Subir Gokarn: Monetary policy considerations after the crisis – practitioners' perspectives

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Introduction

I would like to thank the Ministry of Finance and the National Institute of Public Finance and Policy for inviting me to speak at this International Conference on Economic Policies for Inclusive Development. We tend to associate the process of inclusive growth and development with structural factors and the roles that they play in accelerating growth, enhancing labour productivity, creating human capital, providing access to safety nets and essential public services and so on. Many of the previous sessions have dealt directly with these issues. On the other hand, we do not usually associate monetary policy with these typically long-term considerations. However, among the many lessons that will be drawn from the recent crisis, is the critical one that imbalances in the financial sector can significantly disrupt the processes that sustain stable, long-term growth, which is a key requirement for effective inclusion. High volatility and a propensity for destabilizing shocks do not allow either the private or public sectors to make the resource commitments consistent with these two objectives. On the fiscal front, particularly, the costs of rescuing the economy from a crisis may significantly reduce the capacity of governments to sustain commitments to growth and welfare enhancing expenditure.

From this perspective, economic stability, defined in the broadest possible sense, can be seen as an essential component of any strategy for inclusive development. To the extent that central banks play a role in providing that stability, the experience of the crisis has led to considerable thinking and debate on its implications for central bank mandates, strategies and instruments in the quest for maintaining stability. A lot of this is being articulated by central bankers around the world, as they try and distill the lessons of the crisis into what they should be doing more or less of, or differently and how they should go about fulfilling possibly changed objectives.

In this talk, I would like to explore some of the thinking around these issues as reflected in recent articulations by a cross-section of central bankers and use this as a backdrop for our own thinking on how to deal with challenges to macroeconomic stability. I will first lay out a simple framework, which I find useful to think about monetary policy and central banking and then use it to talk about issues that have emerged in the post-crisis debates.

A stability framework

The well-known Taylor Rule has dominated the analytics of monetary policy over the past two decades. In its standard form, in which the optimal short-term interest rate is a function of both the deviation of the inflation rate from its target and the output/unemployment gap, it accommodates both formal inflation targeting and a more flexible growth-inflation balance as objectives of monetary policy. However, when we look at the range of activities that central banks around the world perform, it is clear that monetary policy is only one of many in the case of most countries. Prudential regulation and supervision is also a responsibility in most cases, so at least one dimension of financial stability was already on the charters of many central banks. Many of them also managed the Balance of Payments through active intervention, with both exchange rate and reserve accumulation objectives in mind.

Looking over this landscape, the point I would like to make is that even as central banks typically pursued multiple objectives, some of which may have been only informally articulated, there was a common theme running through all of them. This was stability. In other words, the core objective of central bank activity along all of the dimensions referred to earlier – price, output, financial sector and external sector – was to preserve stability on that respective dimension. This provides the foundation for what I will call the Stability Framework. Stated in terms of objectives, it covers these four dimensions of central bank activity:

The first two components are non-controversial and reflect the formalization of the Taylor Rule.

1. Price Stability: minimizing the deviation of the actual inflation rate from a target or benchmark rate
2. Output Stability: minimizing the deviation of real economic activity from its potential

The next two are more difficult to pin down, because they may mean different things in different contexts. Also, unlike the first two, which are amenable to a single instrument approach, the next two, besides not being necessarily sensitive to policy rates (at least in the desired direction), may need different, even multiple, instruments in different situations. In fact, much of the debate on these objectives revolves around the issues of definition and controllability. Given this, for my purpose, I will use rather broad definitions for these two objectives.

3. Financial Stability: minimizing the risk that the financial system collapses, thereby disrupting economic activity
4. External Stability: minimizing the risks associated with financing a current account deficit with volatile capital inflows, which may disrupt economic activity.

Of course, not all central banks assigned non-zero weights to all dimensions. To a large extent, the post-crisis debate on monetary policy and central banking has been shaped by this asymmetry: should the weights for, particularly, the last two objectives be introduced or changed to reflect the learnings from the crisis?

I will now go on to explore current thinking on the components of this framework in three sections: Price and Output Stability together and then Financial Stability and External Stability separately.

Price and output stability

I would argue that very little has changed with respect to the basic approach to price and output stability as a result of the crisis. The basic objective of the monetary policy function of central banks still remains price stability, with or without attention being given to output stability. However a number of issues emerge even within the relatively robust intellectual foundations of this proposition. About a year ago, there was a debate between John Taylor and Ben Bernanke on the appropriate measure of inflation to be used in calculating the appropriate policy position from the Taylor Rule formula. In response to the claim that the Fed’s easy money policy was a significant contributory factor to the crisis, Bernanke argued that the Fed’s relatively easy stance was justified by the fact that inflation forecasts were trending significantly downward, while Taylor rebutted saying that actual inflation rates and not forecasts were the appropriate inputs into the formula. Had this been done, the policy stance would have been different and so might have been the outcome.

