## Subir Gokarn: The Second International Research Conference – genesis, motivation and theme

Welcome remarks by Dr Subir Gokarn, Deputy Governor of the Reserve Bank of India, at the Second International Research Conference of the Reserve Bank of India, Mumbai, 1 February 2012.

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Members of the central banking fraternity, participants from the financial, academic and media communities, other distinguished guests: on behalf of the Reserve Bank of India, let me welcome you all to this Second International Research Conference.

### Genesis of the conference

The Reserve Bank of India's First International Research Conference was held in 2010. In that year, The Reserve Bank, which commenced operations on April 1, 1935, entered its 75th year. A series of knowledge-sharing events such as seminars, special memorial lectures, outreach programmes were organised on this occasion, culminating in the First International Research Conference.

The First Conference focussed on "*Challenges to Central Banking in the Context of Financial Crisis*". At the Conference, two broad themes were covered. The first was the conduct of monetary policy during crisis, including financial stability as an objective and the second related to the challenges posed to the central banking, including that to regulation and supervision, by globalisation and market failures. Five specific challenges were discussed, namely : (a) managing national monetary policy decisions in a globalizing environment, given the growing complexity in the interactions between external developments and domestic variables, (b) redefining the mandate of central banks, given the pre-crisis attraction of inflation targeting and the post-crisis debate on the role of central banks in relation to asset prices, (c) responsibility of central banks towards financial stability, particularly beyond the conventional Lender of the Last Resort (LOLR) function, (d) managing the costs and benefits of regulation, in view of the difficulty in drawing a fine balance between regulation and financial innovations, and (e) the autonomy and accountability of central banks, particularly during exit from the crisis. The Conference had brought together central bankers, academicians, policy makers, financial regulators and supervisors and private sector experts to a common platform. There were very important lessons to take from that Conference and that is why we are here to repeat it as a biennial event.

In dealing with the crisis of 2008, while we deliberated on the pros and cons of each potential response at length, the uncertainty was large and risks were inherent in each of the actions we took. Often, our judgments left us with a feeling that we were at times acting subconsciously. This reinforced our view that it was necessary to enhance the role of research for policy making. This Conference series was one step in that direction. Through this Conference, the Reserve Bank intends to bring together central bankers, academicians, policy makers, financial regulators and supervisors and private sector experts to a common platform to share their thoughts and to evolve solutions. The Conference will hopefully provide a useful forum for the economists across the globe to exchange their views and research findings on issues relevant from a central bank's perspective, which will, in turn, provide valuable insights for policymakers.

### Motivation behind the Second International Research Conference

The world has moved a great deal since the First Conference, but without resolving its financial problems. As a result, the sustainability of the recovery is in doubt. At the time of the

First Conference, we were seeing green shoots of revival and were hoping that recovery may well strengthen in due course. Since then, growth in emerging markets rebounded but inflation surged. By contrast, recovery in advanced economies was relatively subdued. Inflation remained largely benign, but nevertheless did climb up from extremely low levels, posing some difficulties. Financial fragilities stayed unresolved. In spite of some deleveraging, risks abounded and were compounded as public sector balance sheets weakened with weaker growth and private sector bailouts.

Clearly, new dimensions of financial crisis have emerged since the first Conference. The nature of the crisis has changed with fragilities of the private sector balance sheets transmitting to the fragilities of the sovereign balance sheets. There appears to be no solution till the burden sharing problem amongst various state and non-state actors are resolved. Sovereign debt sustainability poses the biggest threat to sustainability of the recovery, while coming into potential conflict with the central banking objectives of price stability and financial stability. Any crisis resolution strategy needs to accord priority to resolution of sovereign debt problems, but there is a lack of clarity on what roles central banks can perform in this. A case could be made that it would be better that central banks focus on their main jobs, while let Governments handle their debt problems. However, at the present juncture there are significant spillovers. Monetary authorities' actions impinge on markets' ability to refinance debt and fiscal authorities' actions constraints monetary responses.

