Need for Thought Diversity to Combat Group-Think in Central Banking

Rakesh Mohan

Executive Director, International Monetary Fund; former Professor, Yale University; Deputy Governor, Reserve Bank of India

History tells us that there has been no constancy in the practice of central banking since central banking as we know it began at the turn of the twentieth century. There is no one size that fits all. Central banking functions and practices change in conjunction with the economic environment. This can be seen over time in the same jurisdiction, and at the same time across different countries, as can also be observed today. Central bankers around the world, and those who oversee them, need to acknowledge this and act accordingly. We need different horses for different courses. Yet a good deal of discourse on central banking and monetary policy around the world is conducted as if the same nostrums can be prescribed across space and time.

This principle applies to a large number of issues ranging from the practice of monetary policy for price stability and exchange rate arrangements, to the management of financial stability and reserve assets. Emerging market economies (EMEs) and developed countries have very different preoccupations and these need to be borne in mind when devising strategies for their proper functioning. This is especially important as the EMEs have generally emerged from the North Atlantic financial crisis (NAFC) in better shape than the old-established industrial nations: their precepts and experience should therefore be heeded more in the future than hitherto. Advanced economies themselves have witnessed a sea change in their practice of monetary policy since the advent of the NAFC.

What are the lessons from the new developments of the last few years? The costs of this economic crisis are consistent with those suffered by other countries in the past, but this time the fall-out has been concentrated on the core of the world economy in the U.S. and Europe. The lasting social and economic costs of extended economic stagnation and the sharp unemployment levels that prevail now, seldom experienced in advanced economies (AEs) since the great depression, are yet to be evaluated comprehensively. Poor countries or EMEs like India can ill-afford such severe consequences that typically emanate from the eruption of systemic financial instability. A case in point is Indonesia, which lost more than a decade after the 1990s Asian crisis. AEs may also experience a lost decade as a consequence of the NAFC, but their income levels are such that they can possibly afford such stagnation, though at a tremendous social cost. EMEs, however, do not have this luxury, so the maintenance of financial stability assumes greater significance in the ordering of economic policy objectives.

Central Banking in the Pre-Crisis Period: Narrowing Mandates

Not surprisingly, rethinking is now under way on what constitutes best practices in macroeconomic management, encompassing fiscal, monetary, and financial policies. The narrow monetary policy fixation on consumer price index-based inflation targeting frameworks is being questioned, as is the phenomenon of the Great Moderation itself. This was a period when, in fact, massive credit expansion took place along with an eventually unsustainable asset price boom putting in question the idea of the "Great Moderation" itself. Furthermore, there was an increasing consensus on the role of central banks being confined to monetary policymaking to the exclusion of financial regulation and supervision, and narrowing of monetary policy itself to

inflation targeting through changes in the short-term policy rate. The U.K. led this movement when it took away responsibilities for banking regulation and supervision from the Bank of England (BoE), set up the Financial Services Authority (FSA), unified all financial sector regulation and supervision in this authority and formally adopted inflation targeting for their monetary policy. As a result the BoE lost day to day contact with banks and financial markets as a whole and initially had difficulty in responding when the financial crisis erupted. In the conduct of monetary policy, central banks later had to adopt various measures now characterized as "Unconventional Monetary Policy" (UMP), and depart from the narrow confines of inflation targeting. They had to give equal consideration to the restoration and maintenance of financial stability and the need for shoring up of economic growth. There is now a reversal in thinking and practice, with the UK again leading the way. The FSA has been folded back into the BoE; and banking supervision is sought to be brought into the fold of the European Central Bank (ECB). There is also increasing consensus that the primary responsibility for financial stability should rest with central banks, along with that of price stability.