However, this was a debate on detail, not on the basic approach. One line of argument that has emerged after the crisis is that inflation targeting – assigning a relatively low weight to the output gap in the Taylor Rule – had been discredited. Many economies which did target inflation in this way appeared to have lost a little bit of the flexibility or response to the

impending financial shock, which then made its impact even more severe. Proponents of inflation targeting have defended the approach by introducing a number of nuances into their cases. Charles Bean, Deputy Governor of the Bank of England, for example, argues that the crisis does not invalidate the case for targeting, since there needs to be a credible long-term anchoring for inflationary expectations and an explicit target is the best way to achieve that (Bean, 2010). Rather, the crisis suggests that rigid adherence to the target may be the problem and that the central bank needs some "constrained discretion" to respond to temporary price-level shocks.

Lars Svensson, Deputy Governor of Sveriges Riksbank, also advocates flexible inflation targeting "applied in the right way and in particular using all the information about financial conditions that is relevant for the forecast of inflation and resource utilization at any horizon – remains the best practice monetary policy before, during and after the financial crisis" (Svensson, 2010).

The Reserve Bank of India has defined itself as not being an inflation targeter in the strict sense. In recent speeches, Governor Subbarao has put forward two kinds of arguments against committing to an explicit target (Subbarao, 2010). One is logistical, with reference to the current absence of an effective, nationally representative index to target. The other is conceptual, referring to the frequency of temporary, often mild supply shocks, to which monetary responses are unwarranted because of lags, but which would be required if inflation were effectively targeted. Expectations are sought to be managed through the articulation of medium and long term inflation objectives on the premise that communication is also a tool of monetary policy, and by striving for consistency between the overall macroeconomic assessment and policy actions. The significant decline in the average rate of inflation since the mid-1990s reflects the effectiveness of monetary policy in managing inflation, in combination with a range of structural reforms.

This is not the place to resolve the "to target or not to target" debate. The point I want to emphasize is that the approach to the core objectives of monetary policy, whether inflation alone or the growth-inflation balance, does not appear to have been significantly impacted by the crisis. In normal circumstances, i.e., in the absence of a visible domestic or external shock, what was held to be valid before the crisis remains so after it. It is when such shocks strike that the room for maneuver needs to be available, providing enough flexibility in terms of powers and instruments to deal with a variety of shocks.

Financial stability

In hindsight, financial stability has always been a part of this flexibility, on the basis of which central banks in many countries have used their powers to try and avoid catastrophic damage to the financial system. Sometimes this has been soft power by way of facilitating mergers and acquisitions of vulnerable institutions; on other occasions, the muscle of the "lender of the last resort" role has been used. In fact, I would argue that it is precisely this role that makes central banks critical players in preventing the financial system from being incapacitated by liquidity constraints. But, beyond this traditional function, a number of issues arise on both goals and instruments.

One approach to integrating financial stability explicitly into the central bank mandate is to introduce an additional variable into the standard Taylor Rule (e.g. William Poole, 2010). This will then allow the policy rate to be set at a level which is consistent with whatever indicator of financial stability is used – e.g., the deviation of asset prices from some benchmark valuation based on fundamentals. In other words, the policy response is conditioned both by commodity price inflation and by asset price inflation. The dilemma, of course, is that real activity will probably be constrained by a policy response to asset price inflation, something that may not necessarily have been warranted by economic conditions. Finding the right benchmark – real estate, equities or a complex portfolio – by which to measure financial instability may also pose challenges, not to mention the fact that a major source of instability

is in the balance sheets of financial intermediaries, which may not be fully captured by market prices because of information asymmetries.

A less explicit approach to central banks dealing with financial stability is "leaning against the wind" – situational responses to what appear to be unsustainable increases in asset prices. Of course, a judgment would have to be made as to whether a bubble is in progress in order to justify a response. Jurgen Stark, member of the Executive Board of the ECB, accepts the difficulties involved with identifying a bubble and, consequently, the risks inherent in a leaning against the wind strategy (Stark, 2010). He argues burst bubbles may be more costly for the economy than previously believed. In terms of effectiveness, he points to research suggesting that monetary responses to asset price movements have a strong signaling impact, materially changing the risk perceptions and behavior of financial intermediaries. In short, he sees conventional monetary instruments as a legitimate instrument in addressing the financial stability objective.