Central banks were seen as partly responsible for the current crisis, but they were also at the forefront of unprecedented public policy response that was put in place swiftly, using a combination of conventional and unconventional measures, to contain the severity of the crisis and stimulate recovery towards resumption of normal growth. While responding to the crisis, the RBI recognised that learning right lessons from the global crisis to strengthen its crisis prevention and management frameworks was critically important for the RBI to be able to perform more effectively the multiple roles it plays, including in the realm of financial stability.

In the decades before the crisis, financial stability steadily lost its importance as an explicit central bank policy objective. The question, therefore, was how to focus on financial stability along with monetary policy. What was it that the central banks needed to do differently? Move away from hard inflation targeting to a more diverse role? Accordingly, the theme of the first conference was "Challenges to Central Banking in the Context of the Financial Crisis". Since the FIRC, the challenges for central banks have only increased. Apart from the central banks needing to consider price stability and financial stability, they now had to grapple with sovereign debt sustainability – something they do not have core competency in, but need to get involved with so as to preserve financial and macroeconomic stability.

In essence, the central banks of advanced economies now face a new trilemma, i.e. the need to simultaneously ensure price stability, financial stability and sustainable sovereign debt, which may not be possible if monetary policy accommodates on a sustained basis the needs of the financial systems and sovereigns. This trilemma is also faced in many emerging market economies, albeit in a somewhat different way. These economies confront a much stronger inflationary environment and, therefore, the conflict between price stability and the other two objectives are much sharper.

## Theme of the Second International Research Conference (SIRC) and its relevance

The pre-crisis policy environment was characterized by growing preference for separation of price stability centric monetary policy from financial stability and debt management, even though country practices varied. In response to the financial crisis, central banks went beyond the conventional "lender of last resort" role, and also recognised that price stability does not guarantee financial stability. With the return of financial stability objective to central banks, along with additional tools in the form of either micro-prudential regulation/supervision or macro-prudential regulation, or both, central banks have to deal with any apparent conflicts between price stability and financial stability objectives, while aiming generally to maximize the complementarities and synergies between the two.

Besides the monetary policy response to the crisis, the fiscal stimulus used across countries to bailout the financial systems and to support economic growth has led to large build up of sovereign debt, and in some countries the levels look unsustainable. In several countries, sustained slowdown in growth has also magnified fiscal pressures, arising from both weak revenue realization and the need for more stimulus. Sovereign risk concerns have impacted financial market conditions adversely, and central banks are increasingly being seen as "sovereign lenders of last resort", even when they resort to OMOs aimed at improving the liquidity and financial market conditions necessary for better monetary policy transmission. In some countries, the debt levels are so large that return to sustainable levels may take decades, and without the tacit backing of central back accommodation, financing of government deficits and addressing the debt stock concerns may become increasingly difficult. As a result, even if central banks do not perform the debt management function, they will have a major role in the resolution of the sovereign debt problem. Previous episodes of large debt overhang suggest that inflation has often been the saviour. The risk of sacrificing "price stability" goal with greater responsibility on financial stability and sovereign debt provides a setting, which could be characterised as typical of a trilemma for a central bank.

Accordingly, the theme of the SIRC is "Monetary Policy, Financial Stability and Sustainable Sovereign Debt – The New Trilemma". We have three technical sessions at the Conference to deal with each of the three goals – price stability, financial stability and sovereign debt sustainability – and see how they conflict with other goals. The first session deals with "Conducting Monetary Policy Post-Crisis: Challenges to Transmission Mechanism and Operating Framework". The second covers the "Impact of Crisis on Sovereign Debt: Implications for Macro-economy and Inter-linkages with other Policies". The third focuses on "Financial Stability: Evolving Issues and Challenges in the context of Post-Crisis Macroeconomic and Financial Developments". Each of these three topics is important in understanding the New Trilemma. Following these, we also would have two Governor's panels discussing specific policy questions relating to the new trilemma and the interactions between the new and old trilemmas.