The wisdom of light-touch financial sector regulation, earlier promoted as international best practice on the back of the efficient markets hypothesis, is also being questioned now and more intrusive and comprehensive regulation is being reconsidered and made respectable. A great deal of discussion is taking place on the introduction of tighter financial sector regulation and supervision and its coordination internationally, in multilateral fora such as the Bank for International Settlements (BIS), the Financial Stability Board (FSB), and in the European Union. This is also finding its reflection in national level jurisdictions in new legislations such as the Dodd-Frank Wall Street Reform and Consumer Protection Act of 2010 in the U.S., which are strengthening the role of central banks in maintain financial stability. In addition, as a result of the huge fiscal expansion worldwide, fiscal policy is back at the center of economic policy-making, with monetary policy having been seen to be constrained by the zero interest rate bound. Even this constraint was then addressed by the practice of UMP with unprecedented quantitative expansion being used by leading central banks in the North Atlantic.

So we have now experienced an extended era of close to zero interest rates. This policy has been instituted to stimulate lending so that economic growth can be revived. The huge expansion of central bank balance sheets, accompanied by near zero interest rates has so far not led to expansion in lending, although financial markets have clearly benefitted. But, perhaps counter intuitively, is it possible that interest rates below a certain level actually lead to lower lending? Below a certain interest rate level, there is no incentive for banks to take the risk that lending implies. It is better for them to buy so called risk-free treasury bonds and to keep reserves in central bank deposits, especially if they are interest-bearing.

Partly as a result of this, quantitative easing by the Fed, the BoE, and the ECB, has brought attention back to the symbiosis between national treasuries and central banks, shifting from the previous trend that had emphasized the 'purity' of independent monetary policymaking. Moreover, the European Central Bank has effectively had to abandon its declared policy of no bail-outs for sovereign debt in order to preserve European financial stability.

All of this has an impact on central banks' real or perceived independence, but we need a proper debate on this. We shouldn't see the independence of central banks as an objective in itself, but much more as a means toward some end. The addition of various new responsibilities, particularly related to financial stability, is seen as a problem because it could erode the perceived independence of central banks. However, the subject is more complicated than this and needs more discussion and clarification.

As one example, it is clear now that a great deal of financial innovation in the West was misguided, and central bankers should have developed the right tools to keep this under control. Loose mon-

etary policy and very low interest rates were responsible for the search for yields that led to a great deal of innovation that has been neither economically nor socially useful. All of this was abetted by light-touch financial regulation. There was rare academic unanimity on the neatness of inflation targeting and light touch financial regulation over the 15 years preceding the crisis. Much of this view was rooted in the belief in rationality of financial markets that we now know was wholly misplaced.

Resilience of the EMEs During the NAFC: The Role of Their Central Banks

The experience of the Reserve Bank of India (RBI), and other central banks in EMEs is noteworthy and perhaps worthy of emulation. In the years before the North Atlantic financial crisis, the RBI followed a course of active policy intervention, both in terms of monetary policy and in pursuing active and intrusive financial regulation. This went against the received wisdom of the time and was viewed critically by both domestic and foreign observers—but this policy has now largely been vindicated. In contrast to the then prevailing approach of laissez-faire liberalisation, the RBI demonstrated the value of independent thinking in the face of considerable group think that was characteristic of much thinking on monetary policy and financial regulation around the world. Such an eclectic approach has a long tradition. Pragmatism in the interest of maintaining financial stability has been the RBI's hallmark, with the former governors, Bimal Jalan and Y. Venugopal Reddy playing an invaluable role in the pre-crisis decade.

Additionally, the orthodox doctrine of free cross-border capital flows is now being reconsidered in light of the imbalances that have become a staple of the global economy. There has been a persistence of inflation and growth differentials between developed countries and EMEs for an extended period. This implies a corresponding nominal interest rate differential, leading to arbitrage capital flows that then put further upward pressure on exchange rates and result in even more arbitrage flows. The International Monetary Fund, after a careful review lasting over two years, has itself now come out with a new policy endorsing capital flow management in certain conditions. For example, it now recognizes that in the face of global spillovers from UMP in leading AEs, central banks in EMEs may need to take capital flow measures to preserve financial stability in their own economies, as they had indeed been doing even before the NAFC. Similarly, it has endorsed the actions of the Swiss National Bank in setting a ceiling on the appreciation of the Swiss Franc through aggressive forex intervention. Thus, central banks have to act in many different ways depending on objective economic developments domestically or in the world economy. For EMEs there has been little alternative but to practice regular foreign exchange intervention, reserve accumulation and some degree of capital account management. Now some similar actions have to be taken by some of the most AEs such as Switzerland.

