On the Sources of Central Banker's Influence over the Economy: Comments[1]

Chairman Mario Bleijer, Professor Stephen G. Cecchetti, Professor William H. Buiter, Dr Guillermo A. Calvo and fellow Governors,

It is my pleasure to join the symposium and as desired by you, Mr. Chairman, offer initial informal comments on Professor Cecchetti's paper on 'Sources of Central Banker's Influence over the Economy'. Professor Cecchetti first succinctly brings out the convergence of developments regarding application of monetary theory to the practice of central banking and second, poses three challenges to both academics and practitioners. I will make some general observations on the convergence issue and later comment upon the challenges. Of course, I shall draw upon India's experience as appropriate.

In terms of objectives, it is true that there is a convergence in the thinking of all central bankers towards a primary objective such as price stability. It is useful to note that, more recently, a strong trade-off between volatility in growth and inflation masks or understates the equally important consideration of financial stability. In India, along with price stability, growth objective is demonstrably subsumed in the objective of meeting genuine credit demand and in communications and policy measures, a clear focus on financial stability has assumed added significance in recent years.

Secondly, I agree with the point that the central banks have a better design than before and also gained a distinct identity in the last two decades. But without satisfactory fiscal rules, implementation of any monetary rule becomes difficult as also the autonomy or independence of central banks and its accountability. It is mainly for political economy reasons that the central banks in general attempt to focus sharply on a 'single objective' or mandate. This is an arrangement for convenience and merely gives a distinct identity to a central bank and serves as a basis for autonomy. In India the fiscal dominance over monetary policy has come down with elimination of automatic monetization of fiscal deficits in 1997 and

[1] Prepared informal comments by Dr. Y.V. Reddy, Governor, Reserve Bank of India, initiating a discussion at the Central Bank Governors' Symposium, organised by the Bank of England at London on June 23, 2006.

effective this year, withdrawal from participation in primary issuances of government securities. In fact, Reserve Bank played an active and interactive role in designing fiscal rules in view of their criticality for monetary policy. We provided technical inputs and assistance to Government of India as well as States while considering Fiscal Responsibility Legislations. The point of harmony between fisc and monetary policy is, therefore, well taken and I would stress, on the basis of our experience in India, the value of coordination between fiscal and monetary authorities in matters of structural transformation, specially legislations relating to the economy.

Thirdly, on the emphasis placed upon the tool of short-term interest rate, the real interest rate is, in some ways, an outcome of policy implementation in containing inflation expectations. Shifts in inflation expectations are indeed the proximate cause of the changes in the mean level of inflation and the policy makers do, therefore, focus on maintaining credibility by carefully monitoring inflation expectations for any indications that they are rising. This forward-looking approach has helped India in bringing down inflation rates from over eight per cent to about four to five per cent in recent years.

There is also a need to recognise the importance of inflation perceptions. In other words, if the prices of commodities, which are purchased frequently, rise, the perception of inflation would be different from say, a rise in the price of television set. While recognizing the overlap, the distinction between inflationary expectations and inflation perceptions in the context of inflation policy is worth bearing in mind. For example, inflation perceptions tend to harden if prices of frequently purchased goods increase.

There is an interesting issue here on delicate distinction between monitoring and influencing inflation expectations on the one hand and giving forward indication on the other. In practice, it is a delicate task to make such distinction but it is critical to bear such a distinction in policy-making and communication. As Governor Mervyn King eloquently argued in his speech yesterday at the Lord Mayor's banquet in the City, there are dangers of a central bank trying to give forward guidance in this highly uncertain world. Governor King said, *"The Monetary Policy Committee (MPC) reaches a new judgment each month, made afresh in the light of all the new information about the prospects for inflation. We don't decide in advance. So trying* *to give direct hints on the path of interest rates over the next few months risks deceiving financial markets into believing there are definite plans for the next few months when no such plans exist"*.