## The papers at the conference

Let me now briefly touch upon the papers that we have received at the Conference. We have nine very good papers spread equally over the three sessions. Many of them will find a place in the frontier literature. All of them address some very important policy questions and will surely enhance our understanding from a central banking policy point of view. Importantly, in discussing the new trilemma, these papers have not neglected the question of growth that is central to central bank objectives. It needs to be emphasized that the central banks pursuit of price stability is not devoid of the growth objective, but is the very basis of achieving sustainable long-term growth. Some papers at the Conference directly address questions such as the link between finance and growth or the link between debt overhang and growth. There are others that investigate aspects of the three pillars of macroeconomic policies that define the New Trilemma by dealing with one or more of these pillars. Most of these have also gone into the impact of policy choices on growth. Political economy questions relating to policy-making and policy implementation have also been raised in some papers, making them that much more appealing from a practioners' viewpoint.

The choice of techniques used in these papers is quite varied. Some of them use panel regressions sifting through cross-country data, while others time series techniques such as vector auto regression and impulse response functions. There are some that have been developed in the framework of overlapping generations (OLG) models with sticky prices and solved analytically. However, the richness in all the papers lies more in raising policy questions and addressing them in a meaningful way. So the proceedings of this conference could be expected to provide us useful guidance on the post-crisis policy framework in the context of the new trilemma, and the challenges new trilemma may pose for managing the old trilemma.

## Some questions for the conference

The three nodes of the new trilemma represent three pillars of a sound macroeconomic environment. Price stability, financial stability and sustainable sovereign debt are necessary for sustainable high growth. You will hear about the policy conflicts relating to the pursuit of these three pillars at the same time from Governor Subbarao, who will be delivering his key note address shortly. But before that I would raise some specific questions in the context of the Conference theme.

### *Should pre-crisis monetary policy be held responsible for the crisis?*

Some have argued that policy rates in advanced economies were kept at levels lower than what would have been necessary had the central bank followed a rule-based policy, such as, the Taylor rule. Other, however, would suggest that monetary policy was not the reason for the crisis as the "forecast of inflation as well as inflation expectations" were low, indicating that the threat to price stability from developments in macro economy and financial markets were largely absent.

### *Has the response of monetary policy to the crisis been appropriate?*

Use of both conventional and unconventional policy was unprecedented in recent history. Have these measures been effective? Some would say but for these measures, another Great Depression would have become unavoidable. Others, however, sustained weak growth and employment conditions as evidence of policy measures not paying off as yet.

### *What are the lessons from the crisis for monetary policy framework?*

They are many. Price stability does not ensure financial stability, and the costs of cleaning up after a financial crisis are very high. Asset price bubbles potentially could be more risky than thought earlier, but direct monetary policy response may still have to be avoided. Macro-prudential tools may be more suitable for that. Imbalances grow in good times, as during the great moderation, and preventing the build-up of imbalances in good times would require unpleasant timely policy actions.

### *What constrains effective transmission of monetary policy?*

The effectiveness of conventional and unconventional measures has been constrained by the process of intense deleveraging in the advanced economies. Deflationary headwinds and zero lower bound (ZLB) for nominal rates are harder to deal with than demand induced inflationary pressures. The surfeit of liquidity in the global system has resulted in sharp increases in global commodity prices as well as capital flows induced asset prices in EMEs, exerting thereby inflationary pressures. EMEs face a different transmission challenge, when the inflation process is driven by supply shocks, to which interest rate actions may not be most appropriate.

I hope I have provided you with the broad context behind the theme of this Conference. Governor Subbarao will now take you through some specifics, laying out what is meant by trilemma, how it differs from the Old trilemma, the various conflicts that might arise and how best we can attempt to manage these.