Reserve accumulation in EMEs is often perceived as resulting only from precautionary motives and viewed critically. What is forgotten is the need for the expansion of central bank balance sheets in the presence of seven percent-plus real GDP annual growth (nominal growth of 12-15 percent) in some significant EMEs over a sustained period. In such circumstances, base money needs to grow at some similar rate and hence central bank assets too. If the EME is practising prudent fiscal policy, the supply of domestic securities may not be adequate for expanding the central bank balance sheet: hence the demand for foreign securities and foreign exchange reserves. When this happens with a large economy like China, the whole world feels the consequences. More needs to be done to expand the supply of risk-free foreign assets for such central bank needs. As large EMEs like India and Indonesia, among others, join China in such a growth mode over the next couple of decades, the demand for such assets can only expand.

All of these considerations must be seen against the background of the resilience exhibited by Asian and Latin American EMEs including, in particular, India. We need to look at the underlying reasons

for this. The immediate impact of the crisis on these economies during 2008-2010 was through two channels. First, there was a sudden reversal of capital flows, which had been unprecedented in magnitude during the years prior to the crisis. This reversal had significant impact on the capital and foreign exchange markets in these countries. The foreign exchange reserves accumulated in the surplus years were then put to good use. Second, the fall in global trade far exceeded the contraction in global GDP. In spite of these setbacks, no significant banks or financial institutions in these countries exhibited substantial stress: none required a bail-out. After the initial reversal of capital flows, with the onset of zero interest policy rates and UMP in advanced economies, capital flows again resumed with the associated impact on their exchange rates and foreign exchange management.

Evidently, these countries have been doing something right since the various Latin American crises of the 1980s and 1990s, and the Asian crisis of the late 1990s.

While much of the world increasingly insulated the central bank from financial sector and banking regulation, the RBI, and other central banks in EMEs, consciously viewed regulation as an integral tool of monetary policymaking, broadly interpreted, which also focused on financial stability. Furthermore, they actively intervened in their foreign exchange markets and undertook capital account management to varying degrees. They viewed the barrage of financial innovations, ostensibly to aid risk management, with caution and had programmed their introduction on a gradual basis. On the external side, opening the capital account had been pursued with great circumspection, though much of professional economic advice was to the contrary. Had the RBI and other EME central banks not deviated from then established received wisdom of central banking practice, they might not have fared so well.

The consequence of this overall policy stance was that India escaped the worst consequences of this international crisis, as it had also done during the Asian crisis. It was able to resume its pre-crisis growth path relatively quickly, and at relatively low fiscal cost, though some storm clouds have indeed appeared recently, primarily due to excessive continued fiscal expansion. Prior to the crisis, this cautious approach had merely been seen as one being pursued by non-modern, inadequately-informed, conservative policymakers.

Conclusion

In this post-crisis period, international discussion on financial sector reform is revisiting many of these questions, and the Indian approach is no longer an outlier. Other EMEs in Asia and Latin America have followed similar approaches since the late 1990s. A generally cautious but consistent approach to economic liberalisation appears to have brought greater financial stability as well as accelerating economic growth. These are all rich lessons to which the world should pay greater attention if it is to re-embark on the road to growth and prosperity.

As economic conditions change, financial markets grow and deepen in EMEs, and the world creeps back to some degree of normality, EME central banks will have to keep changing their approach as needed. Correspondingly, central banks of AEs will also have to unwind their UMP, but are likely to remain with their new responsibilities for maintaining financial stability. The important point is that we must encourage diversity in thinking both across time and space and eschew group-think in monetary policy and financial regulation.