# Discussion of Capital Flows and Balance of Payments Pressures: Tailoring Policy Response

Abhijit Sen Gupta

**World Bank**

27th - 28th March 2008

# Main Highlights

**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.
- Segregates countries based on the circumstances under which they may be facing capital inflows/outflows and balance of payments pressures.

# Main Highlights

**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.
- Segregates countries based on the circumstances under which they may be facing capital inflows/outflows and balance of payments pressures.

# Main Highlights

**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.
- Segregates countries based on the circumstances under which they may be facing capital inflows/outflows and balance of payments pressures.

# Main Highlights

**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.
- Segregates countries based on the circumstances under which they may be facing capital inflows/outflows and balance of payments pressures.

# Main Highlights

**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.
- Segregates countries based on the circumstances under which they may be facing capital inflows/outflows and balance of payments pressures.

# Main Highlights

**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.
- Segregates countries based on the circumstances under which they may be facing capital inflows/outflows and balance of payments pressures.

# Main Highlights

- 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.

# Main Highlights

- 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.

# Main Highlights

- 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.

# Main Highlights

- 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.

# Outline

1. Main Highlights

2. Comments
   - How India has fared?
   - Comments on the Paper

# How India has fared?

- 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 ($\approx \$64 billion$)

# How India has fared?

- 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 ($\approx \$64 billion$)

# How India has fared?

- 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 ($\approx \$64 billion$)

# How India has fared?

- 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 ($\approx \$64 billion$)

# How India has fared?

- 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 $(\approx \$64 billion)$

# How India has fared?

- 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 ($\approx$\$64$billion$)

# How India has fared?

- Do not tighten monetary policy.
- Between 2003 and 2007, the RBI raised the CRR 9 times, the reverse repo rate 6 times and the repo rate 7 times.

- Tighten fiscal policy.
- Fiscal consolidation has been achieved to a large extent through a strategy of moderate and few rates, removal of exemptions and broadening of the tax base.

- Relax controls on capital outflows.
- Last year a number of measures were introduced to encourage foreign exchange outflow including enhancing the limit for investment in JVs/WOS by Indian companies, portfolio investment abroad by listed companies and prepayment of ECBs without RBI approval.

# How India has fared?

- Do not tighten monetary policy.
- Between 2003 and 2007, the RBI raised the CRR 9 times, the reverse repo rate 6 times and the repo rate 7 times.

- Tighten fiscal policy.
- Fiscal consolidation has been achieved to a large extent through a strategy of moderate and few rates, removal of exemptions and broadening of the tax base.

- Relax controls on capital outflows.
- Last year a number of measures were introduced to encourage foreign exchange outflow including enhancing the limit for investment in JVs/WOS by Indian companies, portfolio investment abroad by listed companies and prepayment of ECBs without RBI approval.

# How India has fared?

- Do not tighten monetary policy.
- Between 2003 and 2007, the RBI raised the CRR 9 times, the reverse repo rate 6 times and the repo rate 7 times.

- Tighten fiscal policy.
- Fiscal consolidation has been achieved to a large extent through a strategy of moderate and few rates, removal of exemptions and broadening of the tax base.

- Relax controls on capital outflows.
- Last year a number of measures were introduced to encourage foreign exchange outflow including enhancing the limit for investment in JVs/WOS by Indian companies, portfolio investment abroad by listed companies and prepayment of ECBs without RBI approval.

# How India has fared?

- Do not tighten monetary policy.
- Between 2003 and 2007, the RBI raised the CRR 9 times, the reverse repo rate 6 times and the repo rate 7 times.

- Tighten fiscal policy.
- Fiscal consolidation has been achieved to a large extent through a strategy of moderate and few rates, removal of exemptions and broadening of the tax base.

- Relax controls on capital outflows.
- Last year a number of measures were introduced to encourage foreign exchange outflow including enhancing the limit for investment in JVs/WOS by Indian companies, portfolio investment abroad by listed companies and prepayment of ECBs without RBI approval.

# How India has fared?

- Do not tighten monetary policy.
- Between 2003 and 2007, the RBI raised the CRR 9 times, the reverse repo rate 6 times and the repo rate 7 times.

- Tighten fiscal policy.
- Fiscal consolidation has been achieved to a large extent through a strategy of moderate and few rates, removal of exemptions and broadening of the tax base.

- Relax controls on capital outflows.
- Last year a number of measures were introduced to encourage foreign exchange outflow including enhancing the limit for investment in JVs/WOS by Indian companies, portfolio investment abroad by listed companies and prepayment of ECBs without RBI approval.

# How India has fared?

- Do not tighten monetary policy.
- Between 2003 and 2007, the RBI raised the CRR 9 times, the reverse repo rate 6 times and the repo rate 7 times.

