Deepak Mohanty: The Second International Research Conference – concluding remarks

Speech by Mr Deepak Mohanty, Executive Director of the Reserve Bank of India, at the Second International Research Conference of the Reserve Bank of India, Mumbai, 2 February 2012.

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We have had one and half days of intellectually stimulating discussions on a range of critical central banking issues revolving around the New Trilemma that has been defined by this Conference. While we may not have clear solutions, expectations from central banks are very high. The deliberations in this Conference, I believe, make some contributions in guiding policy and spurring further research. Given the time constraint, I have to be quite selective in summing up.

Setting the tone for the conference, ***Dr. Subir Gokarn*** introduced the concept of the "new trilemma" and explained how challenges for central banks have magnified and become more complex since the global crisis. Now central banks, particularly in advanced economies, face the challenge of simultaneously ensuring price stability, financial stability and sovereign debt sustainability. This may not be possible if monetary policy accommodates, on a sustained basis, the needs of the sovereigns and financial systems.

Governor ***Dr. Subbarao*** characterized the "new trilemma" as a "holy trilemma" in his keynote address, and posed a number of important questions. How do the three objectives underlying the trilemma reinforce and conflict with each other? He recognised the return of fiscal dominance as a reality for central banks. But he viewed that fiscal responsibility is more than a question of monetary policy independence. It is a question of sustaining macroeconomic stability. Governments and central banks in each jurisdiction will have to define the country specific arrangements, subject to certain broad tenets. One, the fundamental responsibility of central banks for price stability should not be compromised; two, central banks should have a lead, but not an exclusive responsibility, for financial stability; three, central bank responsibility for sovereign debt sustainability should only be restricted to protecting financial stability; four, in the matter of ensuring financial stability, the government must normally leave the responsibility to the regulators and assume an activist role only in times of crises. It is possible that the short-term policies aimed at price stability, financial stability and sovereign debt sustainability could, at times, run counter to policies required for promoting growth. But growth achieved at the cost of the objectives of the new trilemma cannot be sustained. He emphasized the role of communication in explaining the policy intent in addressing the trilemma.

In the technical sessions, the ***First Session*** on "*conducting monetary policy post-crisis: challenges to transmission mechanism and operating framework*" focused on whether the framework of monetary policy needs to be re-designed in the light of lessons drawn from the crisis.

Leading the discussion, ***Professor Benjamin Friedman*** drew attention to the interplay between financial stability and responsive monetary policy. He suggested that one has to look into the three building blocks of macroeconomic and financial policy-set, in order to prevent the recurrence of crisis. The three elements of the policy-set are: one, monetary policy centered on an active use of short-term interest rates; two, an intermediation system built on banks and other deposit-type institutions with significantly leveraged balance sheets and three, asset markets characterised with open entry and free trading. Prof. Friedman articulated that if these policy mix sow the seeds of the crisis, there is a need to change the policy mix.

Professor ***Eswar Prasad*** argued that central banks need not be constrained by the orthodox one instrument one target framework but need to explicitly address the financial stability concerns. He argued that under more realistic conditions of imperfect markets and credit constrained consumers, flexible headline inflation targeting could be the optimal monetary policy framework.

In the Indian context, ***Mr.Deepak Mohanty*** provided evidence that policy rate increases have a negative effect on output growth with a lag of two quarters and a moderating impact on inflation with a lag of three quarters and the overall impact on inflation persists through 8–10 quarters.

Summarising the first session, ***Mr. H R Khan***, Deputy Governor emphasized that the orthodoxy that central banks should restrict themselves just to setting interest rates and not regulate or supervise financial markets has come under question since the financial crisis. ***Dr. Subir Gokarn***, Deputy Governor highlighted three important messages from the session: one, monetary policy framework should not be locked into single target, two, more flexibility in defining objectives and instruments is necessary, three, boundary conditions for policy environment keep changing, but transmission within the boundary conditions is what a central bank could aim at.

