Panel Discussion on

'Challenges for the Central Banks'

August 14, 2009

Taj Krishna Hotel, Hyderabad

Summary of the Proceedings

Reserve Bank of India

Panel Discussion on 'Challenges for the Central Banks'
Hyderabad
August 14, 2009

Webcast

As part of its Platinum Jubilee Celebrations, the Reserve Bank of India (RBI) organised a Panel Discussion on 'Challenges for the Central Banks' on August 14, 2009 at Hyderabad. Apart from Dr. D. Subbarao, Governor, the distinguished panel comprised three former Governors of the Reserve Bank, viz., Shri M. Narasimham (currently Chairman, Administrative Staff College of India), Dr. C. Rangarajan (currently Chairman, Economic Advisory Council to the Prime Minister) and Dr. Y.V. Reddy (currently Professor Emeritus of Economics, University of Hyderabad). Dr. Shankar Acharya, (Member, Board of Governors and Honorary Professor at the ICRIER) moderated the panel discussion.

In his welcome address, **Shri H.R. Khan**, Executive Director, Reserve Bank of India, highlighted the importance of the subject chosen for panel discussion in context of ongoing global financial crisis. Recalling the association of the panellists with the Reserve Bank during their respective tenures as Governors, he stated that the Reserve Bank had earned a reputation of being a reliable, respected and responsive institution over the past 75 years.

In his opening remarks, **Dr. Shankar Acharya**, described the panellists as the giants of central banking in India. Recalling his professional association with each one of them, he observed that the Reserve Bank had been extraordinarily fortunate to have such wise and knowledgeable people at the top.

Key points made by each of the four panellists are set out below:

Shri M Narasimham

Regulation – Key to Monetary and Financial Stability in the Context of Globalisation

Shri M. Narasimham, leading the discussion, touched upon several vital challenges facing the central banks in the context of the current global financial crisis. He expressed concern over indiscriminate use of derivative instruments as well as laxity in financial sector regulation in major advanced economies in the recent period. In view of the fast pace of innovations and high growth in the financial sector in the recent years, the objective of financial stability has now assumed more importance vis-a-vis the objective of monetary stability. While monetary management has a quantitative focus, financial stability has a structural and institutional focus on the health of banks and other financial institutions. Effective regulation is the core of financial stability policies.

Large liquidity infused by major advanced economies over the past couple of years to calm the financial markets could threaten monetary stability in future. The illiquid assets now acquired by several central banks could be source of insolvency for them in future.

Turning to India, he noted that banking regulation in India in the pre-1990s was intrusive and focused more on micro management; this approach, however, did not strengthen the banking sector. On the other hand, the banking sector reforms initiated in the 1990s, with their focus on deregulation and liberalisation but with macro prudential regulation and phased adherence to international norms on asset quality, capital adequacy, income recognition, accounting and governance standards have imparted resilience to the Indian banking system. This approach has fostered financial stability in the country and staved off financial crisis. He took note of the interest being evinced internationally in study and emulation of the Indian regulatory model, perhaps vindicating the approach that the Reserve

Bank and other regulatory agencies in India had followed. Going forward, he suggested putting in place a regulatory council consisting of major regulatory agencies (such as, the Board for Financial Supervision of the Reserve Bank, NABARD, SEBI, IRDA, PFRDA) with the Reserve Bank as the coordinating body and playing the role of 'Regulator of the Last Resort'.

Shri Narasimham stressed that large fiscal deficits constrain the conduct of monetary policy in India. Large fiscal deficits could crowd out private investment and raise interest rates. The process of fiscal consolidation that the country had witnessed since the beginning of this decade has suffered a setback over the past two years. There was a need to revert to the path of fiscal discipline and consolidation. In this context, he hoped that the proposed separation of debt management function from the Reserve Bank would be helpful.

Central banks have today become transparent in their conduct and operations. Highlighting the importance of transparency (which he referred to as being accountable to the public at large), he felt that the challenge for the central banks in future would be to carry along the market participants through transparent and clear communication policies rather than taking them by surprise. He commended the Reserve Bank for setting high standards in this regard. He also felt that the debate on independent central banks was less shrill now with the acceptance of the position that the central banks have to serve the interests of economic policy, at least in democratic countries.

Dr. C Rangarajan

Price Stability – Primary Concern of Monetary Policy

Dr. C. Rangarajan noted that the Reserve Bank had managed the Indian economy – in terms of key indicators such as growth, inflation and external sector management-both in deficit and surplus times - admirably well. He noted that central banks around the world had been evolving over the years and their actions were dominated by public policy considerations. On to the challenges emanating from the global financial crisis, **Dr. Rangarajan** pointed out that some challenges that the central banks had been facing were perennial in nature, but the circumstances and the responses could be different.