- Tighten fiscal policy.
- Fiscal consolidation has been achieved to a large extent through a strategy of moderate and few rates, removal of exemptions and broadening of the tax base.

- Relax controls on capital outflows.
- Last year a number of measures were introduced to encourage foreign exchange outflow including enhancing the limit for investment in JVs/WOS by Indian companies, portfolio investment abroad by listed companies and prepayment of ECBs without RBI approval.

# How India has fared?

- 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.

- Strict monetary policy also has its roots in upside risk to inflation from high global commodity prices.

# How India has fared?

- 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.

- Strict monetary policy also has its roots in upside risk to inflation from high global commodity prices.

# How India has fared?

- 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.

- Strict monetary policy also has its roots in upside risk to inflation from high global commodity prices.

# How India has fared?

- 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.

- Strict monetary policy also has its roots in upside risk to inflation from high global commodity prices.

# How India has fared?

- 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.
- Strict monetary policy also has its roots in upside risk to inflation from high global commodity prices.

# Outline

# Comments on the Paper

- Important to recognize the underlying cause of capital flows as policy response would be different.
  - Exogenous increase in capital flows.
  - Capital flows to satisfy an increase in domestic demand.
- Composition of the capital flow – FDI vs. portfolio flows

# Comments on the Paper

- Important to recognize the underlying cause of capital flows as policy response would be different.
  - Exogenous increase in capital flows.
  - Capital flows to satisfy an increase in domestic demand.
- Composition of the capital flow – FDI vs. portfolio flows

# Comments on the Paper

- Important to recognize the underlying cause of capital flows as policy response would be different.
  - Exogenous increase in capital flows.
  - Capital flows to satisfy an increase in domestic demand.

- Composition of the capital flow – FDI vs. portfolio flows

# Comments on the Paper

- Important to recognize the underlying cause of capital flows as policy response would be different.
  - Exogenous increase in capital flows.
  - Capital flows to satisfy an increase in domestic demand.

- Composition of the capital flow – FDI vs. portfolio flows

# Comments on the Paper

- While fiscal prudence is a good idea to lower interest rates it does not match with stylized facts (Kaminsky, Reinhart & Vègh (2004) and Alesina and Tabellini (2005)).

- Fiscal prudence, by reducing concerns about country's future macro economic 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.

# Comments on the Paper

- While fiscal prudence is a good idea to lower interest rates it does not match with stylized facts (Kaminsky, Reinhart & Vègh (2004) and Alesina and Tabellini (2005)).
- Fiscal prudence, by reducing concerns about country's future macro economic 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.

# Comments on the Paper

- While fiscal prudence is a good idea to lower interest rates it does not match with stylized facts (Kaminsky, Reinhart & Vègh (2004) and Alesina and Tabellini (2005)).
- Fiscal prudence, by reducing concerns about country's future macro economic 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.

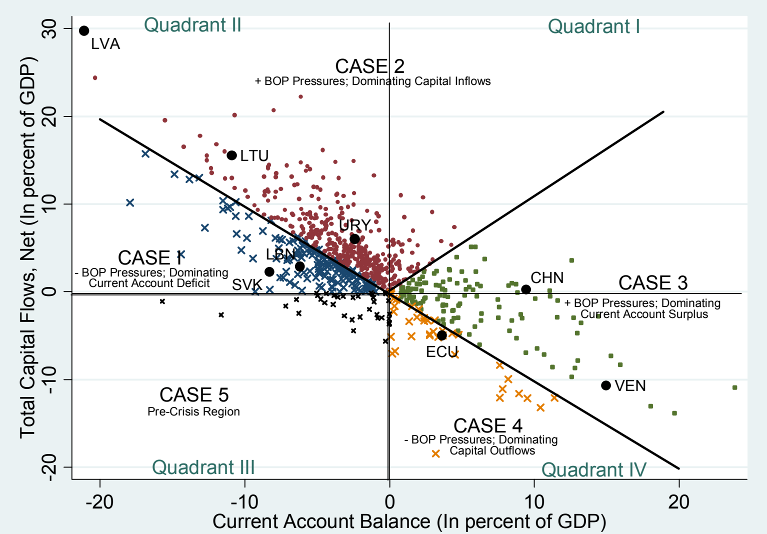
# Comments on the Paper

- While fiscal prudence is a good idea to lower interest rates it does not match with stylized facts (Kaminsky, Reinhart & Vègh (2004) and Alesina and Tabellini (2005)).
- Fiscal prudence, by reducing concerns about country's future macro economic 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.

# Appendix Outline

3. Appendix
   - Taxonomy
   - Policy Response

# Taxonomy Based on Total Capital Flows and Current Account Balances




Note: 'x' indicates negative BOP pressures. Highlighted countries corresponds to 2006. Transition economies depicted only from 1995 onwards.

# Policy Response under various Cases