By contrast, Adam Posen, external member of the Bank of England's Monetary Policy Committee, argues that from the angles of identification of bubbles, cleanup costs angle and the effectiveness of monetary instruments, leaning against the wind will not work (Posen, 2010). He believes that we as yet know too little about the underlying mechanisms and therefore, the probabilities of making the wrong move are high, with obviously adverse consequences for the real economy. This largely seems an unresolved issue, which makes it difficult to translate into clear policy implications.

However, there have been some significant developments in the thinking on the central bank role in financial stability. This has come not from the monetary policy perspective, but from the prudential regulation viewpoint. Prudence was largely seen to be an entity-specific phenomenon in the pre-crisis period. If the balance sheet risks of every entity were identified and provided for, it was believed that the system as a whole would be safe. That perception has been decisively proved false by the crisis; there is "superadditivity" in the system with the risk in the whole being more than the sum of the risks in the parts as a result of multiple and complex inter-relationships between supervised and unsupervised entities. The concept of macro-prudential or systemic risk mitigation has assumed great importance in the post-crisis regulatory architecture. While national and international regulatory agencies deal with the operationalization of this concept, with respect to both indicators and mitigation measures, some broad understanding on the role of the central bank in this process has emerged.

One, the repository of information on the basis of which systemic risks can be gauged is with the prudential regulator, which may be either inside or outside the central bank. Leveraging the micro-prudential data and assessments that emerge from the supervisory process into making systemic risk judgements is where new resources and skills need to be brought in and in a way in which they can effectively work with the traditional supervisory establishment. However, once judgements are made and a response is warranted, both central banks and governments come into the picture. If the threat is one of liquidity shortages, the lender of the last resort function will come into play. If the threat is more of insolvency, governments may have to decide between letting institutions fail and arranging conditional rescues, which will involve possibly significant infusions of capital. Given the significance of inter-connections between prudentially regulated and unregulated entities, other regulatory agencies who keep some watch on the latter, also become logical parts of a collective and co-ordinated systemic risk monitoring and mitigation framework.

This is the direction in which many countries, including India, are moving. These new arrangements will obviously take some time to evolve, and, since they are essentially pre-emptive in nature, the non-recurrence of a financial crisis for reasons similar to the previous one will be one test of their effectiveness. However, the underlying premise that the best way to deal with financial stability is through the prudential rather than the monetary route is a sound one and resolves some of the dilemmas about stability indicators and the effectiveness of monetary instruments referred to earlier.

This has been the premise of the Indian approach to financial stability even though it may not have been explicitly stated as such. The Statutory Liquidity Ratio (SLR) provided the banking system with a credit risk-free buffer, an instrument that is coming back into global consideration in the form of enhanced norms for fully liquid assets to be held by banks. In dealing with what was perceived to be an overheating real estate market, earlier during 2005–06 and more recently in the latest quarterly review of November 2010, prudential measures in the form of loanto value ratio caps and higher risk weights and provisioning requirements were used as a way to buffer the financial system from a potential decline in prices, without having to take an explicit view of what constituted a fair value of the assets.

External stability

There are both long-term and short-term issues in relation to the central bank's role in external management. Should the exchange rate be a policy instrument for long-term growth? Are the choices and trade-offs different between large and small economies? These are important questions in the current global economic debate. However, in the immediate aftermath of the crisis, a short-term concern has arisen with respect to the possibility of large capital inflows into emerging economies. This reflects the unevenness of the strength of the recovery in advanced and emerging economies and the attempts by the former to find ways to continue to provide stimulus. The latter are clearly worried that a surge would destabilize their domestic economies through exchange rate appreciation or excess liquidity in a situation in which they are generally trying to cool things down a bit.

What should central banks be doing to deal with this situation? It must be viewed as an essentially short-term phenomenon, because if it achieves the intended stimulus in the advanced economies, there will be a rebalancing of flows as those economies begin to recover more strongly. In that case, the conclusions of an IMF Staff Position Note, co-authored by Jonathan Ostry and others, are relevant "... if the economy is operating near potential, if the level of reserves is adequate, if the exchange rate is not undervalued and if the flows are likely to be transitory, then the use of capital controls – in addition to both prudential and macroeconomic policy – is justified as part of the policy toolkit to manage inflows" (Ostry et al. 2010).

While the justification for controls is subject to several conditions, clearly, many countries that do not meet all those conditions would be equally tempted to use controls as a way of protecting themselves against the threats to stability from volatile capital flows and exchange rates and domestic liquidity conditions. In fact, the IMF Note also reports empirical results indicating that countries which had controls aimed at achieving a less risky profile of external liabilities showed greater robustness during the crisis.