In fact, the Fed announced a few days ago that Chairman Ben Bernanke had established a sub-committee to examine a number of communications issues. More generally, the appropriateness of a central bank doing the thinking on course of markets for the market-participants rather than allowing them to do it, is questionable and this was articulated by Mr. Schioppa of European Central Bank a couple of years ago. It is not surprising that almost all central bankers prefer to inform and to fall short of guiding. The notable exception to this practice was the former Chairman Alan Greenspan though his successor Mr. Ben Bernanke is clearly revisiting the approach, perhaps for very valid reasons. Guidance on future course becomes far more difficult when the policy rates of monetary authorities get closer to what appears to be the relevant range of neutral interest rates. This is because the trade offs get more acute, judgmental and contextual relative to a state when interest rates are clearly farther from the range of possible neutral rates and the direction of movement is fairly obvious to all. The challenge of communication gets more daunting, if simultaneously, the inflation expectations are also under stress.

We, in India, prefer to provide detailed information and share relevant analysis fully to influence expectations but are hesitant to give firm inferences from analysis or forward guidance.

Fourthly, though the focus of central banks is on short-term interest rate and the considerations weighing in a decision on this instrument require in practice, monitoring and analysis of a host of indicators, both external and domestic including expectations, perhaps even in the inflation-targeting countries. We in India have switched to multiple indicators approach. There are two issues that need to be noted here. Where administered interest rates prevail, there are complications. There are also often inexplicable disconnects between the short and the long term interest rates – what Chairman Greenspan had referred to as 'conundrum'.

Fifthly, financial stability considerations may, in our view, require the use of interest rate tool, in conjunction with other prudential measures. Some times, there could be even a trade-off between raising the short-term interest rate and tightening of prudential norms if risks are perceived to originate from certain segments of the market. The highly leveraged lending operations in the backdrop of asset price bubbles, might require adjustments in margins and risk-based capital requirements. In India, noticing the unusual movements in several asset prices in recent years, we have been enhancing risk weights and provisioning requirements by banks for certain categories of assets.

Coming to the specific issues, since the focus of monetary policy is on influencing the 'aggregate demand', at the macro level, the aggregates represent an amalgamation of different forces in operation at the micro level, sometimes moving in different directions. For instance, when the general price level increases, there could be sectors where prices are coming down; the same is the case with employment, consumption, production and investment. Therefore, the micro foundations of macroeconomic analysis would not mean a one-to-one correspondence between the two. This relationship is somewhat nebulous but very important and should be viewed seriously with its significance as well as inherent limitations in mind.

Secondly, excessive leveraging in any conditions of financial markets is a source of potential instability. Since leveraging is influenced by the cost of financing, the decisions affecting the cost and availability of credit do influence aggregate demand conditions. Even if the source of financing is not bank funding, the interest rate conditions in the market definitely influence the opportunity cost of even internal resources of firms. The effectiveness of interest rate and exchange rate channels, no doubt, depends upon the depth and vibrancy of the debt and foreign exchange markets. In India, special efforts have, therefore, been made to develop these markets so that the efficacy of the transmission channel improves. In general, it may be held that in less developed financial markets, by using direct monetary instruments in conjunction with market-based instruments, the overall policy effectiveness can be improved.

Nominal rigidities arise in different segments of the market due to a variety of factors: the existence of organised and unorganised markets in parallel, tax regime, labour and income policies and trade union strength, level of competition or market imperfections, etc. For example, since nominal rigidities are high in less developed and relatively imperfect and underdeveloped markets, it should not lead to a conclusion that monetary policy is more effective under these conditions. Of course, in India recent events in equity markets are not easily explicable and so we can appreciate the comment that equity markets have a mind of their own.

As a group, the central bankers could take some credit for little explicit indexation in recent periods. However, the Indian conditions on indexations are worth noting. The indexation is available only to workforce in the organised sector, which accounts for less than ten per cent of the total workforce, and within that, mainly to those in the public sector. Having secured the principle of indexation, it is not given up by the organised work force, whatever be the level of inflation. No doubt, at the margin or incrementally, there could be less pressure for indexation, but existing privileges are not easy to be eliminated.

On the policy actions, under relatively more stable economic environment, the need, the extent and the duration of the policy interventions becomes less and less. Central banks are now taking baby steps – sometimes more frequent steps and at other times after a long gap, and in both directions – to respond to, what appear to be, ripples rather than huge waves in the sea of economic activity. For instance, what is considered as a ‘neutral rate’ of interest in the present period appears to be much lower compared to several years before.

The issue of significance here is whether the neutral rate in respect of emerging market economies, which has been coming down in tandem with global rates, will tend to be distinctly higher than in developed economies. If so, how much higher would be appropriate?

Thank you.