

## Appendix C: Policy Responses to Capital Inflows and Their Effects

Policy measures	Effects and effectiveness
<p>Sterilization (for defending ER stability)  <u>Instruments:</u> reserve requirements, sterilization</p>	<ul style="list-style-type: none"> <li>- Using a higher reserve requirement raises the cost of financial intermediation and distorts resource allocations. Sterilization through open market operation (OMO) often leads to increased interest rates inducing further unintended capital inflows and causes significant quasi-fiscal costs.</li> <li>- In either case, sterilization can be self-defeating by raising the level of macroeconomic policy inconsistencies and encouraging further capital inflows. Greater sterilization effectiveness means more limited sustainability.</li> <li>- It may create a liquidity problem if maturity mismatch is present.</li> <li>- Real (effective) ER can be eroded as inflation goes up.</li> </ul>
<p>Greater ER flexibility/appreciation  <u>Instruments:</u> widening the band for ER to fluctuate; making ER fluctuation, etc.</p>	<ul style="list-style-type: none"> <li>- Greater exchange rate flexibility can reduce pressure on monetary intervention and sterilization.</li> <li>- It does not always mean nominal exchange rate appreciation. Rather, it is meant to introduce two-way risks and thereby discourage speculative capital inflows. This usually involves, in the context of a de facto peg or a tightly managed float, introducing a wider band of fluctuation.</li> <li>- Expectations of ER appreciation could encourage inflows of short-term speculative capital, while discouraging some inflows by longer-term investors.</li> </ul>
<p>Fiscal tightening  <u>Instruments:</u> Narrowing budget deficits by increasing revenues and/or reducing current and investment expenditures</p>	<ul style="list-style-type: none"> <li>- Fiscal tightening can contain inflationary pressure and prevent a real appreciation of the currency. In addition, fiscal tightening could also reduce pressure on the real exchange rate (by limiting the increase in the relative price of non-tradable goods) and the increase of interest rate.</li> </ul>
<p>Liberalization of capital outflows  <u>Instruments:</u> Relaxation of FDI and portfolio investment outflows, and overseas lending conditions</p>	<ul style="list-style-type: none"> <li>- The impact of this measure depends on whether there is a sufficient pent-up demand for foreign assets. If not, making it easier to repatriate funds may even lead to additional net capital inflows.</li> </ul>
<p>Capital inflows controls  <u>Instruments:</u> e.g. Tobin tax</p>	<ul style="list-style-type: none"> <li>- Their effectiveness is mixed. As such a policy is applied, investors' confidence could collapse and the development of a capital market would be seriously damaged.</li> </ul>
<p>Further trade liberalization  <u>Instruments:</u> tariff reduction and the like</p>	<ul style="list-style-type: none"> <li>- It can have some effects on downward pressure on inflation. But further trade liberalization could encourage more imports. Over time, however, it may improve export competitiveness by reducing the price of imported inputs and may not contribute much to reducing net imports.</li> <li>- It may also encourage further capital inflows by showing a signal of authorities' commitment to a liberal and open international economic policy regime.</li> </ul>

Source: A summary by the authors.