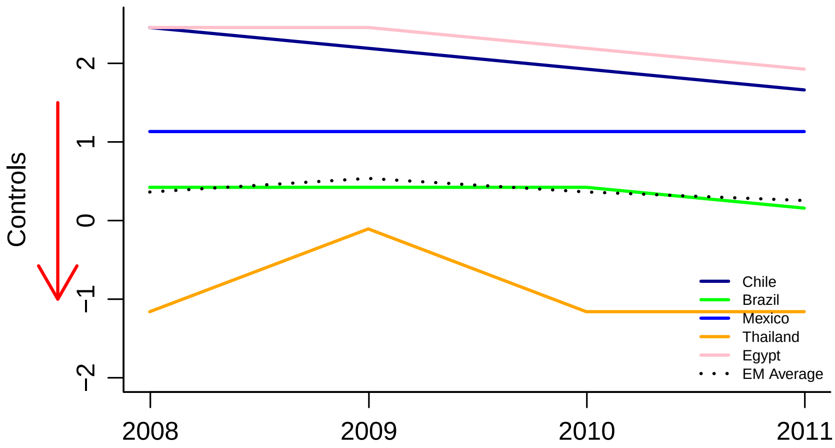
Initially, they cut interest rate

EM treasury bill rates, 3M to 6M



Not all EMs imposed capital controls

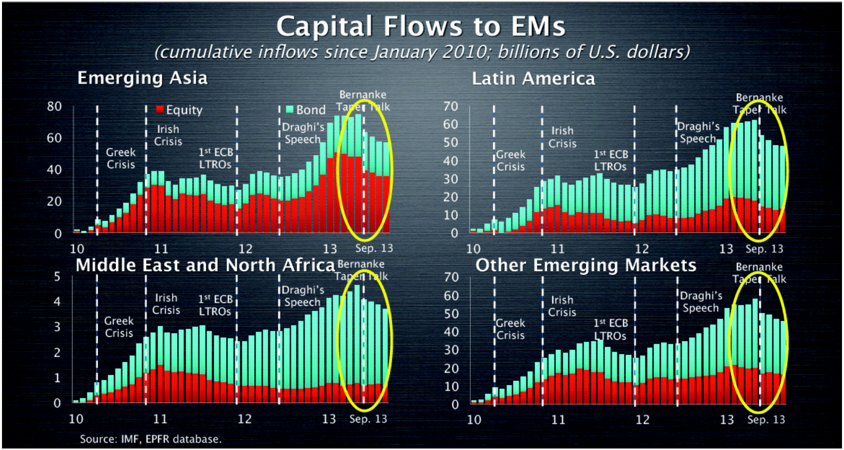
Chinn-Ito Score



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?

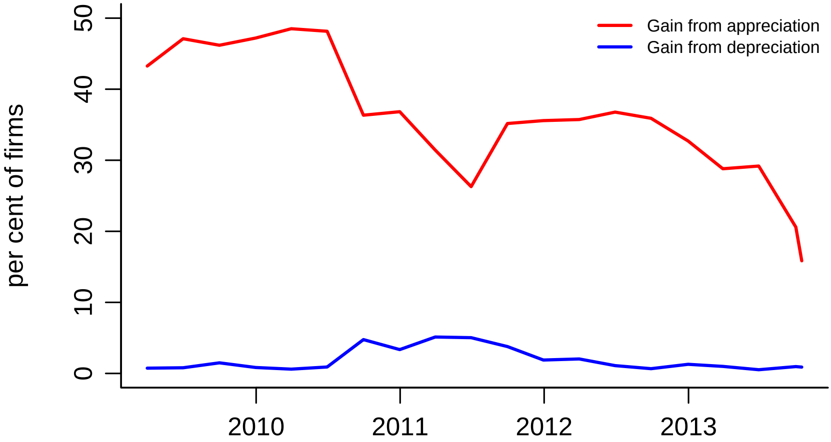
Capital Flows to EMs have fallen



Concerns from capital outflows

- Currency exposure
- Inflation
- Macro vulnerabilities

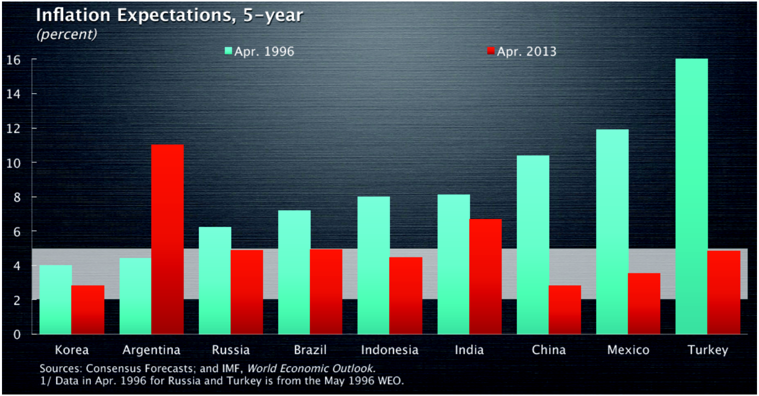
Unhedged currency exposure in EM's



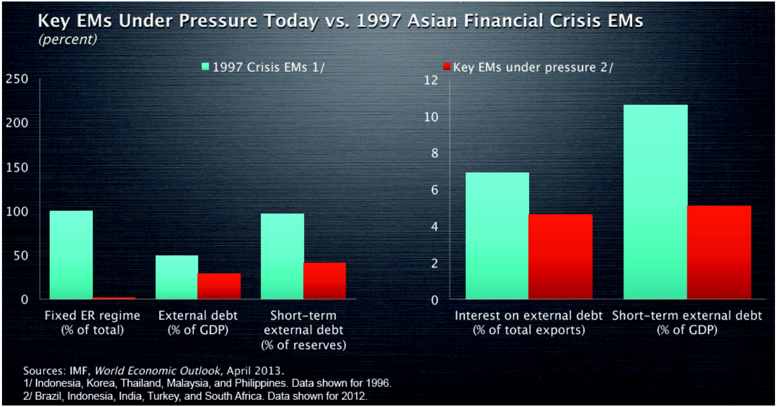
Poorly Anchored Expectations?

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

Inflation Expectations



Macro Vulnerabilities?



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.