The ***Second Session*** was devoted to the theme, "*Impact of Crisis on Sovereign Debt: Implications for Macro-economy and Inter-linkages with other Policies*". In this session, ***Frank Smets*** suggested that large scale asset purchase programs can lower long term interest rates. But there is a risk that the central bank could lose its hard earned credibility.

Jorgen Elmeskov indicated that debt beyond a threshold level can adversely affect growth. Hence, debt reductions should be aimed by improving primary balance and raising productivity growth.

Parthasarathy Shome suggested that the solution to the present economic crisis led by European sovereign debt crisis lies in austerity through stronger IMF surveillance.

Summing up the proceedings of the session, ***Dr. K.C. Chakraborty***, Deputy Governor, emphasized that more than quantum of debt, the purpose of debt, and the quality of assets created against the debt are important. ***Benjamin Friedman*** noted that with higher debt, if economic growth is adversely affected, inflation may be used to lower debt-GDP ratio as there is not much growth sacrifice at moderate levels of inflation.

The ***third session*** was devoted to the financial stability issues. In this session, ***Stephen G Cecchetti*** indicated that when private credit to GDP ratio exceeds a threshold of 100 per cent, financial sector could be a drag on growth by reducing productivity growth.

Bill White felt that leaning against economic and financial excesses during boom makes more sense as cleaning up after the bust is impossible. The trilemma is less on the upswing, but magnifies in the downswing.

Y.C. Park questioned the efficacy of macro-prudential tools in containing mortgage credit growth in Korea. The capital control tools are largely towards containing capital inflows but there are no effective tools to control capital outflows.

While summing up the third session, ***Mr. Anand Sinha***, Deputy Governor noted that the potential conflict between monetary policy and macro-prudential policies is overdone, and indicated that India offers an example that macro prudential policy has been less reactive and more preventive.

Naoyuki Shinohara noted that the international architecture to deal with some of the challenges discussed is still not in place as yet, and the expectations should recognize that.

In the panel discussions, Governor Gudmundsson highlighted the importance of clarity on domains and tools and the difficulty of maintaining financial stability with flexible exchange rate movements.

Governor Khatiwada underscored the need to consolidate the role of different regulators to achieve policy effectiveness of multiple goals, particularly in developing economies.

Governor Rehman indicated that, given the chain of inter-linkages among Monetary Policy, Debt Management and Financial Stability, it is not possible to have a meaningful separation and underscored the important role of Government in promoting global coordination to minimize spillover and to contain debt.

Governor Tombini emphasized that fiscal legacy has generated multiple equilibria for central banks and emphasized the importance of fiscal consolidation for overall macroeconomic stability.

Governor Subbarao underscored that the new trilemma is not only an economic issue but also an issue of institutional architecture. He emphasized on the need for explicit, though not exclusive, mandate for financial stability for RBI.

Governor Anwar indicated that the old trilemma continues for EDEs because of the spillover effects and emphasized the importance of communication among the central banks in the region.

Managing Director Mr. Menon emphasized that central banks should try to be independent within the government rather than of the government and also highlighted the role of financial markets in addressing the trilemma.

Governor Najeeb underscored the independence of central banks, particularly in EDEs, to enhance policy credibility.

Martin Wolf emphasised that the global economy has changed with a series of shocks over the past 5 to 6 years, questioning the self-sustaining nature of financial markets. This underscores the increased role of public policy in the financial sector, greater responsibility for the central banks in the economy and enhanced global co-ordination.

At the end, let me list out some of the major takeaways from this conference.

First, the new trilemma is a reality, and fiscal discipline is critically important for financial stability and price stability.

Second, interaction between sovereign debt and monetary policy is an important determinant of market confidence. A comprehensive fiscal exit strategy should explicitly recognize the objective of a sustainable public debt ratio and policies that should underpin a fiscal adjustment path.

Third, right balance between growth in the financial sector and real sector is important to prevent imbalances. Warning signals always flash before the crisis. Often imbalances are ignored, even if identified earlier. Leaning against imbalances could be less costly than cleaning up later.

Fourth, macro prudential measures are useful, but their effectiveness in preventing crisis is yet to be tested. These tools need to be fine-tuned.

Thank you for your kind attention.