In the context of monetary policy independence, while a central bank can have multiple objectives, there should be clarity on the prioritisation of the objectives. In particular, maintaining price stability should be the primary objective of monetary policy. Multiple objectives, without any prioritisation, can cause confusion and uncertainty. In India, that growth and price stability are objectives of monetary policy. Price stability is important as it reduces uncertainty about the future, promotes savings and investments and helps to reduce poverty. While the emphasis on growth and inflation changes year to year, suggestive of a short-run trade-off, it is recognised that there is no long-run trade-off between the two objectives. The Philips Curve was vertical in the long-run. Any attempt to exploit the short-run trade-off will not be helpful in the long-run.

On the issue of inflation targeting (IT), he opined that IT with some explicit inflation rate as the objective would be difficult for India in view of recurrent supply shocks. But, a soft approach to IT, by recognising some threshold level of inflation, is important. Internationally, both IT and non-IT regimes have faced difficulties and therefore, it may not be appropriate to blame IT regimes for the current global crisis.

Dr. Rangarajan was of the view that regulatory failure was the major reason for the current global financial crisis; some segments of the financial markets were either loosely regulated or not regulated at all and implications of some financial products were not fully understood. The need to evolve an appropriate regulatory framework embracing all segments of the markets, institutions and instruments were some possible lessons to be learnt from the current crisis.

On whether financial stability should be an independent objective of monetary policy he opined that maintaining price stability should be the primary concern of monetary policy. In the long run, price stability can help maintain exchange rate stability and safeguard financial stability.

In order to minimise the adverse impact of the financial crisis on the real economy, governments and central banks had joined hands and have pumped large amount of liquidity. He, however, felt that there was no congruence of objectives in the process and the conflict between the monetary policy and fiscal policy objectives could surface. While the governments do well to focus on fiscal consolidation, the central banks have to pursue their objective of maintaining price stability.

Central banking is neither a craft nor a science. The diagnosis of the economy is difficult, while the instruments available with the central bank are imprecise. In this context, clarity in objectives would be helpful.

Dr. Y V Reddy

Global Context of Central Bank Challenges

Dr. Y.V. Reddy expressed confidence over the ability of the Reserve Bank not only in tiding over the present crisis but also in meeting the challenges in future. The Reserve Bank has avoided undue volatility in both the internal and external values of the currency, and this has contributed to the unshaken faith of the public in the Indian banking system even in the wake of the global financial crisis.

The global financial crisis emanated from the centre of the global financial system, which was supposed to have the best regulation in place and whose players (particularly the large financial conglomerates numbering around 15) were supposed to have the best risk management systems in place. However, when some of these supposedly well regulated conglomerates failed, the rest of them lost faith in each other and refused to deal with each other. While most countries are now proposing to reform their financial sectors as a consequence of the crisis, there was a lack of agreement among them on the type of the financial systems they require and the path to such systems. The future role of central banks and the likely challenges will depend upon how the financial systems evolve in response to the ongoing debate.

On the issue of accountability of central banks, **Dr. Reddy** highlighted that financial stability was not formally defined for the central banks. Financial stability depended on the macro-economic stability and interfaced with the global economy. While central banks were now free from political bosses, they had become cosy with market players, at least in the developed countries, and this might have led to weakening of regulatory oversight and the current crisis. The issue of a single objective – only price stability – is again under debate. Welcoming countercyclical approaches to prevent asset price bubbles, he highlighted that such approaches needed to recognise the issue of trade and financial cycles, on which the domestic policy might not really have control.

Financial sector is footloose as it attempts to take maximum advantage of regulatory and tax arbitrage. In this context, soft or light-touch regulation by the major advanced countries to attract financial activity might also have contributed to the crisis. Such arbitrage avenues needed to be addressed and in this context, the recent G20 initiatives are important. But, it also raises issues of sovereignty.

From a macro perspective, the current financial crisis reflected the combination of excess leverage and excess liquidity and, therefore, these excesses need to be contained and indeed ought to be reversed in the interest of financial stability. Paradoxically, the ongoing policy stimulus measures appear to be further aggravating the excesses. Prior to the crisis, it was recognized that there was excess consumption in the US and excess investment in China. The ongoing stimulus efforts in the USA and China are aimed at boosting consumption and investment, respectively, adding to the original excesses.