So, is this an argument for capital controls, an inversion of the pre-crisis view? To an extent, yes, reflecting the conditions during the crisis and how different groups of countries have emerged from it. However, the specific conditions, both domestic and global, that would determine the desirability of capital controls for specific countries need to be thought through.

Intervention to manage the exchange rate is another way in which a central bank may contribute to external stability. From a short-term perspective, the decision to intervene in order to avoid destabilizing both exporting and import-competing domestic producers needs to be viewed in the overall context of domestic conditions. An assessment by Masaaki Shirakawa, Governor, Bank of Japan, illustrates the dilemma. He argues that in a situation in which policy rates are already at the zero boundary, exchange rate appreciation, which helps dampen inflationary pressures, would allow the low interest rate scenario to persist, thereby raising the risks of an asset price bubble (Shirakawa, 2010). In other words, for a country in a zero interest rate situation, it is important to preserve and even grow external demand for its products so that it can create the space to normalize domestic policy.

If one were to apply this reasoning to countries in which rising domestic demand is contributing to inflationary pressures, appreciation would presumably help contain those pressures, by way of a contraction of demand in exporting and importcompeting sectors. While the long-run growth of, particularly, the former is important from the perspective of inclusive development, given their relative labour intensity, the arguments made above point to some of the trade-offs involved in using the exchange rate as a policy instrument in different macroeconomic conditions.

The Reserve Bank's policy on exchange rates has been articulated as broadly non-interventionist, except when confronted with excessively volatile, lumpy or disruptive flows. This is an approach consistent with the notions of "flexibility" or "constrained discretion" used earlier in the context of boundary conditions for traditional approaches to monetary policy. These are, essentially, boundary conditions, which would presumably trigger some deviation from normal policy if abnormal circumstances were to arise. What would constitute abnormal conditions, of course, cannot be explicitly indicated but will presumably be defined by specific circumstances in which actions are taken.

Concluding remarks

In this talk, I have tried to provide a sense of the choices, dilemmas and constraints facing central bankers as they attempt to navigate their economies out of the crisis. In the process, some traditional positions on monetary policy and central banking activity may have been reinforced, while some new thinking on mandates and instruments may have emerged. Clearly, these are issues for which analytical foundations need to be strengthened or even developed from scratch to enable an internally consistent view of policy choices in different circumstances. Central bankers will obviously be avid consumers of these intellectual developments. But, even as that process unfolds, there are some important messages to be extracted from the thoughts and articulation of practitioners. Let me conclude with what I believe to be three key messages.

First, the crisis has not in any way undermined the core objectives and approaches of monetary policy, i.e., the use of conventional interest rate and liquidity instruments to address commodity price and output stability, with whatever weights may be assigned to the two objectives. What it has done is to make the case for flexibility in deviating from a set path when confronted with shocks. This essentially suggests that a standard approach be followed in normal times but deviations are legitimate when times turn abnormal; of course somebody has to decide when this occurs. Defining and quantifying "abnormality" is clearly an important analytical requirement to make this judgement more reliable.

Second, even as the boundaries of normality are being approached or breached, it is difficult to see responses being confined to traditional instruments or, for that matter, traditional structures. As far as financial stability is concerned, the analytics supporting the use of conventional monetary instruments may be advancing, but there is still a strong contrary view. What is being recognized is that, even though these instruments may contribute, prudential measures may be a more efficient way to address the issue. Further, the post-crisis recognition of systemic risk, based on inter-connectedness, makes the case for co-ordination on risk management, with clearly defined roles for different agencies.

Third, while addressing external stability in general terms seems to be becoming an acceptable component of a broadened central bank mandate, the nature of the response will depend significantly on both the state of the domestic economy and global conditions. Also, short-term objectives may be in conflict with long-term ones, requiring some prioritization.

Let me conclude with a quote from a recent speech by Ben Bernanke: "… the past two years have demonstrated the value of policy flexibility and openness to new approaches. During the crisis, central banks were creative and innovative, developing programmes that played a significant role in easing financial stress and supporting economic activity. As the

global financial system and national economies become increasingly complex and interdependent, novel policy challenges will continue to require innovative policy responses" (Bernanke, 2010).

These innovative responses need to manifest on three fronts. One, broader mandates for central banks will need to be made explicit and conditional on the priority of the core mandates. This should eventually lead to definitions and quantification of conditions in which the broader mandates will kick in. Two, appropriate instruments need to be dusted off or developed to ensure that broader mandates can be fulfilled. A single or a small number of traditional monetary instruments cannot be expected to do the job. Finally, these broader mandates may be more effectively pursued in a collective institutional framework, which will inevitably raise co-ordination challenges, which need to be addressed. I would like to thank the organizers once again for inviting me and thank you all for listening to me.

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