He attributed the prevention of the crisis in India to the exercise of commonsense.

Dr. D. Subbarao

Monetary-Fiscal Coordination, Clarity of Central Bank Mandate, Balanced Regulation and Monetary Policy in Globalised Environment

Dr. D. Subbarao dealt on the four major challenges being faced by central banks, including the Reserve Bank in the current context. First, fiscal and monetary authorities have responded in a coordinated manner to counter the crisis. The familiar tensions have, however, started to surface. Fiscal deficits have ballooned on the back of stimulus measures and support to the financial sector. The neat arrangements that existed hitherto – in the form of fiscal responsibility legislations and prohibition of central bank financing of the fisc - between the monetary policy and the fiscal policy have been broken in the process. Fiscal deficits are unlikely to come down even after the crisis gets over. Demographic factors and the sustained spurt in pension liabilities may keep deficits at elevated levels and force the Governments to borrow more. Tensions between these two policies may, therefore, persist in the years to come.

Similar tensions are playing out in India at the current juncture. The recent fiscal stimulus packages over and above the Sixth Pay Commission, farm debt waiver and extended safety net programmes have resulted in higher government borrowing, which is impeding the monetary policy objectives. Higher deficits militated against a soft interest rate regime. While stimulus was necessary in view of the circumstances, a credible timetable for return to the path of fiscal consolidation in the medium term was necessary so that monetary accommodation could be reversed. The first challenge, therefore, for central banks around the world and in India was to conduct monetary policy in coordination with fiscal policy, but without becoming hostage to fiscal compulsions.

The second challenge being faced by central banks, according to **Dr. Subbarao**, was the need to define the mandate of central banks and reforming the regulatory structures. He wondered whether there was a clear mandate to the central banks on safeguarding financial stability; if so, were they lax in executing the mandate and were there flaws in the accounting mechanism and regulatory oversight? He was of the view that the current crisis could be attributed to the narrow focus of central banks on just one objective (price stability). Asset price bubbles and financial stability concerns were ignored. In this context, he stated that unlike some major central banks, the Reserve Bank of India continues to be a full service central bank focussing on a wide spectrum of activities, such as, monetary policy, issuer of currency, regulator of banks, NBFCs and key financial markets, external sector management and public debt management. Inflation targeting approach was not suitable for India in view of a variety of factors such as recurrent monsoon and other supply shocks, large weight of food prices in the consumption baskets, and large fiscal deficits. Overall, the evidence from the current global crisis would suggest that the minimalist formula of exclusive focus on inflation targeting does not work. Therefore, the challenges are: What should be the mandate of central banks? Should financial stability be the exclusive responsibility of the central banks or a shared responsibility? Does the widening of the mandate to include financial stability threaten central bank independence?

The third challenge for the central banks, according to **Dr. Subbarao,** was to get an optimum balance of liberalisation and regulation. While liberalisation is important for growth process, it should be managed to avoid forces of destabilisation. One reason of the crisis was the excess liquidity in the system and the resultant search for yield, based on the notion that real value could be added though financial engineering. This had resulted in build- up of imbalances and excesses in the system which were ignored by lax regulation. However, the crisis lessons do not make any case for overregulation as it could suppress growth impulses; having conservative policies could be costly. It would therefore be desirable to balance the costs and benefits of regulation.

The fourth challenge, according to him, was conducting monetary policy in a globalised environment. Growing trade integration and financial integration with rest of the world was primarily responsible for global financial crisis impacting India even though our direct financial sector exposure was not significant and the financial sector was robust and resilient. Capital flows are typically quite volatile and have implications for domestic liquidity, credit availability, exchange rate dynamics, the real economy, and financial stability. Capital flows that cannot be absorbed therefore need to be actively managed. The combination of an open capital account, a fixed exchange rate and an independent monetary policy – the "impossible trinity" - is not possible. Central banks in many EMEs therefore adopt middle solutions – compromising on all the three partially. Even though capital controls were difficult and could be leaky, there is still a need to manage them. The real life challenge is to manage the trinity in a transparent, predictable and stable manner. Financial flows pose a challenge not only for the EMEs like India but also for the advanced economies like the US.

The expositions by the panellists were followed by a ‘question and answer’ session: issues related to financial inclusion, role of banking correspondents/banking facilitators, capital account convertibility were covered in this session. **Dr. Shankar Acharya** summed up the proceedings. The panel discussion concluded with **Dr. N. Krishna Mohan**, Regional Director, Reserve Bank, Hyderabad, proposing vote of thanks.

Overall Key Messages

A number of important issues emerged from the discussions and the subsequent “question and answer” session. These are summarized below:

1. Monetary stability should continue to be an important objective of central banks. Central bank can deliver overall (aggregate) price stability. Some goods and services will see higher inflation than others. Stability in prices of individual goods and services cannot be maintained by monetary policy; that is a task for other official agencies and policies.

2. While there may be a case for multiple objectives for monetary policy, a clear hierarchy of objectives is necessary for clarity and effectiveness. Amongst the various objectives, price stability should, however, be the pre-dominant objective of monetary policy.

3. While there is a short-run trade-off between growth and inflation, there is no long-run trade-off between these two variables. Any attempt to exploit the short-run trade-off to aim higher growth on a sustained basis will hurt both price stability and overall output.

4. In one view, single-minded inflation targeting (IT) or price-stability approaches to the conduct of monetary policy over the past decade led to financial imbalances and the crisis. However, according to another view, both IT and non-IT regimes faced crisis. Weak regulation was the cause of the crisis.

5. IT with a particular inflation target will be difficult for India to pursue in view of large and continuous supply shocks. However, a soft form of IT using estimates of threshold inflation may be useful.

6. The conduct of monetary policy has become more complex, especially in the EMEs, in view of the growing financial openness. The impossible trinity needs to be managed by central banks in a transparent and predictable manner.

7. Monetary policy should not ignore asset prices. Pre-emptive monetary and prudential measures can be used to throw sand in the wheels and dampen the fluctuations.

8. The Reserve Bank has successfully avoided undue volatility in both the internal and external values of the currency, and this has contributed to preserving the confidence of the public in the Indian banking system even in the wake of the global financial crisis.

9. Should financial stability be one of the explicit objectives of central banks? In one view, financial stability should be an important and explicit objective of monetary policy. A contrary view is that price stability objective is sufficient as it contributes to financial stability in the long-run. However, effective regulation of banks, other financial institutions and financial markets is critical to avoid financial excesses and ensure a healthy growth of the financial sector.

10. While price stability can be easily defined and measured, it is difficult to do the same in respect of financial stability. In view of these conceptual difficulties, how can a central bank be accountable for the financial stability objective? Should

financial stability be the sole responsibility of the central banks? Or, in view of the active involvement of governments in bailouts etc, should it be a shared responsibility? If it is a shared responsibility, then how central bank's independence should be ensured?

11. While tightening of financial regulation in lax jurisdictions is necessary, there is no case for over-regulation. Excessive regulation can be harmful and have significant costs. A right balance is needed between regulation and liberalization of the financial sector. Growth of the real economy, and not of the financial sector per se, should be the policy objective.

12. Light-touch regulation and tax benefits to promote international financial centres should be discouraged. These can breed instability in the race to bottom.

13. Many economies, especially the advanced economies, are attempting to reform their financial systems consequent to the crisis. However, there is no unanimity on the road map for reforms or on the final destination. Until there is some clarity on the new financial architecture, the challenges for central banks cannot be precisely and clearly defined at the current juncture.

14. Large fiscal deficits constrain the conduct of monetary policy. They can crowd out private investment and militate against a regime of softer interest rates.

15. In the aftermath of the global financial crisis, fiscal deficits have increased rapidly within a period of just two years, both in India and elsewhere. Fiscal deficits may remain at elevated levels in major economies in view of demographic factors. These deficits have renewed tensions between monetary and fiscal policies. Effective coordination between the two policies has assumed greater importance. Over the medium-term, fiscal policy should return to the path of consolidation through a transparent and credible road map. It is also necessary for

withdrawal of large monetary accommodation following the crisis. Otherwise, the price stability objective will be threatened.

16. On financial inclusion, opening of more brick and mortar branches has its limitations. The policy regime in regard to banking correspondents/banking facilitators may need to be further liberalised for greater financial inclusion. It was, however, observed that such loans have an element of sub-prime and financial inclusion efforts should not be seen as a charity.

17. Globally, there is a rethinking on the benefits of capital account convertibility. There is now less enthusiasm for full capital account convertibility, even among economists of repute who had earlier actively canvassed it. While capital account convertibility, as a long-term objective is unexceptionable, it would depend upon proper discipline in macroeconomic policies. Full capital account convertibility is not necessarily the ideal goal at this stage. Capital account convertibility is a process, not an event. It should not be viewed as a binary event and a 'hasten slowly' approach would be beneficial. Capital account liberalisation should take into account macroeconomic situation, with full recognition of costs and benefits.

August 26, 2009